TDC *VISION TO MOMENTUM*

Capitalization, Scale, and Investment: Does Growth Equal Gain?

William Penn Foundation | February 9, 2015

Capitalization – Take Two

- *Getting Beyond Breakeven* had two major findings:
  – Pervasive weak financial health
  – Strong financial literacy
- Why?
  – Strategic planning not grounded in external market.
  – Financial analysis not connected to organizational context.
  – Chaotic philanthropic markets.

Capitalization – Take Two

- Five years of dialogue resulted in the impetus for a more nuanced look:
  - What is adequate capitalization?
  - How does it change for organizations of different scale?
  - Which investments are supportive and which are counterproductive?
  - Can the capital markets support it all?
  - Can market players make more informed decisions?

A Study in Two Parts

Part I: Trends in the Greater Philadelphia Ecosystem

- How did organizations fare from 2007 to 2011? Who gained? Who lost ground?

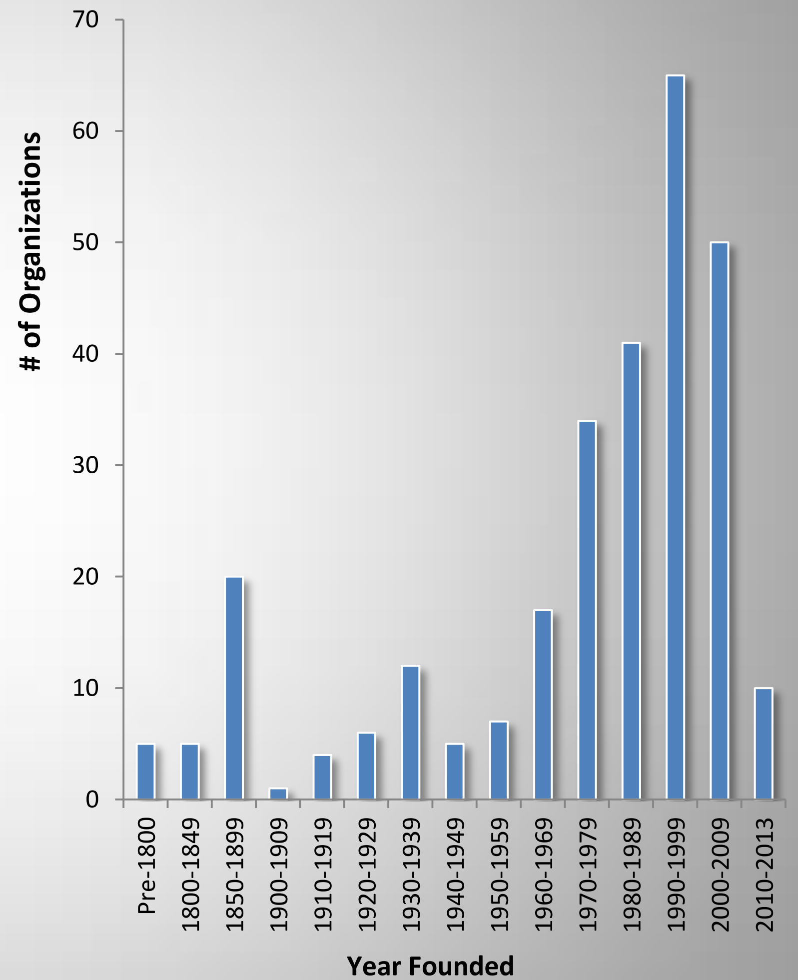
Part II: Assessing Investments Toward Growth

- Has growth become the proxy metric for success?
- When is growth not advisable?
- How can organizations understand the feasibility for growth?

PART I. TRENDS IN THE GREATER PHILADELPHIA ECOSYSTEM

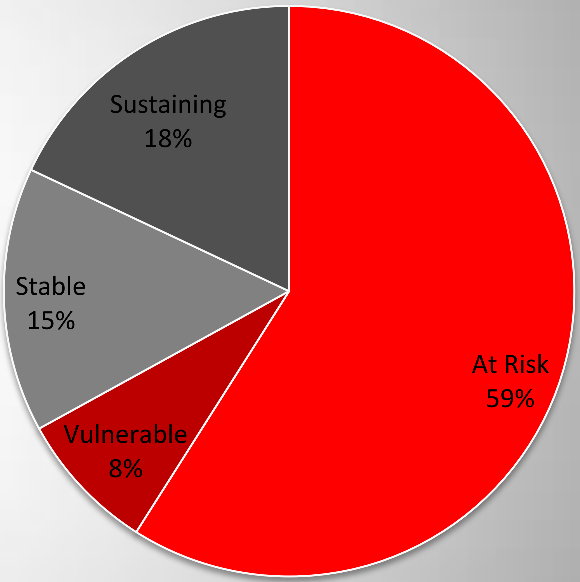
The Philadelphia Market Today

- Philadelphia's dense and mature arts market is the result of deliberate and significant investment in past 20 years.
- Great for arts consumers but has not resulted in financially strong organizations.
- Competition has increased for ticket buyers and for philanthropic support.
  - The markets for audiences and contributed dollars are changing.



Organizations remain financially weak.

- About 70% of organizations were At Risk or Vulnerable in financial health.
  - Defined as low or no available unrestricted net assets, low or no cash, and weak or broken business models.
- Approximately same rate as found in first study.

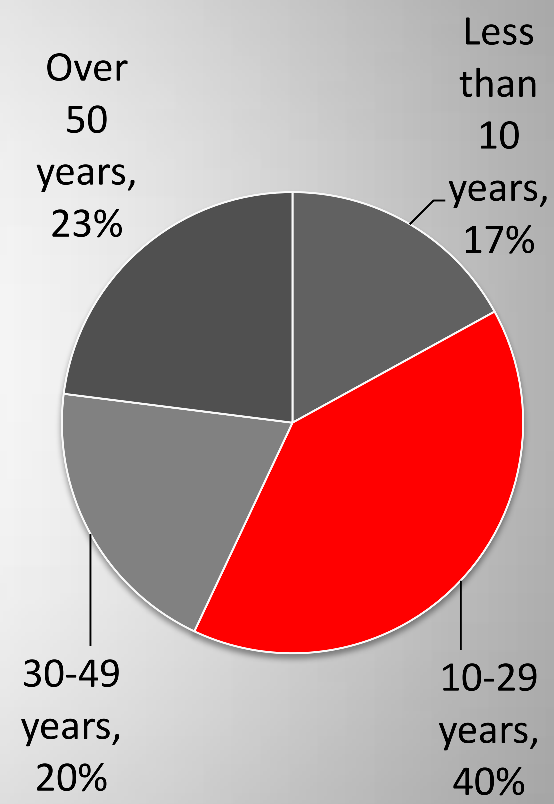


Competition increased.

- Many interviewees felt more intense competition, regardless of size or discipline.
- Three contributing factors:
  - Organizations didn’t exit the field.
  - Large organizations, but not the largest, took a bigger slice of the pie.
  - The audience of paid patrons did not grow.

Limited exits.

- Closures rates are different in the nonprofit world.
  - In the for-profit world, 80% of firms close in 10 years, vs. 17% in the nonprofit world.
  - Did not see evidence of significant exits after the recession.
  - Barriers to exit include single donor passion and sweat equity.
- Potential results include:
  - Logjam of weak teenagers.
  - Higher barriers to entry.



Sources: Harrison and Laincz (2008); Chang and Tuckman (1991); Twonbley (2003).

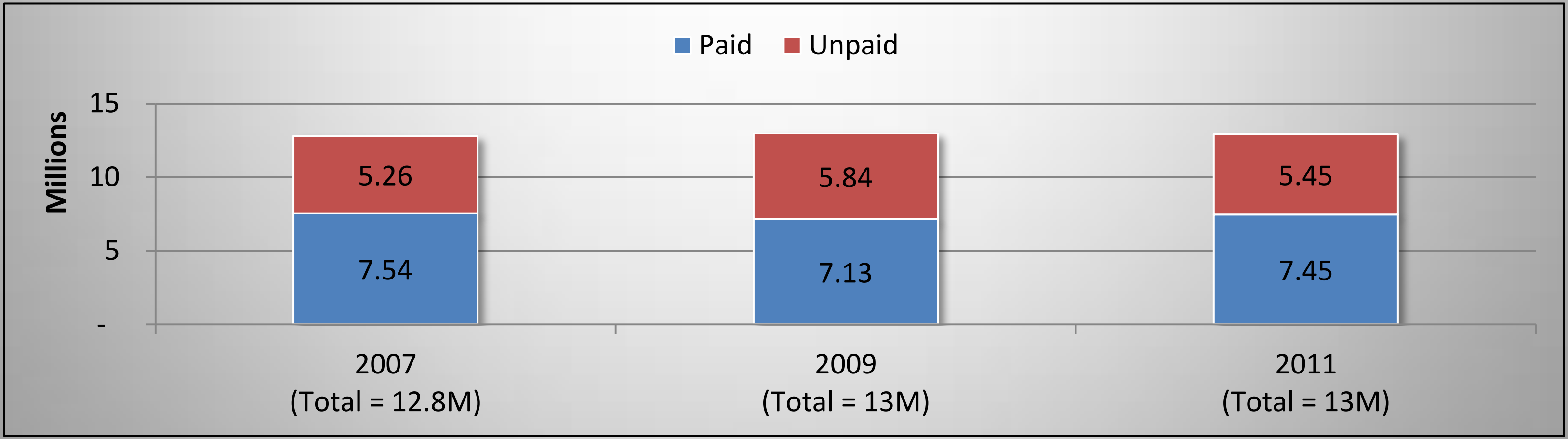
Large organizations grew.

- Generally, very large organizations swamp the system.
- In Philadelphia, large organizations have grown in size and number.
- More crowded playing field at the top, with large and very large organizations competing in same league.

	Number of Organizations			Aggregate Expense		
Budget Size	**2007**	**2011**	**% change**	**2007**	**2011**	**% change**
<$250K	118	122	3%	$10M	$10.8M	9%
$250-500K	33	40	21%	$11M	$14.3M	30%
$500K-1.5M	55	64	16%	$51.5M	$54.7M	6%
$1.5-5M	35	26	(26%)	$60.3M	$65.7M	9%
$5-20M (large)	14	23	64%	$158.6M	$218M	37%
$20M+ (very large)	7	7	0%	$289M	$279.5M	(3%)

Paid patrons were stagnant.

- Earned revenue beat inflation, due to increased ticket prices.
- Paid patrons declined - churn is an invisible factor.
- Implies organizational growth is not demand-driven.

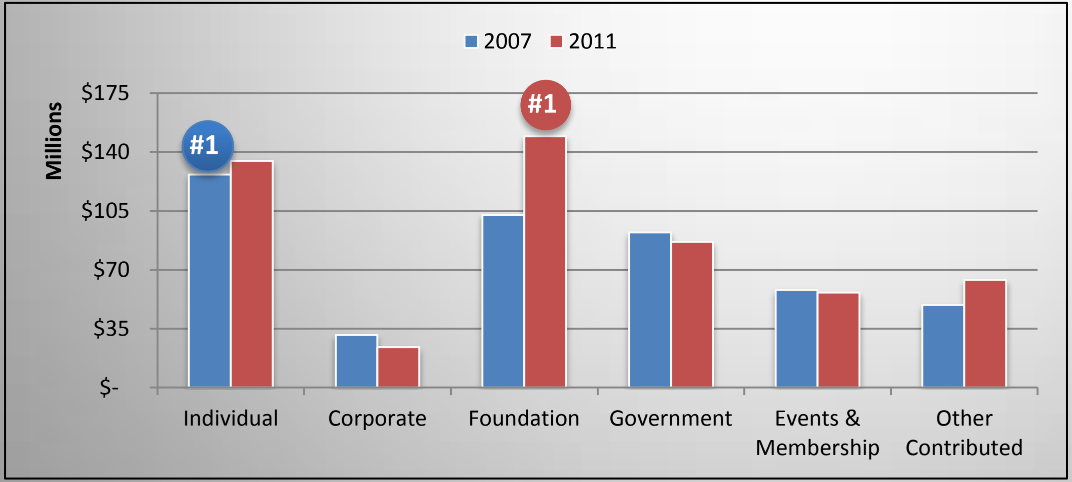


Audience behavior is in transition.

- Demographics and audience behavior are changing.
- Organizations know it and are planning for it.
- Interviews called out the need for increased market knowledge.

The philanthropic market is in transition.

- Philadelphia's foundations and individuals led the way to growth.
  - Foundations tipped the balance and became the largest source of contributed revenue.
- Uncertainty about who will take up the lead.
  - Key major donors are retiring, and key foundations are changing their policies and priorities in the arts.
  - Organizations are not sure how to engage new generation.



Revenue Type	Philadelphia 2007-11 Trend	National 2007-11 Trend
Individuals	6%	(5%)
Foundations	46%	10%
Corporations	(24%)	15%
Government	(6%)	(11%)

Sources: Giving USA, Americans for the Arts

Serving a market in transition is hard.

- Organizations face a conundrum.
  - They must maintain current audiences and donors AND shift dollars to attract and retain new audiences and donors.
  - Funding often does not account for both needs.
    - 90% of interviewees had a strategy, but only 20% had the money to fund it.
    - Estimate at least $1.4 billion in capital campaigns.

What does this imply?

- The arts and culture sector is hobbled by imperfect ways of gauging success.
  - Sector struggles to measure intrinsic value and instrumental outcomes.
  - Growth and longevity have become the proxy for success.
- We need to start a sector-wide dialogue toward new shared cultural norms.
  - Growth does not always equal success.
    - When is growth appropriate and when is it debilitating?
  - How do organizations and their supporters talk about the real measures of success ?
  - What are strategies that create more sustainable organizations providing great art and programming?

PART II. ASSESSING INVESTMENTS TOWARD GROWTH

Growth in the System

- Wanted to look at outcomes from significant investments.
  - We found, instead, erratic investments with sample sizes too small to draw conclusions.
- Many organizations stayed in place during the recession then grew past baseline.
  - Total of 11% growth to budgets (8% inflation).
  - Highest increases to non-program expenses.

Expense Type	2007	2011	Rate of Growth
Program	$432M	$463M	7%
Marketing	$36M	$43M	20%
Fundraising	$48M	$55M	15%
Administrative	$65M	$82M	26%

What determines feasible growth?

- We found that organizations that grew the most were very likely to be financially weak.
- *Sustainable* growth is different from *significant* growth.
  - Easy to spend money but hard to predict the net profit from an investment.
- Effective investments consider organizational fundamentals.

Time Horizon	The time span needed for an organization to realize its mission.
Business Model Drivers	The presence of large fixed costs that constrain an organization's ability to be flexible based on available resources.
Organizational Lifecycle	Organizations go through a developmental lifecycle, much like living organisms. At points of transition, organizations require more capital.
Scale	The budget size of individual organizations, as well as the magnitude of their investments.
Revenue Dependencies	The mix of revenue streams fueling an organization.
Strategic Goals	The motivations that drive an organization's investments. It's important to understand when financial return is the primary motive and when it is not.

Ignoring the Fundamentals

Common assumptions that ignore the fundamentals:

1. *If we could only get to scale, our financial problems would be solved.*
2. *More marketing means more people will come.*
3. *We need to invest more in fundraising staff because we need to find more individual donors.*
4. *If we invest more in the highest quality art and market it relentlessly, then everything will be okay.*

If only we could get to scale…

- Bigger is not necessarily better; small can be beautiful.
  - Small organizations run on careful balance of goodwill and money.
    - Sweat equity is not scalable.
    - Even adding a single staff person can tip a functioning small organization out of whack.
  - Smaller organizations are often inappropriately encouraged to grow in organizational sophistication, but the same investments could be used to deliver programs for as long as their audiences want them.

If only we could get to scale…

- Organizations can grow when there is demand.
  - Need holistic planning that scopes the full operational need and that establishes tested audience and philanthropic demand.
  - Need strong leadership that can ask the tough questions during planning and take decisive action if not all goes according to plan.

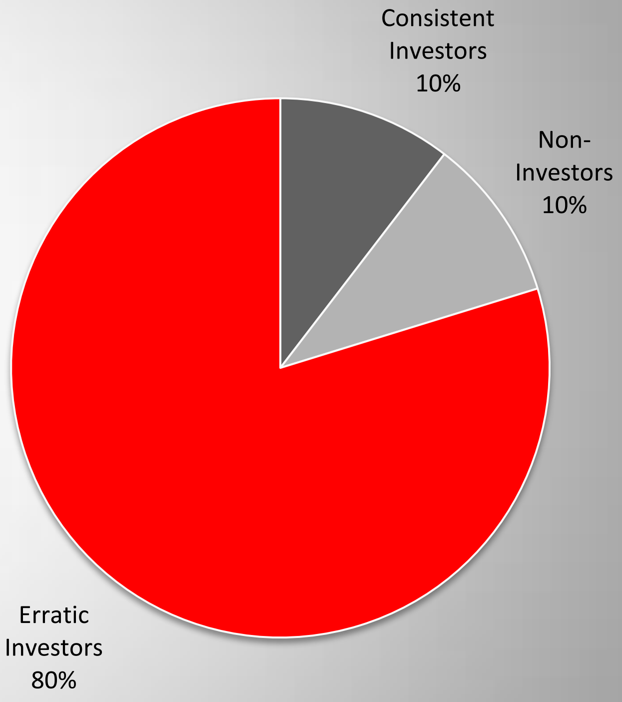
More marketing = more people

- Scale matters in marketing.
  - Doubling a small marketing budget won't make a difference.
- Earned income goals matter.
  - Increased marketing can outstrip earned income potential.

Budget Size	Average Marketing Budget
<$250K	$10,838
$250-500K	$31,964
$500K-1.5M	$68,665
$1.5-5M	$221,630
$5-20M	$752,014
$20M+	$2,928,429

More marketing = more people

- Even larger spends may not be enough.
  - Brand is not promoted; data implies that sales, rather than marketing, is the default investment.
  - Successfully reaching multiple audience targets requires a larger infrastructure than what currently exists.
  - New audience development requires consistent investment over time.



Marketing Implications

- At the organizational level, marketing investment needs to be based on each organization's mission, size, and strategy:
  - *What is the organization chasing?*
    - *Stability (retention, attraction, diversity); or*
    - *Growth (all the above plus increased market share)*
  - *And to what end?*
    - *Net revenue? Donor pipeline?*
    - *Validation of the art? Of the organization?*

- The smallest organizations need to size investment to defined goals.
- Mid-sized to large organizations may need significant investment to deal with audience shifts.
- Supporters need to grapple with their desired outcomes.
  - *Is there one meta audience goal?*
  - *A community vibrancy goal?*
  - *Or, are we supporting the aims of individual organizations?*

Fundraising staff = more donors

- Raising money from individuals is too expensive for some organizations.
  - Small and mid-sized organizations cannot afford skilled, dedicated development staff.
  - Board gifts are leading indicators of individual success.
  - And, many rely on foundations as the more efficient source.
- Yet many organizations request support to do individual fundraising.

Budget Size	Average Board Gift	Total Individual Contributions	Total Other Contributions	2011 Average Fundraising Spend	Average Fundraising Efficiency	Efficiency with staff*
<$250K	$624	$11,643	$53,396	$3,992	0.06	1.60
$250-500K	$1,418	$56,586	$161,047	$23,330	0.11	0.57
$500K-1.5M	$2,334	$123,377	$354,926	$81,488	0.17	0.38
$1.5-5M	$5,348	$460,463	$1,216,807	$242,101	0.14	n/a
$5-20M	$16,821	$3,293,890	$8,377,388	$1,171,678	0.10	n/a
>$20M	$72,242	$5,073,962	$17,208,692	$2,199,328	0.10	n/a

*Assumes $100K for full cost of one dedicated development staffer

Fundraising staff = more donors

- No need for more solicitors if there is no pipeline established.
  - Many interviewees, even the largest and most established, were not sure of new donor sources.
  - An organization’s networks matter.
    - Organizations identified new wealth through extensive research, but actual connections to new generations of donors were weak.

Fundraising Implications

- Organizations of a smaller scale need to assess their market and their ability to grow individual support by asking:
  - *What are we chasing?*
    - *Major donors that can provide net income?*
    - *Broad-based retail giving as demonstration of community support?*
  - *Can our board support this?*
- Larger organizations seeking to diversify an already established donor base require investment in creating new networks before they build staff capacity.

Quality + marketing = success

- Quality and engagement are necessary yet insufficient factors for success.
- Scale matters in marketing – see Assumption Two.
- Program coverage is eroding.
  - The amount of program costs plus marketing covered by earned income is declining year over year. The pressure is exceptionally high in the performing arts.
  - Increasing investment often creates greater contributed revenue need.
    - Increased reliance on contributed revenue in Philadelphia supports this hypothesis.

Quality + marketing = success

- The data demonstrates that contributed revenue success was a *leading* rather than trailing indicator of program investment.
  - This implies that funding is available for *new* programming, but not as result of programming.
- It also reveals that obtaining increased funding may not always fix the problem.
  - Funder tastes may not align with that of the rest of the audience.
  - Increased investment in programs could exacerbate the program coverage problem.

Program Implications

- Organizations' priority is putting art and culture into the world.
  - However, the economics make them beholden to two masters when making investments in program.
    - Program expense covered by earned and contributed revenue.
  - Increased quality and improved marketing will often result in the need for increased contributed revenue.
  - Increased contributed revenue is often more easily obtained for new programming rather than sustained programming.
- Donors need to understand that their tastes may not drive earned income and therefore their investments should consider those implications.

Conclusion

- We found a system that:
  - Has grown unexpectedly, fueled by foundation dollars, and which remains fragile.
  - Is full of smart ideas about how to address a changing environment.
    - Those ideas require investment, but are often swamped by conversations and assumptions about growth.

Conclusion

- Both funders and organizations need to understand how to balance and integrate where they choose to invest and why.
  - *What are we chasing when we invest in marketing and fundraising? Are we after stability or growth? Are we seeking an enhanced bottom line or validation of the art?*
  - *What is the role of growth in program in fueling mission and sustainability? When does it make sense to replace old programs rather than simply adding new ones?*
  - *How do the answers change for organizations at different scales, business models, and revenue dependencies?*
  - *How can organizations have realistic conversations with their supporters about the appropriate metrics of success?*

Conclusion

- It is an exciting time in Philadelphia
  - Growth in the city, a dense marketplace, and changing audiences create a wonderful opportunity for arts and culture organizations.
  - Thoughtfully scaling to the appropriate markets and having a thoughtful conversation with supporters will position organizations to capitalize on this exciting moment.