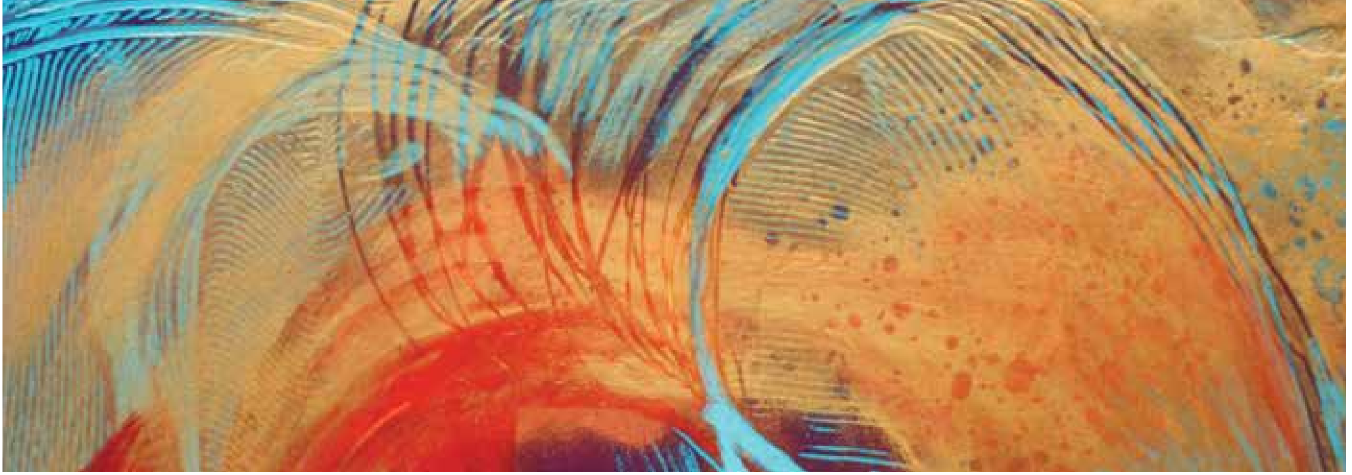

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Capital, Equity, and Looking at Nonprofits as Enterprises

by Clara Miller

***Editors' note:** NPQ considers the practice described here to be a significant development in philanthropy.*

"Enterprise capital," the nonprofit equivalent of for-profit equity capital, is what fuels an organization's rise to the next level of performance. Here, the author outlines how these "equity-like" capital grants work.

THE F. B. HERON FOUNDATION IS AN INVESTOR—a capital investor—in enterprises where we see opportunity for mutually productive social and financial gain. As is the case with most foundations, our work includes nonprofits but is not exclusive to them: we invest across the spectrum of legal forms of organization, in public and private for-profits, governments, cooperatives, nonprofits, and hybrids. Our approach differs from that of most foundations in that *all* our investing is done to further our mission—the typical approach being that only grants to nonprofits are mission focused. We look for opportunities to make a positive difference through the power of finance and enterprise, skillfully deployed. Lately, we have been encouraged that a growing number of our foundation colleagues are finding ways to make the powerful combination of financial tools (debt, equity, grants, performance contracts, and more), enterprises (nonprofits, for-profits, and others), and program savvy work together to further their philanthropic agenda.

There is one particular need, however, that gets little attention, and it falls under the category of grants—and that is a nonprofit equivalent of for-profit equity capital, especially that subdivision of equity that focuses on mid-stage enterprise growth and change. While there exist some notable exceptions—the Edna McConnell Clark Foundation (EMCF), Omidyar Network, New Profit Inc., Venture Philanthropy Partners (VPP), and Nonprofit Finance Fund have done pioneering work in this area—both this kind of capital investing and the analysis, modeling, and structuring of a multi-party "grant deal" that gives the concept integrity are rare.

But this is not for lack of conversation about capital. In fact, for a while now I've been hearing

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a lot of loose talk about capital in the nonprofit sector—loose, in the sense that we use the word "capital" interchangeably with words like "money," "income," "debt," and even "buildings." Hand-wringing about our sector-wide need for "capital"—or even "access to capital"—is invariably accompanied by vigorous head-nodding from all sides. "Lack of capital" is reflexively cited as the sector's final barrier to rapid scaling (of the nirvanic "hockey-stick trajectory" variety). And it has become axiomatic that unleashing untold trillions of dollars from the global capital markets (most of which are evidently panting for nonprofit action) will fix all manner of social ills.

But in our experience, "revenue," or "income," is far more fundamental to enterprise and mission success than capital—preferably reliable, repeatable net revenue. We're talking proceeds of government contracts, reimbursements by third-party payors, sales, net interest, tuition, bingo receipts, dues, ticket sales, annual appeal fundraising, investment earnings, and more. Without it, all bets are off: revenue pays for the operations that deliver goods and services day in and day out. Most businesses—including nonprofits—rely on revenue, not capital, to deliver every day. It's revenue, not capital, that we need to pay rent, salaries, the electric bill, and similar expenses—and without it, we don't have a sustainable business. Capital cannot make up for a permanent lack of net revenue.

So why the flap about capital?

The widely miscast and misunderstood "capital" (particularly "enterprise capital"), while less fundamental than revenue, cradles a growing star performer and takes it to the next level of performance. Lack of capital can sink an enterprise just as it seems to be taking off, even when revenue is pouring in the door.

Planning for, raising, and deploying equity-like capital in a nonprofit fulfills three needs that are universal for a growing or changing enterprise, regardless of tax status: 1) capital *investment*—separate and distinct from regular income, or revenue—when growth or change occurs; 2) the benefits of shared "ownership" and shared risk by a concerted, expanded group of investors and, potentially, supporters; and 3) the adoption of a protective rather than an exploitative role for these stakeholders (aka the equity holders ethic).[1]

Without equity-like behaviors and significant amounts of capital in the form of equity-like capital grants, significant long-term growth in nonprofits is painfully slow, often unsustainable, and frequently accompanied by a reduction in program effectiveness. With this capital, while risk is never absent, it is planned for, managed, and mitigated. The benefits go to the ultimate beneficiaries of the enterprise—where the greatest risk in the nonprofit sector resides—and the Shangri-La of sustainability is at last attainable (or at least understood by all parties, whether attainable or not).

Here's how it works in operation. When any enterprise starts up or grows, it needs both revenue and capital, and, as noted above, the former takes precedence. Beyond regular revenue, owners or managers need at least a bit of capital to set up (or expand, refresh, or improve) the facilities, processes, departments, skill sets, programs, cash reserves, and more that it takes to produce those goods and services in the first place. Capital investment can be as simple and small as a pitcher filled with lemonade, or as complicated and large as oil rigs and barges. And while the platforms built by capital are very different among enterprises, the cash from selling lemonade or selling oil is just the same. Cash is a little like air—everyone breathes the same air, billionaire or foundling, regardless of wealth, body size, planes owned, or trophies accumulated. And when there isn't enough air—or cash—the consequences are the same for all, great and small.

Entrepreneurs get capital to build that "platform" from a variety of sources: at the beginning it may be friends and family, or the well-known approach of "sweat equity" (unpaid labor) bolstered by personal credit cards. Founders of start-ups in both the nonprofit and the for-profit worlds typically use these methods, often combining them with profound resourcefulness.

Later on, when an organization grows, getting financing to build a larger production platform becomes more complicated, and the process of managing growth itself is challenging. At several stages of growth, the enterprise requires additional capital to expand the original setup to meet expanded demand, to make operations more

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efficient, or to create new or improved product or program offerings (or all three!). There is a period—sometimes relatively short, sometimes over years and years—when the enterprise needs to spend capital on expansion before the quantity and reliability of revenue make the enterprise profitable at an expanded or enhanced level of operation. This is because growth typically occurs in a smooth curve, while capacity is built in increments that look more like stair steps, with the investment ideally coming in chunks before the growth (i.e., it's hard to hire one-quarter of a chief financial officer when you need a higher skill level in the finance area). In other words, the enterprise operates at a deficit for a period of time—often years—before it reaches sustainable operations again. If the deficit is temporary, capital investment funds that gap.

Most enterprises, in particular for-profits, use "retained earnings"—essentially savings from profitable operations—to fund growth, especially incremental growth. In the nonprofit world, retained earnings may be unavailable due to emaciated operating margins (i.e., no profits), and are generally frowned upon by funders (i.e., if you already have money, why are we funding you?). So when retained earnings aren't available, sometimes debt can bridge the financial gap, funding expansion of the platform before positive net revenue kicks in.

Debt is sometimes the answer. An enterprise with highly reliable revenue may borrow to pay for expansion ahead of revenue (think nursing homes with approved slots and the revenue that goes with them). But debt has its limits as a source of growth capital. "Reliable revenue" and "smooth growth" leave out many important organizations. Reliability of anything is scarce for organizations that are innovative. And in the nonprofit sector, those providing preventive services or doing advocacy outside an institutional setting have the risk factor of a predictably "sometimes" funding base. For them, the growth trajectory is too unsettled and the path is too obscure to use debt to finance growth, since most loans rely on a fixed schedule of payments over time.

When debt and sweat equity won't do it, where the principals simply lack needed skills, or where loans aren't appropriate for the level of operating uncertainty or scantiness of operating margins implied by growth, owners of many for-profit businesses sell ownership shares, called "equity," in their companies. Equity isn't repaid on a schedule, as is debt, but equity shares (representing ownership of a part of the company) can be sold for a profit by the investor when the company becomes profitable, grows, and the shares increase in value. The company's owners and managers invest the cash proceeds from selling these shares in an enhanced operating platform (capacity), ideally attracting more net revenue that produces more value for both the customers and themselves. Moreover, the larger group of investors/stakeholders takes on the role of assisting in the enterprise's success by helping to attract market share, expand business relationships, or provide coaching. Capital comes in social and intellectual, as well as financial, form. The interests of all owners are aligned: everyone wants growth—but healthy growth—so shares will increase in value over time. Equity holders want to protect the enterprise from overexploitation so it can survive and thrive.

This fund raise—or selling of more equity shares—may happen several times periodically over the life of an enterprise. Sometimes, business is so good that the private shareholders sell their shares to the public—through an initial public offering (IPO)—and the company becomes a "public company," but that's later!

Equity in this form is unavailable to nonprofits, in part because by law nobody can own or directly profit from a nonprofit enterprise, so technically there are no owners. Nonetheless, nonprofits' non-debt growth financing needs remain. Without access to some form of equity-like capital, nonprofits are pretty much sentenced to difficult, unhealthy, or slow growth. Beyond money, they lack supporters who take the protective role of the equity holder, even among board members. Everyone wants the nonprofit to do more, especially when opportunity knocks and additional revenue pours in, and the organization struggles with extreme pressure, given a too-small production capacity (think Disney's masterpiece, the cartoon *The Sorcerer's Apprentice*, where the

Sorcerer's broom enacts ever-increasing demand giving rise to out-of-control operations in the hands of an inadequate head count and skill set!). When intractable problems emerge in the face of success, it's confusing to many nonprofits and their supporters, who view increased revenue as growth, and think, "Mission accomplished—we're having more impact."

Sadly, the highest-performing and most promising organizations are the most vulnerable to severe growing pains, simply because they're opportunistic and successful, and find more and more ways to grow. Their success means they are the ones most likely to attract more revenue—restricted grants, a dizzying array of government contracts, project funding, an expanded list of willing individual givers. If it's like most revenue in the nonprofit world, it doesn't cover the fully loaded cost of operations, much less the cost of growth. And in the absence of equity capital to expand the systems and head count that can serve this heightened demand, retool systems to gain efficiency, and manage a more complex revenue mix, promising projects will not be sustainable, contracts will go unbilled and sometimes unfulfilled, and willing funders will languish unapproached and unstewarded—to name just a few sets of unintended consequences. What seemed like a slam dunk suddenly becomes a nightmare of cash-flow crises, abrupt resignations, internecine board-staff conflicts, and plummeting program results.

In the face of growth without enterprise capital, all enterprises—including, but not exclusively, nonprofits—use other means to "fund" capital needs in response to demand: overexploitation of human capital (i.e., long hours, stagnant pay, reduced benefits, more part-timers and unpaid interns); a slowing of bill payments, evidenced by higher payables and, sometimes, "evergreen" lines of credit; breathless and understaffed operations and poorly maintained facilities; and, worst of all, deteriorating program and product quality.

Enter a philanthropic form of equity, which we call "enterprise capital grants," and which we (and some of our colleagues named above)

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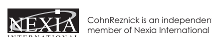
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— Nonprofit Quarterly/NPQ 3/1/2013

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Just as it does for its for-profit cousins, enterprise capital allows growing nonprofits to plan for and pay the inevitable deficits incurred on the way to reaching and maintaining an enhanced and durable level of operations.

consider the heart of our grantmaking. Just as in the for-profit world, these grants, ideally raised in a capital campaign–style concerted effort, acknowledge the need for the heightened amount of investment that accompanies program-focused revenue growth. Just as it does for its for-profit cousins, enterprise capital allows growing nonprofits to plan for and pay the inevitable deficits incurred on the way to reaching and maintaining an enhanced and durable level of operations. And, finally, providers of growth capital, along with the managers and boards of the organizations involved, together acknowledge that growth is risky and that they play a protective role—not only for the enterprise but also, and more importantly, for the ultimate risk takers: the beneficiaries and causes everyone hopes to serve.

While some funders instinctively understand the need for equity-like capital grants (small bits are often labeled "capacity building"), these grants frequently target only one part of operations—the computer system or staff training or board development. The reality is that a growing nonprofit needs relatively large amounts of capital to build an expanded operating platform. This more muscular platform, in turn, reliably attracts more net revenue—including but not confined to fundraising income—and eventually makes these and other expanded capacities part of ongoing operations. An occasional lucky grant for capacity building won't suffice.

The funders mentioned above—EMCF, Omidyar Network, New Profit, and VPP—have had experience providing these growth funds, in concerted campaigns, to individual promising organizations or to "anchors" of local neighborhoods. And while there's much more to learn (and they are the first to say so), we can see some lessons emerging.

Even if you aren't going to be a capital funder (and remember, revenue is more important, so being a good general-support funder is important too), identifying the warning signs of uncapitalized growth and making sure the growth of organizations that serve the people and causes you care about is fully capitalized is critical. Here are some ideas on ways for foundations and givers to proceed:

- **Make sure that growth and sustained change of any kind is capitalized fully.** Otherwise, continue to fund the great programs and services you love so much with regular revenue. Don't provide or use regular revenue to fund growth, unless it's retained earnings from net revenue (and if it is, congratulations!).
- **Make sure that any strategic plans you fund include a rigorous business section.** This must include a competitive analysis of the market; sources of revenue, with projections; and projections of increased operating costs, both structural and marginal, for an expanded organization. In my opinion, it is consulting malpractice to posit a "BHAG"-type strategy with no numbers.[2]
- **Require operating projections and regular financial reporting that separate operating revenue from capital investments on both the income and expense side.** Confusing regular revenue with capital—which is further complicated by "project grants," which are somewhere in the unhelpful middle—is at the heart of much confusion about finances and overly sunny expectations of growth and financial performance.
- **Remember that when revenue grows significantly, capital will be required.** This is counterintuitive: give or get *more*—not less—in the form of growth capital to organizations that you think are great and that are taking on growth. If they get more revenue from others but don't have capital to build the "factory" in order to execute well, then they need you more than ever. Don't stop revenue to give capital—they need both if they are going to grow.
- **Know your financial role, beyond deep program knowledge.** Are you a buyer (paying for program delivery) or a builder (building additional delivery capacity)? You can be both, but paying marginal prices for delivery of additional programming without building capacity to support it will simply shift the unfunded cost to others, or leave it unaddressed. It won't go away, and it will probably do harm to your favorite organizations and, most importantly, their beneficiaries.

- **Find buddies to fund capital campaigns with you for organizations you care about.** There is a reason that classic capital campaigns, most of which target only buildings or endowments, require a multi-party, multi-year fundraising effort. Few foundations make grants big enough, on average, to get a small or midsize organization up a three-to-five-year growth curve. Per the Foundation Center, average grant size for all subject categories was just shy of $166,000, and the median was $28,462. For human service organizations, this was even lower (and the lowest for any category): $86,433 average and $25,000 median.[3] The math is instructive: even the largest grant available from most foundations won't suffice. Midsize high performers will need in the tens of millions of investment capital to truly maintain quality and create sustainability as growth occurs.

Notes

1. See George M. Overholser, *Nonprofit Growth Capital: Defining, Measuring and Managing Growth Capital in Nonprofit Enterprises; Part One: Building Is Not Buying* (New York: Nonprofit Finance Fund, 2005), nonprofitfinancefund.org/files/docs/2010/BuildingIsNotBuying.pdf, for a clear and thoughtful description of the difference between the exploitative role of a buyer and the more protective role of the "builder" (i.e., equity investor) in enterprise finance, including its importance to funders of nonprofits. The author also wrote about this in "The Equity Capital Gap," *Stanford Social Innovation Review* (Summer 2008), www.ssireview.org/articles/entry/the_equity_capital_gap.
2. BHAG: Big Hairy Audacious Goal.
3. The Foundation Center's Statistical Information Service, "Average and Median Grant Amounts by Major Subject Categories, circa 2011" (New York: The Foundation Center, 2013), foundationcenter.org/findfunders/statistics/pdf/04_fund_sub/2011/avg_sub_11.pdf.

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