Grantmakers in the Arts
GIAreader
Vol. 22 No. 1, Spring 2011
Ideas and Information on Arts and Culture

Capitalization Principles in Practice

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Reprinted from the Grantmakers in the Arts ***Reader,*** Vol. 22, No. 1 Spring 2011

Grantmakers in the Arts
Supporting a Creative America

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Capitalization Principles in Practice

Juliana Koo

The presentation of the National Capitalization Project (NCP) engendered a robust discussion at the October 2010 GIA conference in Chicago. GIA heard a range of responses from attendees. While some were very positive — agreeing that capitalization principles are a critical consideration in grantmaking — others felt differently. They wondered whether a discussion of capitalization was only relevant to large foundations or to large arts institutions. They also expressed concern that any focus on the long-term financial needs of large institutions might be detrimental to smaller or emerging organizations that reflect important values, such as innovative artistry, access to the arts, and diverse voices.

Many of the conference presentations and the project summary document reviewed capitalization principles and recommendations for grantmakers at a high level, and didn't allow for a detailed discussion about application or applicability.[1] To provide more context, GIA invited TDC, the facilitator for the NCP convenings, to prepare this article, highlighting concrete examples of grantmakers who are using capitalization concepts in their work.

Whom Did We Talk To?

TDC had fascinating conversations with the following nine individuals. We are hard pressed to make any blanket pronouncements about the group. These arts funders represent many viewpoints, regions, and budget sizes. Most of them have a local or regional purview, but not all. Most provide general operating support and direct balance sheet investments, but again not all.[2] While most give to a diverse range of organizational sizes and types, there is one funder, the Metropolitan Atlanta Arts Fund, that focuses exclusively on small and mid-size institutions.

Institution	Interviewee	Location	Profile	Asset Base[3]	Total Expenses[4]	Arts Grants[5]	Reporting Year
Paul G. Allen Family Foundation	Jim McDonald, Senior Program Officer	Seattle, WA	Small family foundation	$17M	$15M	**$3.45M**	FY2009
Arts & Science Council of Charlotte-Mecklenburg County	Robert Bush, Senior Vice President of Cultural and Community Investment	Charlotte, NC	Nonprofit grantmaker	$35.8M	$13.8M	**$10.8M**	FY2010
Cleveland Foundation	Kathleen Cerveny, Director of Evaluation and Institutional Learning	Cleveland, OH	Community foundation	$1.8B	$95M	**12-14% of $79M**	FY2009
Andrew W. Mellon Foundation	Susan Feder, Program Officer	New York, NY	Large private foundation	$4.9B	$254M	**$46.71M**	FY2010
Metropolitan Atlanta Arts Fund of The Community Foundation for Greater Atlanta	Lisa Cremin, Director	Atlanta, GA	Community foundation	$651M	$142M	**$5M**	FY2009
The James F. and Marion L. Miller Foundation	Martha Richards, Executive Director	Portland, OR	Small family foundation	$175M	$11M	**$3.58M**	FY2009
Montana Arts Council	Arlynn Fishbaugh, Executive Director	Helena, MT	State arts agency	n/a	$1.98M	**$1.08M**	FY2011
William Penn Foundation	Olive Mosier, Director of Arts and Culture	Philadelphia, PA	Large private foundation	$1.9B (unrestricted assets)	$63M	**$14.2M**	FY2009
Virginia G. Piper Charitable Trust	Carol Kratz, Program Director	Phoenix, AZ	Midsize private foundation	$464M	$16.35M	**$2.89M**	FY2010

Why Do They Care about Capitalization?

Most of these funders, particularly those concerned with a particular region, note that they are very familiar with their grantees and the overall condition of the local arts ecosystem. As one funder put it, "We go to bed with these organizations at night, we wake up with them in the morning — there's no escaping them!" The repeated involvement over time led to a galvanizing moment for a number of our interviewees, which got them thinking about capitalization: a recognition of the broad financial instability in the sector and how funding practices of the past twenty years haven't changed the picture.

- Kathleen Cerveny of the Cleveland Foundation noted, “I heard Melanie Beene’s opening plenary at GIA years ago, talking about operating support and stopping the stupid games, and spent the rest of the conference in my room writing a new strategy for arts giving…. It took a number of years and a crisis to implement. There was a moment when everyone in town needed bridge funding and emergency rescues, causing the arts to get a bad rap.”
- More recently, the Arts & Science Council’s board asked during its strategic planning process, “Why are we continually seeing groups with shaky financial footing slipping through the panel review? Why can’t we come up with a way to review financials in an objective way, especially since we sit in the second largest banking center in the country?”

“…our goal is to fund high-quality arts organizations in a way that helps them achieve their mission. To this end, we are concerned about their fiscal health. We believe that the ability of cultural organizations to do their best work is tied to how well they are capitalized.”

- In Portland, Oregon, a group of six funders, including the Miller Foundation, started comparing notes about the five largest organizations in town and realized that none of the funders understood what was going on in the organizations’ finances. The funders started to work together to design a program that would examine the current financial conditions and help the organizations to devise workable strategies to go forward and remain “investable.”

Beyond financial health alone, funders recognized that adequate capitalization is necessary for their grantees to create quality artworks and arts experiences for audiences. Says Olive Mosier, “At William Penn, our goal is to fund high-quality arts organizations in a way that helps them achieve their mission. To this end, we are concerned about their fiscal health. We believe that the ability of cultural organizations to do their best work is tied to how well they are capitalized.”

How Are They Supporting Capitalization in Their Grantmaking?

We observed a number of approaches to applying capitalization considerations:

- Some offered balance sheet investments, giving grants directed toward working capital, operating reserves, risk capital, facilities, or endowment. Some of these grants were part of an integrated program that offered accompanying technical assistance, and others were not.
- Others retained a more traditional approach of giving general operating support or project grants, but have changed the fundamental nature of the conversation they are having with their grantees to reflect a holistic understanding of each organization’s strategic goals.

Here we review four integrated programs that focus on capitalization in the most depth, highlighting lessons TDC thought might have broader applicability to grantmakers who are considering this kind of program. We then list other experiences with balance sheet investments. We close with an examination of how funders have changed the conversation with their grantees in order to set their P&L-based giving (whether through general operating or project grants) into a larger context.

Integrated Programs

Four of our interviewees have (or had) grant programs that offer a multi-pronged approach to capitalization, mixing components such as balance sheet investments, general operating and project support, technical assistance, and peer learning. These programs are rigorous, demanding not just time but also a willingness to turn over stones and question the status quo that participants found both uncomfortable and exhilarating. Quipped one board member of a participating organization, “It’s hard to be grateful for a financial colonoscopy.” These programs align with the NCP recommendations by following up rigorous financial diagnostics with the financial and strategic tools to answer the question, “So I know I’m undercapitalized, now what?”

- **Cleveland Foundation.** From 2003 to 2006, the Cleveland Foundation ran the Arts Advancement program. Arts Advancement was targeted at midsize organizations that the foundation saw as critical to the arts landscape of the region, and favored organizations that had at their core artistic missions dependent on risk taking and innovation. The program granted $3.5 million to five organizations, with 44 percent going to general operating support, 28 percent to working capital, and 28 percent to project grants; and supplied one-on-one consulting in planning and evaluation. Organizations were required to participate in management seminars and monthly peer meetings. By the end of the program, all participants reported stronger balance sheets, and most showed higher engagement from audiences and donors.[6]
- **Miller Foundation.** As noted above, the Miller Foundation is one of six Portland funders interested in stabilizing the five largest arts organizations in the city; Martha Richards of Miller Foundation is the coalition’s coordinator. In 2009, the program began with a detailed review of each organization’s financial condition from an external consultant. Organizations were

then asked to prepare two-year business plans describing how they would achieve surplus budgets and build working capital. The goal was to give each funder the same information on which to base decisions. Organizations agreed to share financial diagnostics at a convening of representatives from their boards and the boards of the foundations. One year into the program, each participant has achieved a balanced budget.

- **Metropolitan Atlanta Arts Fund of The Community Foundation for Greater Atlanta.** Prior to 2009, the fund gave grants based on a model similar to the National Arts Stabilization program, retooled for the small and midsize organizations that are the fund's focus. The program offered multiyear support for nonartistic infrastructure building initiatives, including balance-sheet-strengthening grants for operating reserves or debt reduction. Nonartistic staff salaries were also supported.

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- **Mellon Foundation.** In reviewing its portfolio of grants following a leadership transition, the Mellon Foundation instituted a capitalization-focused program for its long-term dance grantees starting in 2007. Each received an analysis of its financial condition from an outside consultant, and — as in the Portland case — agreed to share this information at a convening. The Mellon Foundation followed up the diagnostics with exit grants and, in some instances, the opportunity to apply for cash reserve grants. The foundation has also refocused its New York Theater Program to provide general operating support for small and midsized theaters, and has selectively invited several of those organizations to apply for cash reserves.

Some lessons to highlight from these programs:

- **Choose your target.** Because of the rigor and large investments these programs entail, funders focus on populations that they care deeply about. As Kathleen Cerveny notes, "These are the ones who are too important to allow to fail, the ones that the community would have to reinvent if they disappeared." For the Mellon Foundation, the choice was determined by a sense of responsibility to long-time grantees who had grown accustomed to a direct relationship with the foundation but would henceforth only be eligible for support through a regranting program.
- **Small and midsize organizations can benefit.** As noted earlier, the Cleveland Foundation's interpretation of "too important to fail" is idiosyncratic, focusing on midsize institutions with a risk-focused mission rather than on community anchors. The Portland initiative did focus on the largest institutions, but says Richards, "There are things we are learning through this program that we can apply to well-managed midsize organizations. Check back with us in two years."
- **Establish readiness.** In a previous iteration of Arts Advancement, the Cleveland Foundation included some organizations in crisis but found that they were not able to get value from the program; some, in fact, closed their doors midstream. For Arts Advancement, the Cleveland Foundation required that organizations have adequate budgets, staff, experience with planning, and record keeping. They also wanted to see presence of a vision, absence of unmanageable debt, and a functional board. As Cerveny notes, "We wanted to see if the organization was in the sweet spot where we could make an impact."

  Readiness is a primary concern of the Metropolitan Atlanta Arts Fund as well. Cremin notes, "The number one criterion was, who is ready to use the money now? For some small organizations, large grants destabilize." To promote readiness, the Metropolitan Atlanta Arts Fund offers technical assistance grants through its Nonprofit Toolbox program.
- **Be respectful.** The Portland initiative nearly fell apart when a letter to grantees came off inadvertently as "you children were bad and now will be told how to do it right." Richards was glad that the coalition was able to put this kerfuffle aside and eventually communicate a positive image of the grantees: "We heightened an awareness of how well these guys had been managed in troubled times. Funders were surprised when we reported that they had all balanced last year." Not only did this new message of respect keep organizations engaged, it also conveyed to other funders and donors that they were worth investing in.
- **External voices can be helpful.** For the Portland initiative and the Mellon Foundation, having an external voice delivering the message about financial conditions was helpful. Richards reports that the third party was able to illuminate internal debates on some grantee boards that were blocking progress. Feder notes that the grantees appreciated the opportunity to place their own companies' positions in the context of aggregated data.

Direct Balance Sheet Investments

Many of our interviewees report giving grants to strengthen balance sheets. Here, we have collected the most notable approaches and lessons we heard.

Working capital and cash reserves. The Metropolitan Atlanta Arts Fund and Virginia G. Piper Charitable Trust report mixed results in their working capital and operating reserves grants, finding that some grantees had a hard time maintaining the funds. In Cleveland, however, all of the participants in Arts Advancement were able to maintain and even grow their working capital. Upon receiving several proposals for reserves, the Mellon Foundation determined that some potential grantees needed a deeper understanding of the challenges they faced in sustaining their current operations (for which the foundation provided additional technical support).

Debt. The Mellon Foundation and Metropolitan Atlanta Arts Fund offer bridge financing programs, similar to the Nonprofit Finance Fund model, for organizations with a known revenue source that need to smooth cash flow. The Mellon Foundation, whose program is for its small and midsize grantees, reports hesitancy on the part of many organizations to take on additional debt, though those who have done so are successfully repaying their loans. The Metropolitan Atlanta Arts Fund is the one funder that reports giving debt relief grants, seeing it as a potential turnaround moment. For organizations without adequate reserves, one bad year can turn into long-term debt that is impossible to pay back. With the debt elimination grant, some strengthened internal practices and regained their credibility with the rest of the funding community. Twenty-six of thirty-seven grantees successfully relieved or mitigated debt as a result of the grant. Over time, however, approximately 50 percent continued or returned to a pattern of deficit spending.

Arlynn Fishbaugh reports a radical change in the Montana Arts Council's approach, looking at return on investment to the public rather than financial need as the primary criterion. Instead of the standard arts council panel, she has recruited state legislators, preferably ones who want to cut arts investment.

Risk capital. The Paul G. Allen Family Foundation and Piper Trust have risk capital programs, focused on giving organizations ramp-up funds for new initiatives that enhance their bottom lines. The grants support capitalization in two ways: as risk capital and as a base for potential contribution toward ongoing surplus budgets. The Cleveland Foundation is embarking on a new initiative, Engaging the Future, that will provide risk capital to participating organizations to think deeply about how to engage new audiences, an issue the foundation believes is a critical one for the entire sector.

Facilities and endowment. Many of our interviewees report a cautious approach to bricks-and-mortar investments. The Mellon Foundation has a clear firewall: it never gives toward construction. It has, however, in certain instances, provided operating funds and cash reserves to help an organization bridge to full operations in a new facility. Having this policy helps engender a conversation about the full cost of new construction. The Arts & Science Council reports a unique approach to facilities, reflecting the flexibility it has as a 501(c)(3). The council recently collaborated with the city of Charlotte on the construction or renovation of five cultural facilities. The city committed hard costs, while the Arts & Science Council spearheaded an endowment campaign that raised $83 million to support operations.

Like facilities support, endowment gifts are carefully considered by all. Especially for funders focused on smaller organizations, such as the Metropolitan Atlanta Arts Fund, organizations are encouraged to stabilize working capital before thinking about endowments.

Changing the Conversation

At the core of the recommendations from the National Capitalization Project is the idea of "changing the conversation" between funders and grantees to reflect a more integrated understanding of how strategic goals and capitalization are linked.

TDC observed that an important factor to the changed conversation is willingness of funders to change their own approaches and mind-sets. The Arts & Science Council board empowered program staff to make wholesale changes to its thirty-year-old operating support program. This license resulted in a more rigorous review process, a change to multiyear funding, and a match requirement, among other shifts. The Miller Foundation has also begun committing to multiyear funding. On one hand, a longer-term commitment offers grantees certainties about the foundation's support. On the other, it sets limits, providing key information grantees can use when they enter into labor negotiations, make budgetary decisions, or cultivate new donors. In the past, the Miller Foundation stepped into the funding gaps for institutions in trouble.

Arlynn Fishbaugh reports a radical change in the Montana Arts Council's approach, looking at return on investment to the public rather than financial need as the primary criterion. Instead of the standard arts council panel, she has recruited state legislators, preferably ones who want to cut arts investment. This strategy has contributed to the agency's ability to get through serious attacks successfully and maintain state funding for the arts in Montana. She says, "We need to change the mind-set of state funding agencies. If an organization is doing well or has a big budget, there's always a panel discussion about whether they should be funded. In Montana, we've recognized that our target market is not arts organizations but the public."

TDC observed funders having a changed conversation in the context of both general operating support and project-based giving. General operating support is the platform from which many of our interviewees have initiated and maintained long-term discussions of capitalization with the organizations they most care about. As one funder put it, “You’ve become their partner in a profound way. General operating support is an extraordinary expression of trust.” It is, of course, possible to care deeply about organizations while giving them project-based support. The Paul G. Allen Family Foundation is careful to think about the larger context for its project grants, encouraging applicants to show budgets that reflect the full cost of quality artistic programming, including overhead. In their Improving Finance Performance (IFP) program, which invests in new initiatives designed to expand revenues or reduce costs, the foundation favors projects that are high priorities in an organization’s strategic plan, shown to be a predictive factor for success in a recently completed evaluation of the program.

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Whether through project or general operating grants, the holistic discussion begins with the initial proposal review. A number of interviewees report rigorous, multifaceted, tailored review processes. One funder thinks of it as a “360 degree review — you have to understand everything about their programming, operations, governance, staff, risks, facilities, balance sheet.” Interviewees report steps they have taken to add nuance and rigor to proposal review, such as external evaluation of financials (Arts & Science Council, Montana Arts Council, Miller Foundation) and in-person site visits involving board and staff (Metropolitan Atlanta Arts Fund).

Many note that retrospective review is not sufficient and look to strategic plans to understand an organization’s forward-looking goals. Grantees — by and large — appreciate this approach. Says Robert Bush at the Arts & Science Council, “When we told our grantees, ‘we are going to hold you to standards you set yourselves,’ we were concerned that we were going to get a lot of fluff, and we didn’t.” Flexibility and honesty are key words when talking about tracking success metrics over time. Says one funder, “If something goes awry, nine times out of ten, they’ll proactively call us to ask for an adjustment, and nine times out of ten, we say ‘of course.’ ” All the funders who use strategic plan metrics to evaluate their grantees report this kind of flexibility, reflecting the understanding that no one has a crystal ball to predict the outcomes of plans.

Flexibility must, of course, be balanced with accountability. What funders are looking for, over time — even more than results (which organizations often cannot control) — is behavior change. Said one funder, “We have let organizations go because we knew they had no interest in doing what it takes to save themselves. We can give them chances, but at the end of the day, if the organization does not want to change, then you say, okay, we don’t either.” Another noted, “We want monitoring of working capital, debt, et cetera, to become part of the culture so that funders aren’t holding the stick.”

A final nuance to highlight regarding the use of financial health indicators is that they do not seem to bias which organizations a funder ultimately chooses to support. The key determining factor for these funders remains a reflection of their institution’s values. An understanding of financial health is, instead, a way to know what it would take for a valued organization to get to stability and artistic success. Martha Richards noted, “We were trying to figure out what these organizations really needed to progress. Fiscal discipline may not be what they thought they needed, but we found that we couldn’t even have that conversation until everyone could agree that their business management was fundamentally sound.”

What Have Been the Results?

Some important outcomes have arisen from the efforts of these grantmakers.

First, they have seen evidence of success in their grantee populations. The Miller and Cleveland foundations both report strengthened budgets and balance sheets among the participants in their integrated programs. The Arts & Science Council reports increased audiences in its grantees.

Second, while transparency can uncover painful realities, it can also highlight positive trends, which can result in broader support of a funder’s grantees. The Miller Foundation and Metropolitan Atlanta Arts Fund’s work has fostered community-wide acknowledgment of the high management standards that nonprofit arts leaders have maintained despite difficult circumstances. For both, a key ingredient was the engagement of the boards on both sides — foundations and organizations. Lisa Cremin of the Metropolitan Atlanta Arts Fund states, “Board chairs of small arts organizations are some of the loneliest people in the world. We showed the grantee boards that their work was serious and that there were serious community people coming to talk to them, and that there was a network of people thinking about this work.”

The third, and most important, outcome is the elevated conversation that the incorporation of capitalization principles allows. Says Olive Mosier, “Since starting to think through the lens of capitalization and business model drivers, I've had a tool through which to better understand and connect with my grantees. They clearly understood these things already, but now I am better able to ask the right prompting questions and have a more productive discussion." Having the right language and the same information allows a conversation among equals, rather than of patron to petitioner or, even worse, parent to child. By equalizing the power dynamics, these funders have fostered a relationship of honesty and trust. As one grantee told his funder, "It's a relief to be able to talk to you about what's really going on. Then we can have a conversation about what to do about it. I don't feel like I have to spin you."

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Finally, the elevated conversation opens up the possibility of having the ultimate discussion about an organization's long-term plans. For Olive Mosier, it is essential to consider the question "Does every organization need a strategy to continue ad infinitum?" and realize it is legitimate for organizations to come to different answers — some can be built for ten years and others for one hundred. Both the William Penn and Mellon foundations offer support to organizations who want to shut their doors responsibly.

Conclusion

"Capitalization" has meant many things to the arts sector: buzzword, carrot, stick, holy grail, red herring. GIA initiated the National Capitalization Project to strip away some of the baggage attached to this word and reveal it for what it means — the supportive resources that allow arts organizations to meet their missions over time. At TDC, we believe that capitalization is relevant to all funders and all organizations that share a goal of continued production and presentation of quality, compelling artworks that enhance their communities. We hope this article has highlighted the diverse ways in which funders have applied the concepts of capitalization for a wide array of grantees and has offered some ideas on how to put them into practice.

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NOTES

1. The summary report is available at www.giarts.org/article/national-capitalization-project.
2. Balance sheet investments refer to grants earmarked for a non-operating capital fund, such as working capital, operating reserve, capital improvement reserve, risk capital, or endowment.
3. Financial data was drawn from Form 990s published in GuideStar and information provided by interviewees. Assets and expenses reported for the Metropolitan Atlanta Arts Fund of The Community Foundation of Greater Atlanta are for the community foundation as a whole. William Penn Foundation asset base figure includes only unrestricted net assets.
4. Total expenses include grants and administrative expenses.
5. Cleveland Foundation does not regularly report the distribution of grants among sub-sectors, and supplied an estimate of proportion directed toward the arts based on past history. The Mellon Foundation figure includes arts and culture grants from Performing Arts, Museums and Art Conservation, and Scholarly Communications grant programs but does not attempt to quantify arts-related grants in the Higher Education and Scholarship program; it does not include a $1M PRI for the foundation's zero-interest loan program (which is described in this article). The Metropolitan Atlanta Arts Fund figure includes $1M in grants distributed by the Arts Fund and $4M from the Community Foundation's donor-advised funds. The Miller Foundation figure includes $2.3 million directed toward the large arts initiative (described in this article). The Montana figure does not include expenditures for programs and technical assistance directed toward arts organizations.
6. A process and outcomes evaluation of Arts Advancement is available on Cleveland Foundation's website.