Understanding Your Capitalization Challenge
League of American Orchestras| May 29, 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 agree
- Understanding how to address the challenge at the organizational level is much harder
Agenda

• How to diagnose your specific challenge based on the understanding of your:
  – Strategy
  – Business model
  – Risk profile
  – Where responsibility for the challenge lies
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

Resources
- Talent
- Space
- Networks

Market
- Customers
- Donors
- Competition

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

- **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
Creating a Risk Profile

Operational Risk

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

Strategic Risk

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

RISK MANAGEMENT

RISK TAKING
TYPES OF CAPITAL
How Well Capitalized Are You Now?

**P&L**
- Revenue
- Expenses

**Balance Sheet**
- Cash/Investments
- Receivables
- Fixed Assets
- Total Assets
- Payables
- Deferred Revenue
- Debt
- Total Liabilities and Net Assets

**Net Assets**

**Elements of Capitalization**
- Operating and Working Capital
- Operating Reserve
- Risk Capital
- Facilities Reserve
- Endowment

**Requires Liquidity**
## 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
Debt As Capital

- **Lines of credit** that can be used sporadically
- **Short/mid-term financing** that is supported by a high ratio of pledges
- **Low-cost short/mid-term financing** that can be paid for by the annual operating budget after appropriate reserves have been funded
DIAGNOSING YOUR CHALLENGE
Where You Start Matters

• Is your organization...?  
  – **At risk**: no cash and high debt  
  – **Vulnerable**: no cash  
  – **Sustaining**: some cash  
  – **Stable**: sufficient cash
<table>
<thead>
<tr>
<th>Moving From At Risk to Sustaining</th>
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<tr>
<td>Improving Operating Model</td>
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<td>Negative URNA</td>
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<td>No Cash</td>
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<td>Working Operating Model</td>
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<td>Thin Balance Sheet</td>
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<th>Considering Growth</th>
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<td>Stable Operating Model</td>
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<td>Healthy Balance Sheet</td>
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<td>Regular Surpluses</td>
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<td>Well Capitalized</td>
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<td>Structural Deficits</td>
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<td>Negative Cash</td>
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# Moving From At Risk to Sustaining

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

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
### Research
- Boards struggle to understand why this is important
- Organizations that changed made it a goal and made attendant investments and choices

### Are You Ready To Do This?
- 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
Undercapitalized

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

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

• 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
## Considering Growth

### Research

- 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.

### Are You Ready To Do This?

- 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?

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

- What types of capital should you consider?
  - Resizing the balance sheet appropriately: work 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

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**Sources:**
- Getting Beyond Breakeven, TDC (2009) and Capitalization, Scale and Investment, TDC (2014)
SCALING TO THE MARKET
What Does It Mean to Scale to Market?

• Scale is determined by market relevance
• Market relevance tells you if your business model works and affects your strategy
  – It is tested through the ability to increase net revenue
    • Earned revenue through marketing
    • Unearned revenue through fundraising
More Marketing = More People?

• Scale matters in marketing.
  – Doubling a small marketing budget won’t make a difference.

• Market size matters
  – Increased marketing can outstrip earned income potential.

<table>
<thead>
<tr>
<th>Budget Size</th>
<th>Average Marketing Budget</th>
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<tbody>
<tr>
<td>&lt;$250K</td>
<td>$10,838</td>
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<tr>
<td>$250-500K</td>
<td>$31,964</td>
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<tr>
<td>$500K-1.5M</td>
<td>$68,665</td>
</tr>
<tr>
<td>$1.5-5M</td>
<td>$221,630</td>
</tr>
<tr>
<td>$5-20M</td>
<td>$752,014</td>
</tr>
<tr>
<td>$20M+</td>
<td>$2,928,429</td>
</tr>
</tbody>
</table>

Source: Capitalization, Scale and Investment, TDC (2014)
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.

Source: *Capitalization, Scale and Investment*, TDC (2014)
Marketing Implications

• At the organizational level, marketing investment needs to be based on each organization’s mission, size, market potential, 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.
Fundraising Staff = More Donors?

- Board gifts are leading indicators of individual giving.
  - Individual giving is what drives long term growth
  - Networks matter
  - Smaller organizations may not benefit from major gift officers

<table>
<thead>
<tr>
<th>Budget Size</th>
<th>Average Board Gift</th>
<th>Total Individual Contributions</th>
<th>Total Other Contributions</th>
<th>2011 Average Fundraising Spend</th>
<th>Average Fundraising Efficiency</th>
<th>Efficiency with staff*</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;$250K</td>
<td>$624</td>
<td>$11,643</td>
<td>$53,396</td>
<td>$3,992</td>
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<td>$1.5-5M</td>
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<tr>
<td>$5-20M</td>
<td>$16,821</td>
<td>$3,293,890</td>
<td>$8,377,388</td>
<td>$1,171,678</td>
<td>0.10</td>
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<tr>
<td>&gt;$20M</td>
<td>$72,242</td>
<td>$5,073,962</td>
<td>$17,208,692</td>
<td>$2,199,328</td>
<td>0.10</td>
<td>n/a</td>
</tr>
</tbody>
</table>

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

Source: Capitalization, Scale and Investment, TDC (2014)
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?
  – Is this a Executive Director/Managing Director function? Do I need a Director of Fundraising?

• Larger organizations seeking to diversify an already established donor base require investment in creating new networks before they build staff capacity.
Business Model and Scale

- An honest discussion of net revenue available allows you to understand if you can:
  - Adjust your current business model
    - More focused choices of programs
    - Reconfiguration of organizational model
  - Change the core model
    - Identify new ways to offer your art
    - Create a new organizational model
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 problem and a business model problem
- Diagnose the right capital challenge
- Understand your market
- Understand your risk profile
- Raise the right capital first
- Don’t confuse growth with success
- Do an honest appraisal of net revenue
- Don’t divorce capital from mission, vision and strategy. It IS a board issue.