TDC *VISION TO MOMENTUM*

Understanding and Messaging Your Capitalization Challenge

Susan Nelson, TDC| June 16, 2015

The Next Step

- Talking about the under-capitalization of the arts sector for five years
- Organizational leaders and funders agree about the issue broadly
  - Unclear if donors and boards understand
- Addressing capitalization challenges at the organizational level is much harder
  - Requires an accurate diagnosis of capitalization stage and a clear messaging of the challenge and type(s) of capital required

DEFINITIONS

Definition Revisited

- Capitalization is having the cash to do **what** you need to do **when** you need to do it
  - It connects organizational mission, vision and strategy
  - It creates investment in the art
  - It allows for the ability to take risk

Capitalization Components: An Integrated Plan

Mission and Vision
- Artistic/cultural production
- Theory of change for impact on audiences and other beneficiaries

Market
- Customers
- Donors
- Competition

Resources
- Talent
- Space
- Networks

Time Horizon, Business Model Drivers, Life Cycle

Integrated Strategy

- **Programmatic strategy** maximizes artistic quality and impact, scaled to demand and available resources
- **Organizational strategy** includes adequate human and other resources to manage program and support activities (e.g. marketing, development, finances, facilities)
- **Capitalization strategy** articulates size and shape of capital needs to support programmatic and organizational strategies

Business Model

- A **business model** is how an organization makes and spends money in service of its mission
- Influenced by:
  - Artistic vision and strategy
  - Local market
  - Time horizon and lifecycle
  - Business drivers (audience, facility, collections, and other fixed costs)
- Comprises:
  - Revenue composition
  - Revenue predictability and reliability
  - Expense composition
  - Surplus size and reliability

Revenue & Capital Serve Different Purposes

- **Revenue** funds regular operations
  - Covers full annual costs of programs & operations
  - Pays an organization to do what it does
- **Capital** provides liquidity, reserves and the ability to take a risk
- Excess revenue creates capital

Creating a Risk Profile

Operational Risk	Strategic Risk

Operational Risk

- Program Risk
- External Risk
  - Audiences
  - Funders
  - Shifts in the economy
- Human capital
  - Loss of leadership

RISK MANAGEMENT

Strategic Risk

- Programmatic
  - Pilots
  - New opportunity
  - Change in core offerings
- Organizational
  - Marketing/development
  - Facilities
  - Change in scale or size

RISK TAKING

TYPES OF CAPITAL

How Well Capitalized Are You Now?

P&L

Revenue
Expenses

Net Income

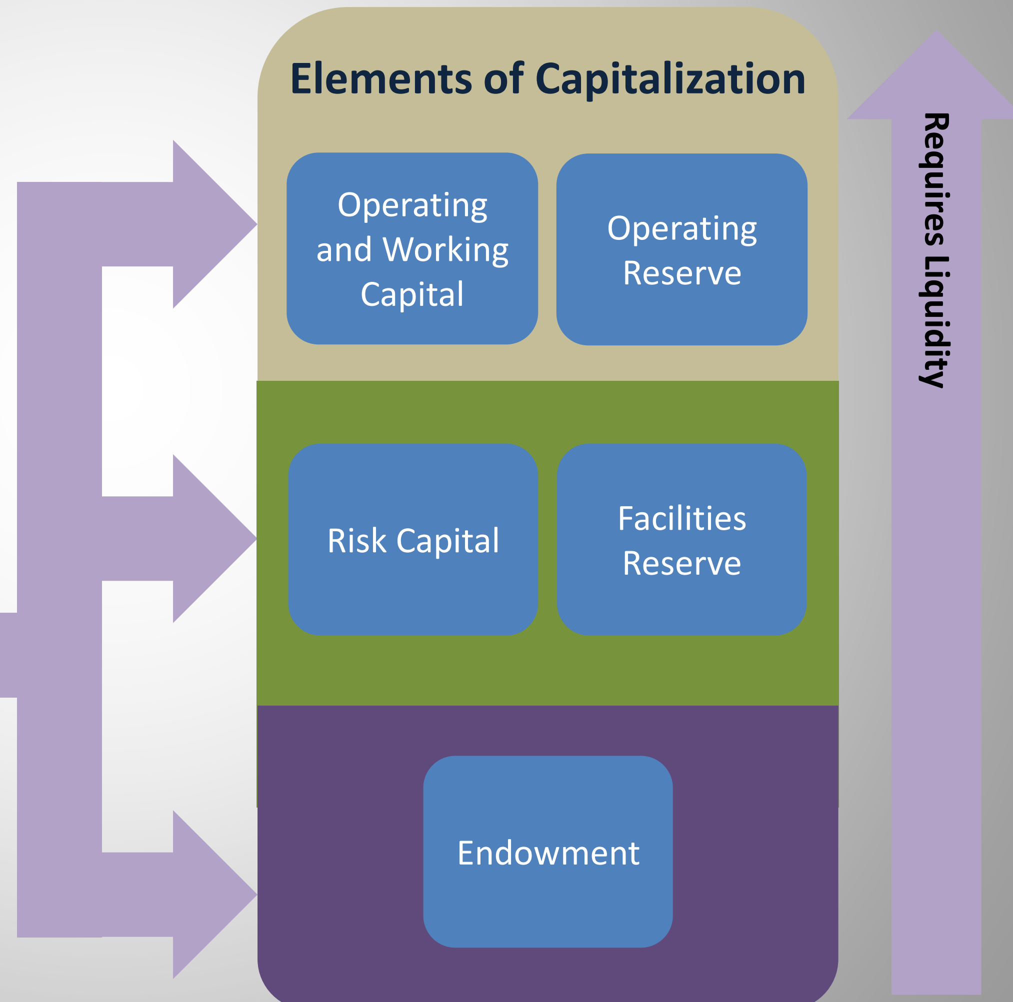
Balance Sheet

Cash/Investments
Receivables
Fixed Assets

Total Assets

Payables
Deferred Revenue
Debt
Net Assets

Total Liabilities
and Net Assets



Baseline Capital Funds

Fund	Purpose	Funded by
Working Capital	Mitigates everyday risk and normal cash flow bumps	Internal sources
Operating Reserve	Protects against unexpected downturns and operating risk profile (risk management)	Cash set aside
Facilities Reserve	Supports replacements of facilities or leasehold improvements	Funding depreciation or seeding new fund
Risk Capital	Can offset one-time big risks or support R&D (risk taking)	People who love you
Endowment	Ensures longevity of organizations with long-term time horizons	People who love you

Transitional Capital Funds

Recovery Capital

- Pays off past debt
- Provides interim working capital
- Moves URNA out of the red
- “Can’t function until you clean it up” capital
- Funded by people who love you

Change Capital

- Required to test a new business model
- Required to execute new business model
- Funded by people who love you

DIAGNOSING YOUR CHALLENGE

Where You Start Matters

- Is your organization…?
  - **At risk**: no cash and high debt
  - **Vulnerable**: very little or no cash
  - **Sustaining**: some cash
  - **Stable & considering growth**: sufficient cash

Is It A Capitalization or A Business Model Issue?

At Risk			
Improving Operating Model	Negative URNA	Breakeven or Deficit	No Cash

Vulnerable			
Improving Operating Model	Flat URNA	Breakeven or Better	Very little cash

Sustaining			
Working Operating Model	Thin Balance Sheet	Breakeven or Better	Undercapitalized

Stable & Considering Growth			
Stable Operating Model	Healthy Balance Sheet	Regular Surpluses	Well Capitalized

Broken Business Model		
Negative URNA	Structural Deficits	Negative Cash

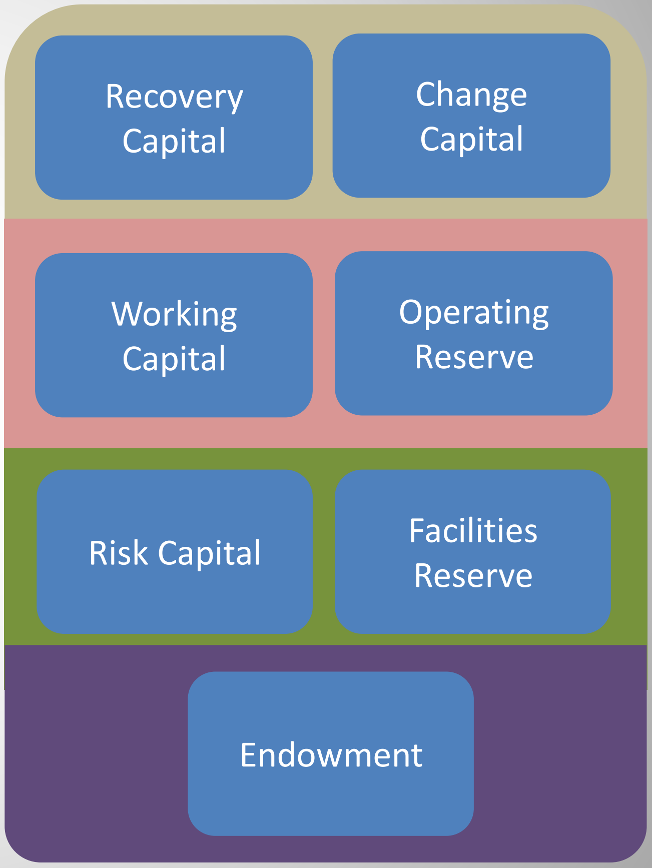
Moving From At Risk to Sustaining

Research	Are You Ready To Do This?
• Two different studies demonstrate that improving financial health was hard • Organizations struggled to make consistent investments in program, marketing and fundraising • Those that changed obtained forms of recovery capital	• Does your model have the ability to do better than breakeven? • Do you understand your risk profile? • Do you have a good understanding of demand?

Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

Moving From At Risk to Sustaining

- What types of capital should you consider?
  - First focus on improving negative net assets through surpluses
  - Recovery capital
  - Change capital
  - Working capital
- Should you pay down debt?
  - No



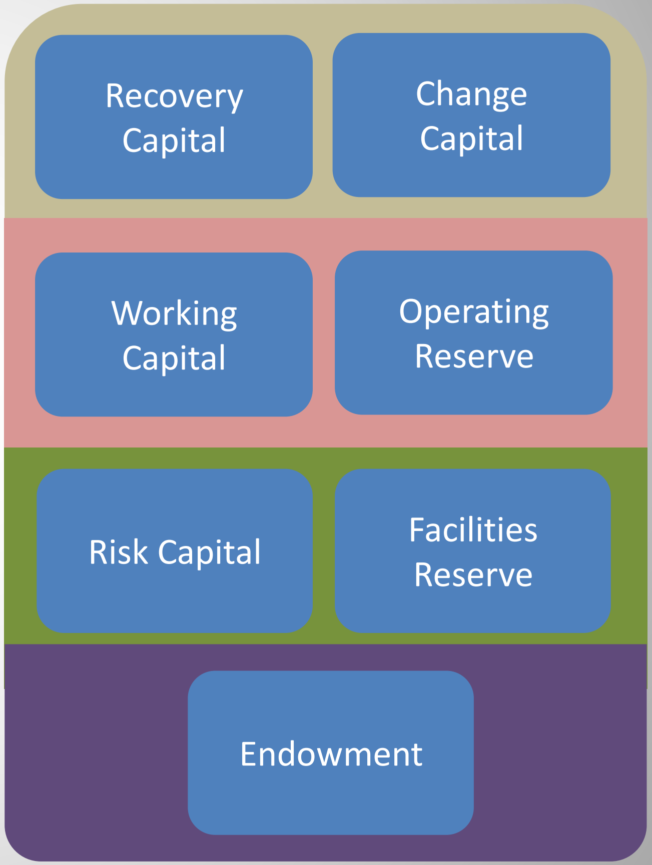
Moving From Vulnerable to Sustaining

Research	Are You Ready To Do This?
• Boards struggle to understand why this is important • Organizations that changed made it a goal and made attendant investments and choices	• Does your model have the ability to do better than breakeven? • Do you understand your risk profile? • Do you have a good understanding of demand?

Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

Moving From Vulnerable to Sustaining

- What types of capital should you consider?
  - Working capital
  - Operating reserves
  - Facilities reserve, where appropriate
- Should you pay down debt?
  - Maybe



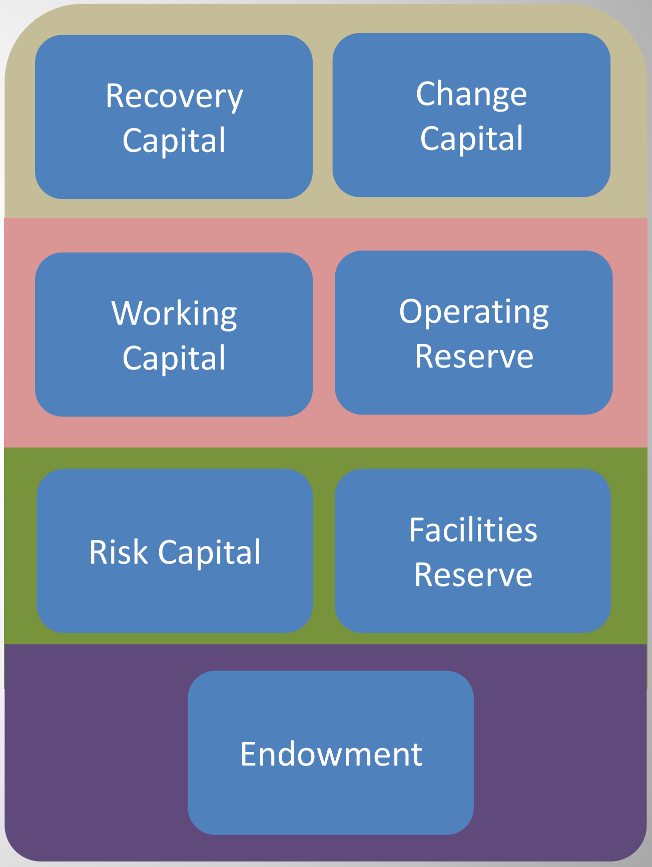
Sustaining

Research	Are You Ready To Do This?
• A minority of organizations actually sit in this category • Boards and funders struggle to understand why this is important • Organizations that have created appropriate capital funds (such as operating & artistic reserves) have benefited organizationally and artistically	• Is your business model working? • Do you generally have annual surpluses, with just occasional deficits? • Do you have a clear and agreed-upon definition of operational and artistic risk? • Do you have a clear and agreed-upon way to communicate how capital will increase impact?

Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

Sustaining

- What types of capital should you consider?
  - Increased working capital
  - Reserves
  - Risk capital
  - Facilities reserve
  - Endowment, potentially
- Should you pay down long-term debt?
  - Maybe
- Should you use debt?
  - Lines of credit for working capital



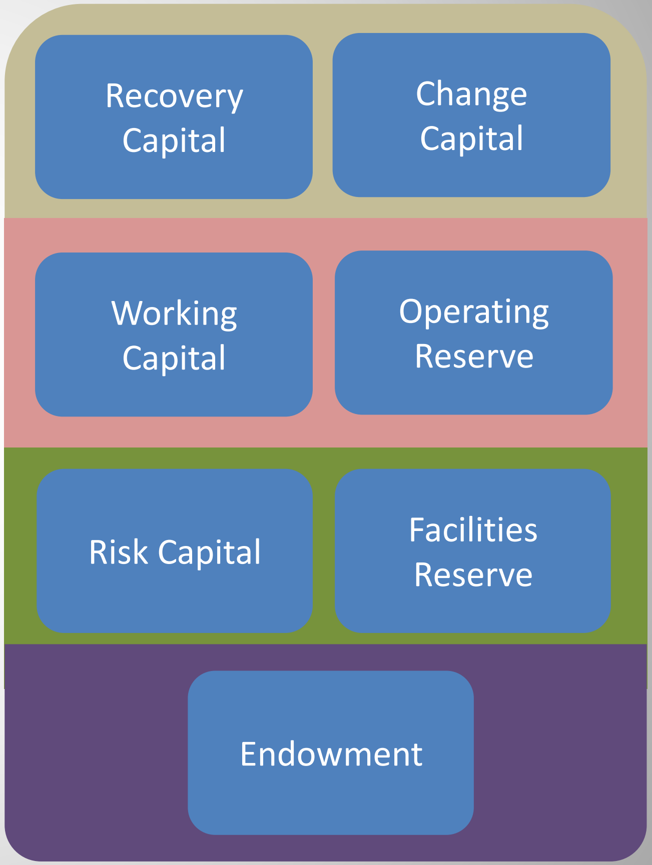
Stable & Considering Growth

Research	Are You Ready To Do This?
• Organizations that don't start from strength do not get stronger. Many get weaker. • In a recent study, it was found that few organizations grew from demand	• Do you have a solid donor base? • Do you have a working balance sheet? – The ability to repay credit lines? – Growth may not fix a weak operating model. Rescaling or right-sizing might. • Do you have a data-driven growth plan? – The ability to increase demand of both audiences and donors?

Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

Stable & Considering Growth

- What types of capital should you consider?
  - Resizing the balance sheet appropriately: working capital and reserves
  - Change and growth capital
  - Facilities reserve, where appropriate
- Consider sweat equity
- Should you use long-term debt?
  - Only to bridge pledges
- Should you use short-term debt?
  - Lines of credit for working capital



Broken Business Model

How Do You Know?

- Consistent losses over a multiyear period
  - Sometimes covered by one-off events
- Fully borrowed lines of credit and inability to pay debt out of annual operations
- Significantly changing budgets or productions during a budget year
- Inability to invest in staff; frozen/diminishing pay levels

What Does It Mean?

- Retest your vision and mission
- Understand and scale to your market
- Create a new capitalization plan that includes transition capital

Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

HOW DO I MESSAGE THIS?

Why is it hard to message my capitalization needs?

- Traditionally money, strategy, and impact have been divorced in this sector.
  - For many staff, leadership, boards, donors, and institutional funders, questions persist about how capitalization directly supports mission and program goals.
  - When capitalization funds have been defined, they are often developed against benchmarks rather than business model needs.
- Results in:
  - Chaotic capital markets
  - Dysfunctional conversations about money and business
  - Missed connections between impact and organizational health

Why is it hard to message my capitalization needs?

- The chaotic nonprofit capital markets result in an environment in which funders and donors often do not support program and capitalization alignment.
  - Limited understanding of what drives individual business models.
  - Surpluses and assets perceived as lack of need.
  - Funders seek to support programmatic outcomes, not organizations.
- Results in:
  - Funders and donors not funding organizations with surpluses
  - Funders and donors restricting funds to protect investments
  - Funding donor interests not organizational strategy

Why is it hard to message my capitalization needs?

- These chaotic markets create conditions in which it is often difficult for organizations to be transparent.
  - Did we manage the money as we said?
  - Are we hiding financial performance?
  - Are we perpetuating broken business models?
- Results in:
  - Funders and donors restrict funds to protect investments
  - Boards and donors do not believe their funds are necessary
  - Funders worry that they are funding structural deficits

A different conversation

- You can take the lead
  - Integrate strategy and money
  - Ask for the right kind of money from the right kind of people
  - Be transparent internally and externally

Taking the lead

- All messaging begins with these questions. The answers are reflected in your strategy:
  - Why does it matter?
    - Mission, vision, programmatic design
  - How do I know it will work?
    - Market and resource testing
  - How much money do I need?
    - Operating needs (program and operating strategy)
    - Capital needs (cash, reserves, risk, investment, endowment)

Taking the lead

- All messaging depends on:
  - Your capitalization stage
  - Types of capital funds required
  - Funding mechanisms to support your capital structure
  - Stakeholders to help you get the money you need

Messaging depends on the capital funds required…

At Risk	Vulnerable	Sustaining	Stable
Recovery Capital	Change Capital	Working Capital	Working Capital
Change Capital	Working Capital	Operating Reserve	Operating Reserve
Working Capital	Endowment (if applicable)	Facilities Reserve (if applicable)	Facilities Reserve (if applicable)
		Endowment (if applicable)	Endowment (if applicable)
		Risk Capital	Risk Capital

…on the funding mechanisms

Fund	At Risk	Vulnerable	Sustaining	Stable
Working Capital	Campaign with key stakeholders	Campaign with key stakeholders	Surpluses	Surpluses
Operating Reserve	X	X	Surpluses	Surpluses
Facilities Reserve	X	X	Surpluses and/or special fundraising for seed funds	Surpluses
Risk Capital	X	X	Surpluses or special fundraising	Surpluses or special fundraising
Endowment	X	Campaign	Campaign	Campaign for growth
Recovery Capital	Syndicate key stakeholders	X	X	X
Change Capital	Campaign with key stakeholders	Campaign with key stakeholders	X	X

… and on who you solicit.

Fund	At Risk	Vulnerable	Sustaining	Stable
Working Capital	Close supporters	Close supporters	All supporters	All supporters
Operating Reserve	X	X	All supporters	All supporters
Facilities Reserve	X	X	All supporters or close supporters, institutional donors	All supporters
Risk Capital	X	X	All supporters or close supporters, institutional donors	All supporters or close supporters, institutional donors
Endowment	X	Close supporters and broader community	Close supporters and broader community	Close supporters and broader community
Recovery Capital	4 or 5 closest supporters	X	X	X
Change Capital	Close supporters	Close supporters	X	X

Crafting and disseminating the message

- How do these factors – your capitalization stage, the capital funds you require, the funding mechanisms, and your donor/funder audience – shape your internal and external message content?

QUESTIONS?

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