TDC *VISION TO MOMENTUM*

Managing Financial Risk

League of American Orchestras| June 10, 2016

The environment

- Orchestras are facing risks and opportunities that are shared:
  - Shifting demographics
  - Rapidly changing consumption patterns
  - Explosion of choices for leisure time
  - De-emphasis of art in education

The opportunity

- **Shifting demographics**: art creates meaning and allows for shared experiences between and amongst peoples of different ages, points of view and cultural backgrounds
- **Consumption patterns**: the changing subscription model results in more individuals attending
- **Explosion of choices**: people want to be entertained and delighted
- **Education**: there is demand to fill the gap

Orchestras are not capitalized to address these opportunities

- Capitalization is having the cash to do **what** you need to do **when** you need to do it
- It is having the resources to manage risk successfully and take risks when you need to
  - Can you invest in the art and the program?
  - Can you invest in developing and sustaining audience?
  - Can you respond to external forces?

What is getting in the way?

- Talking about the under-capitalization of the arts sector for five years
- While organizational leaders agree about the issue broadly, it is unclear if donors and boards understand the issue or their role in addressing it
- Leaders are often hesitant to address this issue openly because they fear it dampens enthusiasm and support
- Organizations that have been able to move forward have a unified board and staff agreement about the need to capitalize to make change

CAPITALIZATION BASICS

Capitalization is part of an integrated plan

Mission and Vision

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

Market

- Customers
- Donors
- Competition

Resources

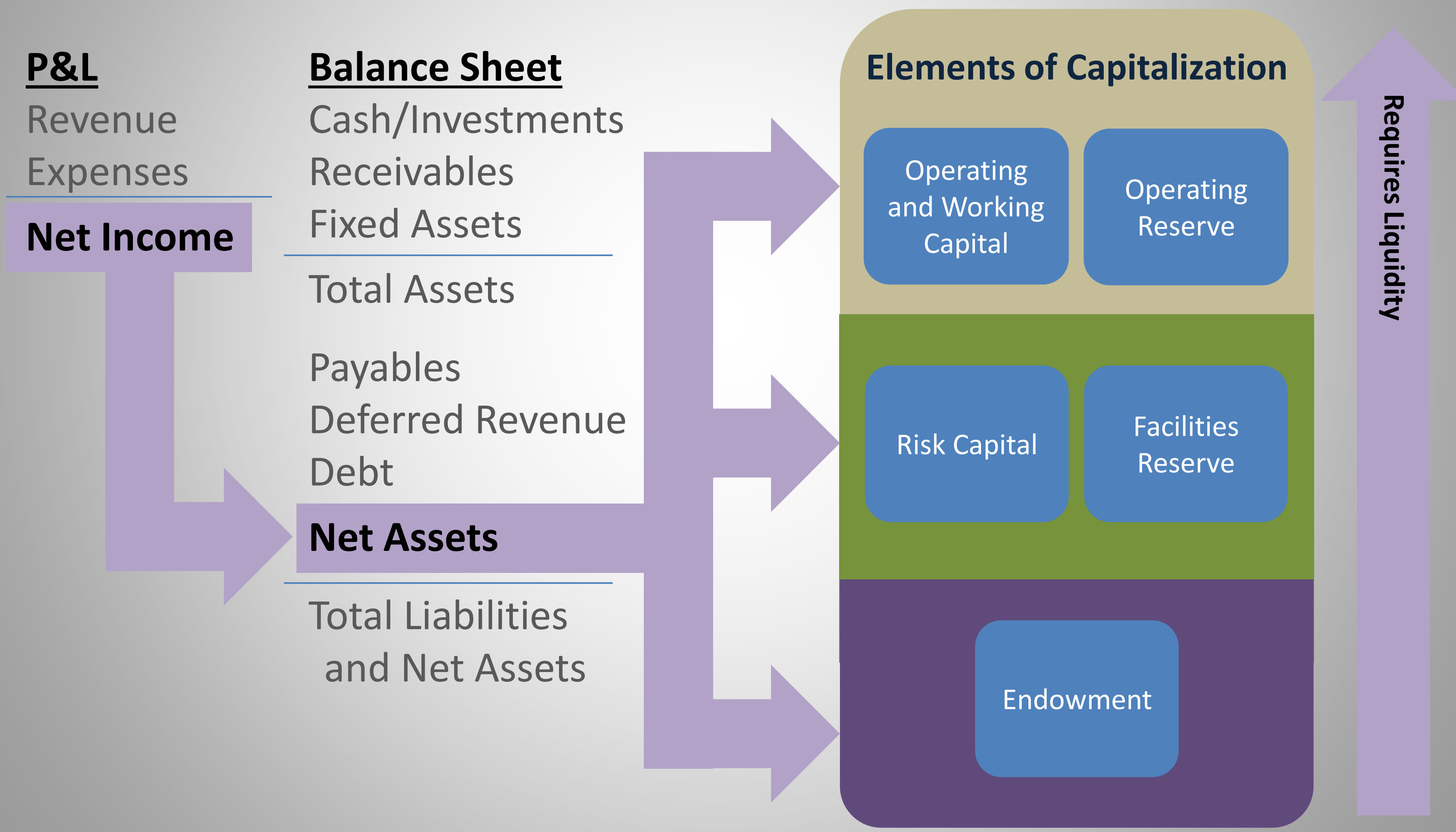
- Talent
- Space
- Networks

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

How well capitalized are you now?



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

What is your capitalization stage?

Recovery

Broken Business Model	Negative URNA	Structural Deficits	Negative Cash

Transition

Weak Operating Model	Thin Balance Sheet	Breakeven or Deficit	<1 Month Cash

Strengthen

Working Operating Model	Thin Balance Sheet	Breakeven or Better	Undercapitalized

Deploy & Maintain

Stable Operating Model	Healthy Balance Sheet	Regular Surpluses	Well capitalized

How should you be capitalized for change?

- The amount of capital you need is dependent on your strategic vision, capitalization stage and your risk profile
- Everyone needs working capital and operating reserves equal to the size and scope of operations
- The amount of risk capital is sized by your risk taking needs
- Some people need extraordinary infusions of capital

YOUR RISK PROFILE IMPACTS YOUR CAPITAL NEEDS

Risk in the context of capitalization

Risk management is about…

- the liquidity and flexibility of your balance sheet, and the role of your reserves in achieving your mission.

Risk taking is about…

- change through thoughtful planning, research and development, and making investments.

Risk aversion is about…

- living in the recovery stage, paralyzed, and unable to think about change…stalled or diminishing vision.
- living in the transition stage, on the cusp, hoping but not knowing if the market is there for you…stalled vision.
- living in the strengthening stage, overly cautious because of the communal memory of scarcity…stalled vision.

Risk in the context of capitalization

Operational Risk	Strategic Risk

Operational Risk

- Program Risk
- External Risk
  - Audiences
  - Funders
  - Shifts in the economy
- Human capital
  - Leadership

RISK MANAGEMENT

Strategic Risk

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

RISK TAKING

Risk management questions

Flexibility and liquidity: operating and facilities reserves

- What are the core expense drivers in which we must continually invest?
  - What is the balance between essential artistic/programmatic costs and fixed costs?
  - What reserves do we need to replenish and when?
- What are the core income drivers, and what is the risk associated with each?
  - How much is artistic risk a part of our business model?
  - How do we account for external forces?

Risk taking questions

Organizational risk, change & recovery capital

- What is the scale of the organizational change that we are undertaking?
  - Small vs. large programmatic risk
    - Could use risk capital but may need change capital
  - Targeted organizational risk
    - Same as above
  - Seismic organizational risk
    - Change or recovery capital
- Is continuous artistic risk part of our mission and vision?
  - Risk capital is part of the ongoing mix of what we need

Risk aversion questions

- Recovery
  - Is our business model working against us?
  - Is what we do relevant and fundable in this market?
  - What capital funds will stabilize us?
- Transition
  - How do we implement changes to our business model?
  - What market testing do we need to do?
- Strengthen/Deploy & Maintain
  - Are we communicating our capital needs clearly enough?
  - Have we identified and sized the risks associated with the projects we wish to undertake?
  - Are our financials clear and policies transparent?

WHAT DOES THIS MEAN?

Are you ready to invest in change?

1. Diagnose your financial condition
2. Understand your strategic position
3. Define your risk management profile and your risk taking needs
4. Confront risk aversion
5. Obtain the right type of capital to make change and take strategic risk

Diagnose your financial condition

Recovery

Broken Business Model	Negative URNA	Structural Deficits	Negative Cash

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Strengthen

Working Operating Model	Thin Balance Sheet	Breakeven or Better	Undercapitalized

Deploy & Maintain

Stable Operating Model	Healthy Balance Sheet	Regular Surpluses	Well capitalized

Diagnose your financial condition

- Do you need recovery capital first? *(Recovery capital pays off past debts, provides interim working capital, and moves unrestricted net assets out of the red)*
  - Are your unrestricted net assets negative?
  - Does it represent greater than 3 months of operating expense?
  - Are you living on others' money?

Diagnose your financial condition

Downtown Symphony Orchestra - Balance Sheet					
	Total	Restricted Funds	Advances & Loans	Fixed Assets	Operations
Cash	1,988,440	520,000	1,448,440		20,000
Accounts receivable	400,000				400,000
Prepaid expenses	120,000				120,000
Total Current Assets	2,508,440	520,000	1,448,440	0	540,000
Buildings & equipment, net	4,160,000			4,160,000	0
Investments	2,500,000	2,500,000			0
Pledges receivable	680,000	680,000			0
Total Assets	9,848,440	3,700,000	1,448,440	4,160,000	540,000
Accounts payable	650,000				650,000
Deferred ticket sales	998,440		998,440		0
Line of credit	450,000		450,000		0
Total Current Liabilities	2,098,440	0	1,448,440	0	650,000
Long-term debt	2,800,000			2,800,000	0
Total Liabilities	4,898,440	0	1,448,440	2,800,000	650,000
Unrestricted net assets	1,000,000			1,360,000	(360,000)
Board-designated net assets	250,000				250,000
Temporarily restricted net assets	1,200,000	1,200,000			0
Permanently restricted net assets	2,500,000	2,500,000			0
Total Net Assets	4,950,000	3,700,000	0	1,360,000	(110,000)
Total Liabilities & Net Assets	9,848,440	3,700,000	1,448,440	4,160,000	540,000

Understand your strategic position

- What are the industry issues you are facing?
- What does your local market look like?
- What programming investments do you need to make?
- What marketing investments do you require?
- Do you need to shift your model?

Understand your strategic position

- Do you need change capital? *(Change capital is required to both test and execute a new business model)*
  - Change requires multi-year investment and the cash to fund the change
  - If you are in any stage beside *Deploy & Maintain*, it is difficult to self-finance change
  - You must be clear that the change you are proposing will ultimately improve your model and not leave you dependent on change capital infusions

Defining your risk profile

- Risk Management
  - Built-in high risk factors require higher levels of operating and facilities reserves:
    - Challenging artistic programs
    - High fixed costs (labor, facilities, etc.)
    - Revenue dependencies
    - Dependence on current leadership
    - Changing local economy
- Risk Taking
  - A strategy that calls for continuous artistic risk taking requires dedicated risk reserves

Confront risk aversion: is your business model broken?

How Do You Know?	What Does It Mean?

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)

The right kind of capital at the right time

Recovery
- Recovery Capital
- Change Capital
- Working Capital

Transition
- Change Capital
- Working Capital
- Endowment (if applicable)

Strengthen
- Working Capital
- Operating Reserve
- Facilities Reserve (if applicable)
- Endowment (if applicable)
- Risk or Opportunity Capital

Deploy & Maintain
- Working Capital
- Operating Reserve
- Facilities Reserve (if applicable)
- Endowment (if applicable)
- Risk or Opportunity Capital

THE PLAYERS

Who needs to be involved?

- Capitalization is a board issue
  - It effects impact and outcomes
  - It is at the core of fiduciary responsibility
  - It grounds strategy
- Successful organizations have board alignment and commitment to the integrated view of program, operations and capital

Summary

- Know where you stand
- Know the difference between a capital and a business model problem
- Diagnose the right capital challenge
- Understand your market
- Understand your risk profile
- Raise the right capital first

Want to learn more?

- Read three stories of arts leaders embracing risk:

http://www.giarts.org/article/capitalization-and-risk