ADVISORY BOARD for the ARTS

Transforming Arts Organizations Worldwide

Overview of Arts Organization Capitalization Needs

Primer for the Board, Funders and Other Stakeholders

Our Research Approach

The Research Questions

How much and what kind of arts capitalization are appropriate for arts organizations?

What rules of thumb exist for capitalization levels for arts organizations, especially for endowments?

To answer the questions, we examined a broad range of literature and video about capitalization and funding from within the arts and culture field and across the non-profit world. We organized the different types of capitalization discussed into a taxonomy of types in order to provide a picture of the types and amounts of capital that would constitute a well-capitalized arts organization. We then examined the amount of capitalization that arts organizations have today, both overall and of various types. Finally, we distilled advice from (and debate among) experts about how to think about capitalization in cash-lean times such as many arts organizations are facing right now.

Source: Advisory Board for the Arts (ABA) research.

The State of Arts Capitalization

Background

The pandemic has brought new attention to the precarious capital positions of many arts organizations. As is typical with economic disruptions, those who entered the pandemic in the most tenuous financial positions have struggled the most and will have the most difficulty exiting the period and returning to health.

The capitalization challenges many arts and culture organizations are now facing now are reminiscent of those coming out of the Great recession. In fact, in the wake of that downturn, several foundations* funded research to:

- Understand the financial literacy of arts organizations
- Determine the sufficiency of their capital positions, and
- Assess appropriate capitalization levels given arts-organization risk profiles

The research concluded that, while financial literacy was generally strong, capitalization levels were woefully insufficient. For example, most arts organizations had much less cash on hand than the four-month minimum that most experts recommend.

A decade later, capitalization had not improved. As the pandemic hit, arts organizations on average found themselves in worse capital positions than when they entered the 2008 downturn. That raises the question: if both arts organizations and funders understand their inadequate capital situations, why do the capital positions remain so precarious?

* See *National Capitalization Project* in “Further Reading”

Why Capital Positions Remain Weak

At a macro level, insufficient arts-focused capital exists to fully fund the capital needs of all potential recipients. Four possible reasons explain why donors do not invest more to improve arts organization capital positions. Some funders…

- … are not aware of the full range of capital needs that arts organizations have.
- … prefer to fund high-profile programs or projects rather than overhead.
- … have concern about the ability or discipline of recipients to use capital funds in the way they are intended.
- … are concerned that underlying business models may not be stable enough to warrant funding

Organizational leaders report that they have a hard time asking funders for more capital out of concern that expressing their full capital needs will be interpreted as weakness. After all, should a thriving, well-managed arts organization need to set aside large cash reserves to protect against stumbles?

The Occasion Presented by the Pandemic

As the pandemic abates, many arts organizations report a concerning financial picture, including projected deficit budgets for the upcoming fiscal year. Without capital infusions, the next few years may see the closure of large numbers of arts organizations that have, until recently, been kept afloat by massive government intervention.

The second existential threat to arts organizations in a dozen years provides a reasonable occasion for renewed dialogue between arts leaders and funders about correct capitalization levels. This briefing is intended to inform those discussions.

Source: ABA research.

Overview of This Briefing

Purpose of This Briefing

This briefing provides an overview of capitalization types, capitalization levels, and advice from experts about appropriate levels for organizations in the arts and culture sector. The report has three related purposes:

- To educate arts and culture stakeholders, including non-financially trained board members, about the types and amount of capital needed by arts organizations.
- To inform conversations with funders about the need to improve capitalization of arts organizations.
- To provide guidance about the appropriate amount of various types of capital organizations should accumulate.

What is 'Capital?'

Capital refers to financial assets an organization needs to support achievement of its mission over time.* It's not just how much capital an organization has, but what kinds of capital it has that determines how well positioned it is to manage the risks it faces. In addition to cash to cover ongoing, predictable expenses, healthy organizations need capital to fund expenses that are out of sync with income (e.g., productions whose expenses precede revenues, occasional roof replacement) , to protect against unexpected shocks and to fund experimentation and transformational change without risking core operations.

Why It Matters

Everyone knows capital is important. Organizations with more can do more, can execute and even expand their missions to new places. Most urgently, when organizations lack sufficient capital, their executives are compelled to spend time raising funds at just the moments when they should be focused on leading through crisis. Well-capitalized arts organizations fared better in the early months of the pandemic and are exiting in much stronger positions than their peers.

Poor capitalization can also place unnecessary stress on staff and reduce artistic innovation. Organizations that feel one 'flop' away from failure are more likely to play it safe in terms of programming.

What This Briefing Will Cover

This report comprises five parts:

1. A high-level summary of current capitalization levels for arts and culture organizations
2. A description of different kinds of capital, and an assessment of the prevalence of each type, according to capitalization experts
3. Advice from experts on rules of thumb for healthy capitalization and capital priorities when tradeoffs must be made
4. Advice from experts on the size of endowments and whether endowment funding is a worthwhile pursuit right now
5. Final thoughts on capitalization and the sustainability of the arts business model

* Adapted from TDC. See "further reading."

Source: ABA research.

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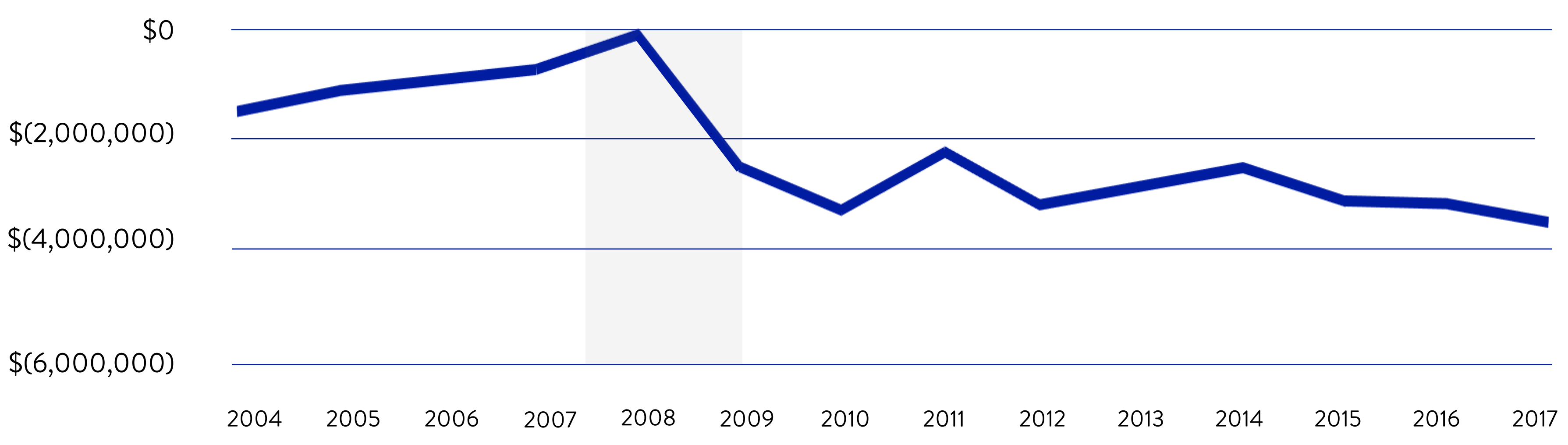
A Look at Capital Liquidity in the Years after the Great Recession

Working Capital, Operating Reserves, and Capital Replacement Reserves require liquid, unrestricted assets. Arts organizations have long struggled to maintain adequate liquidity, a situation made worse by the Great Recession. The graphic below shows the impact of the Recession on liquid unrestricted net assets among a group of 75 theatres benchmarked over time by SMU DataArts. These data are in-line with trends from other arts genres. As a result, going into the pandemic, arts organizations were substantially more cash-strapped than they were going into the Great Recession. Furthermore, the complete stoppage of in-person programming imposed by the pandemic, together with new factors such as inflation, rising costs for talent and soft audience-return, are creating a budget environment in which liquidity challenges for many will be substantially worse than ever before.

Average Liquid Unrestricted Net Assets—Theatres
*2004-2017**



"Worsening negative working capital is a major cause of concern and a threat to the field's future viability. Theatres added infrastructure but now have little financial flexibility should they face another economic downturn."

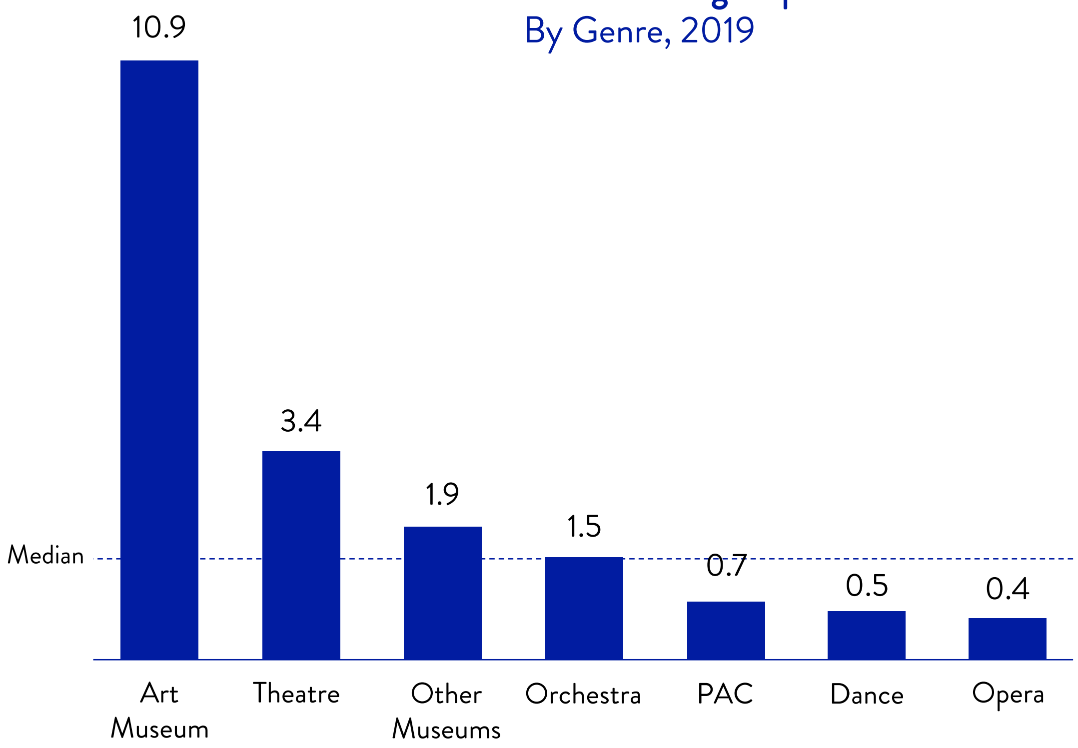
* Inflation-adjusted averages for 75 theatres

Source: Theatres at a Crossroads: Overcoming Downtrends & Protecting Your Organization Through Future Downturns, by Zannie Voss, Manuael Lasaga, and Teresa Eyring, SMU DataArts. https://files.constantcontact.com/3c959b8a701/19e0338a-52ca-4760-94a3-70917c9145f8.pdf

Most Organizations Have Less Than Three Months of Working Capital

By 2019, working capital levels had declined to very low levels in performing arts organizations. Among cultural organizations, only museums had to comfortably smooth out cash flow bumps arising from predictable business cycles. On average, arts and culture organizations had only about a month and a half of working capital on hand, a number that was inflated by museums, who on average held about 11 months of working capital on hand. These low working-capital levels put organizations in terrible cash positions heading into the pandemic. Only government support and exceptionally generous donors kept many organizations afloat. If working capital levels decline coming out of the pandemic as they did coming out of the Great recession, arts organizations will have major liquidity challenges going forward.

Months of Working Capital
By Genre, 2019



$$\text{Months of Working Capital} = \frac{\text{Unrestricted Net Assets} - \text{Current Liabilities}}{12}$$

Most arts organizations lack the cash to last for even a couple of months needed to find emergency funding in the case of a disruption, not to mention true “rainy day” reserves or set-asides for long-term facilities maintenance.

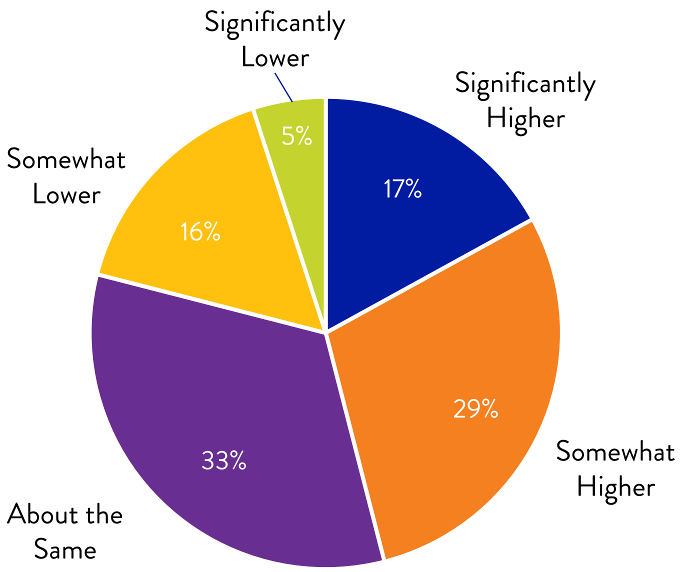
Source: SMU DataArts 2019 Arts Working Capital Report. https://culturaldata.org/reports/working-capital/key-takeaways/; https://culturaldata.org/media/2345/dataartsbufferingagainstuncertainty_35.pdf

Nearly Half of Organizations Anticipate a Budget Deficit Next Year

The capital shortage is placing many arts organizations into precarious financial positions as they emerge from the pandemic. In April of 2022, nearly 50% or organizations anticipated that their organizations will experience deficit budgets for the next fiscal year budget. All this is occurring at a time when capitalization experts recommend that organizations need to be running surpluses in order to replenish “rainy day” funds and rebuild other depleted funds.

Change in Next Year’s Budget

Compared to Most Recent Pre-Pandemic Budget



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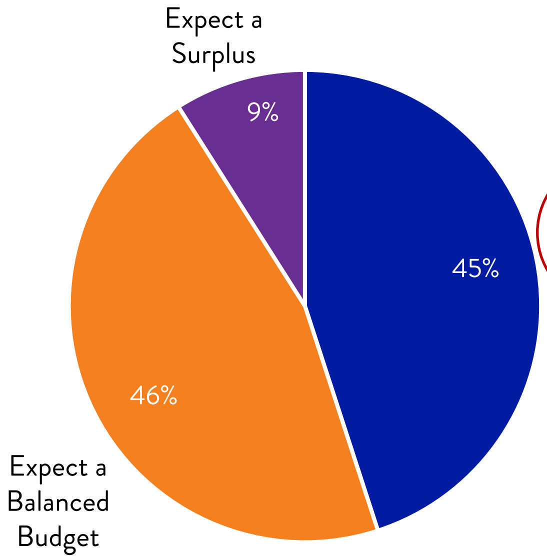
Expectation for Next Year’s Budget



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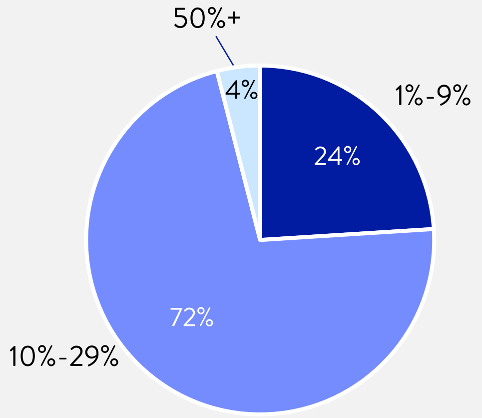
Size of Deficit

As a Percentage of Operating Budget



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Source: ABA Polls of arts leaders.

While Capital Positions Worse, Risks Are Up

The weakened capital positions of many arts organizations is coming at a time when the operating environment is becoming riskier. The purpose of capital is help organizations manage both operating risks (e.g., external shocks, operational challenges) as well as strategic risks (product experimentation, largescale organizational change), it is in shorter supply at a time when it is likely to be needed more than ever.

Earned Income	Contributed Income	Health of Economy	Community Reputation	Open Positions	Staff Pressure	Higher Costs
Strong possibility that audiences will come back slowly and that some will never return. Near term risk may be compounded by possible longer-term trend away from arts attendance among younger generations.	Some foundations and individual donors turning their attention to safety net and social justice issues	Strong possibility that audiences will come back slowly and that some will never return	Perception of social safety net and social justice causes on the rise relative to the arts as crucial contributors to the community	Strong possibility that audiences will come back slowly and that some will never return	Demanding that orgs walk the walk on social justice Changes to schedule to relieve over-work	Staff Inflation Health and safety/COVID related Social justice Digital

Source: ABA; Adapted from TDC.

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Types of Capital and Their Prevalence in the Arts

This page names the three purposes of arts capital, describes the main types of capital that arts organizations need, and characterizes their prevalence in arts and culture organizations. Some capital is needed to maintain existing operations. Income from audiences/visitors does not usually provide sufficient operating capital, and donors often prefer that their contributions fund something more 'permanent' than day-to-day operations. As a result, many arts and culture organizations are chronically low on operating capital. In addition to operations, capital is needed to preserve the organization and its assets over time. For organizations with their own facilities, this includes annual set-asides (Capital Replacement Reserves) for large expenses that occur every few years. Cash strapped organizations find it hard to set aside funds, so, in many organizations, these reserves are underfunded or non-existent. And finally, capital may be needed to protect o organizations taking strategic risks that will enable growth or change. Capital allows organizations to experiment with programming, product, and experience innovations without worrying about loss of near term audiences. In some cases, organizations may decide they need to change the fundamental operating model, and Change Capital may be needed to fund the transformation.

The Question

What financial resources does an organization need to deliver its mission efficiently and effectively?

OPERATING EXISTING PROGRAMS

1 Working Capital Fund
Smooths cash flow bumps arising from predictable business cycles (e.g., seasonal)

TYPICALLY UNDER-FUNDED

2 Operating Reserve
Protects against operational disruption due to unexpected downturns (i.e., "rainy days)

RARELY EXISTS

PRESERVING WHAT EXISTS

3 Capital Replacement Reserve
Funds long-term facilities replacement plans (e.g., new roof every 25 years)

EXISTS INCONSISTENTLY;
OFTEN UNDERFUNDED

5 Endowment
Provides stable funding for ongoing costs using earnings from investments

TYPICALLY LESS THAN 2X
OPERATING BUDGET

CHANGING WHAT EXISTS

4 Opportunity Capital
Provides funding for new ideas (e.g., program innovation, audience development) needed to fuel growth within the existing model

RARELY EXISTS

6 Change Capital
Provides funding to transform the business model (e.g., years of audience decline)

SOMETIMES EXISTS AS PART
OF A STRATEGIC PLAN

Source: Getting Beyond Breakeven: *A Review of Capitalization Needs and Challenges of Philadelphia-Area Arts and Culture Organizations*, TDC, commissioned by The Pew Charitable Trusts and the William Penn Foundation; ABA analysis.

Overview of Arts Capital Accumulation and Replenishment

	1 Working Capital Fund	2 Capital Replacement Reserve	3 Operating Reserve	4 Opportunity Capital	5 Endowment Fund	6 Change Capital
WHAT IS IT	Smooths cash flow bumps arising from predictable business cycles	Funds long-term facilities replacement plans (e.g., new roof every 25 years)	Protects against operational disruption due to unexpected downturns (i.e., rainy days)	Funds new program/audience innovation needed to fuel growth within the existing model	Provides stable funding for ongoing costs using earnings from investments.	Provides funding to transform the business model (e.g., years of audience decline)
STATUS IN THE ARTS	Typically under-funded	Exists inconsistently; often underfunded	Rarely exists	Rarely exists	Typically less than 2X operating budget	Sometimes exists as part of strategic planning process
HOW TO ACCUMULATE	Build into normal budgeting process; initial funding could come from donor effort	Fund annually with 1/20th of the 20 year forecast for replacement of large capital items (or whatever long-term capital forecast term you use.	Raise funds to fill fund to a level equal to the average budget disruption over the past 10 years.	Fund as part of normal budgeting process; initial funding could come from donor effort	Include endowment as part of capital campaign and/or seed from philanthropists closest to the organization.	Fundraise specifically to reduce risk during a period of significant transition or transformation.
WHEN TO SPEND	During clearly defined periods as part of the regular operating cycle when costs are accrued before revenue is made	Any time items on the long-term-capital forecast require replacement	During unplanned earned- or contributed-income disruptions that cannot immediately be offset by budget cuts.	Spend on an ongoing basis, documenting learning to incorporate into future experiments.	Spend as part of normal operations. If funds are not needed, consider drawing them to fund other capital needs.	Spend during transition on resources that will reduce risk or economic disruption.
DECISION FACTORS	Based on experience, is it clear when we'll receive revenues that will offset spending from the Working Capital Fund?	Is the expense on the long-term capital expenditure forecast? If not, have we updated the forecast?	If the fund is regularly tapped for controllable reasons (e.g., revenue underperformance) , consider changes to the operating model or to personnel.	Do we know exactly we want to learn with each experiment? Are we getting better over time at building successful experiments?	Are we financially stable enough that we can afford to restrict funds in an endowment rather than using them to fund current operations?	Does this transition put revenue at risk? How much time do we need to buy ourselves to experiment enough to 'get it right?'
HOW TO REPLENISH	Replenish from normal operating revenues or, in the case of unmet revenue goals, from the *Operating Reserve*.	If capital expenses in a given year exceed the amount in the Reserve, consider 'borrowing' from the Operating Reserve with a commitment to repay.	Replenish ASAP after tapping the fund to a level equal to at least three months of operating funds.	Replenish from normal operating revenues. Occasionally may require 'topping off' if experiments don't pay off immediately.	If invested wisely, it should not need replenishing?	No need to replenish unless organization has underestimated resources required for transformation.

Source: ABA Analysis.

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Capital Needs for Arts Organizations—Factors To Consider

	1 Working Capital Fund	2 Operating Reserve	3 Capital Replacement Reserve	4 Opportunity Capital	5 Endowment Fund	6 Change Capital
WHAT IS IT	Smooths cash flow bumps arising from predictable business cycles	Funds long-term facilities replacement plans (e.g., new roof every 25 years)	Protects against operational disruption due to unexpected downturns (i.e., rainy days)	Funds new program/audience innovation needed to fuel growth within the existing model	Provides stable funding for ongoing costs using earnings from investments.	Provides funding to transform the business model (e.g., years of audience decline)
FACTORS TO CONSIDER WHEN THINKING ABOUT AMOUNT OF CAPITAL	Size of expenses that predictably occur before earned revenue Length of time between expense outlay and revenue Amount of other undesignated income (e.g., contributed) typically received in the same period	Size of operating budget Percentage of costs that are fixed (e.g., facility) or semi-fixed (e.g., contracted staff) Size and duration of disruptions for past 20 years Time required to cut semi-fixed expenses	Twenty-year capital-replacement forecast (projected cost of capital items requiring replacement in next 20 years) Age of capital assets (which is related to likelihood of "surprise" expenses) Pace of capital improvement in genre/sector (e.g., sound systems)	Amount of risk implied in the mission (e.g., programming that advances the artform) Stability of the business model Maturity of organization's innovation/test-and-learn capability Audience stability Business model stability	Presence of high-capacity donors with interest in building long-term stability of the organization Business model stability Importance of signal value of endowment to foundations and community partners	Stability of the business model Stability of audiences/visitors Turnover of key talent Certainty around change destination Quantitative understanding of market
RULES OF THUMB	None. Depends on organization-specific operating cycles.	From organizations that have commissioned analysis of operating reserves, the minimum we've heard is **three months** of operating cash.	None. Depends on condition of organization-specific physical assets.	A set-aside of **at least $100,000** is the floor for an organization that claims to be 'funding product experimentation.'	Endowment should be **at least 4X operating budget** (capable of providing 20% of operating budget) to receive adequate investment attention and beat inflation.	None. Depends on assessment of magnitude and certainty around needed organizational change.
ADVICE	Example: One $8.5 million symphony said, "If we don't have $4 million set aside at the beginning of the year, we shouldn't do the year." That's their Working Capital requirement.	Operating reserves don't *have* to cover all revenue lost during disruptions, but they should provide breathing room to stabilize the organization, make thoughtful cuts and source contributions without panicking.	Get expert advice on projected capital expenses over 20 years and set aside 1/20th of those expenses each year. Revise capital-replacement forecast every three years and adjust set aside.	Organizations without much experience should think about funding as building innovation capability in house as much as they think about trying to get return from individual experiments.	If there's no path to an endowment that is 4X operating budget (with an income stream equal to 20% of operating budget), it's likely that organizational stability is better served by using funds for more immediate capital needs.	Raising "Change Capital" requires that the organization acknowledge that the current business model is not working and that a new business model is required in order to maintain organizational viability.

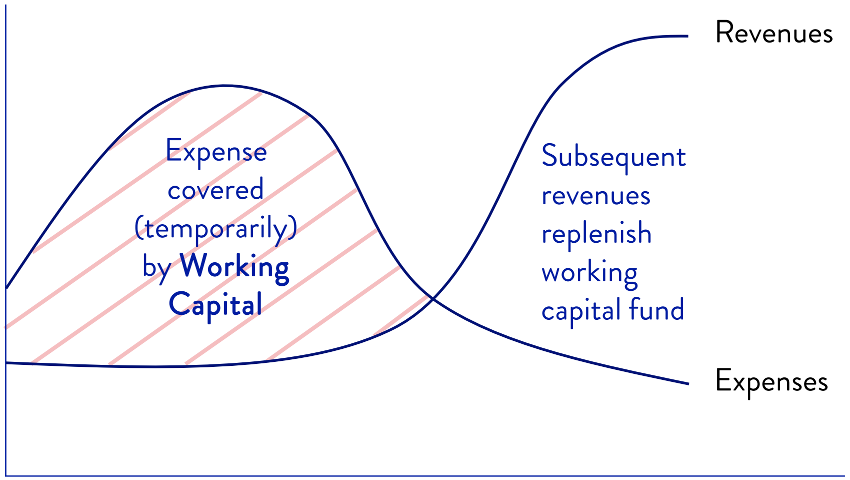
Source: ABA Analysis.

1 An Overview of Working Capital

Working Capital is money used to pay for costs that occur in advance of revenues as part of predictable business cycles (e.g., seasonal revenue, expenses for productions or exhibitions that occur in advance of revenue).

Prevalence in Arts Organizations: Exists in most organizations, but **typically underfunded**.

Illustration of Working Capital



How Much Working Capital Do Organizations Need?

The amount of working capital an organization needs depends heavily on its business model. A festival, for example, has expenses year round but may earn most of its income in just two months. Calculating the amount of Working Capital needed is straightforward, requiring an analysis of historical patterns annual budget cycle is straightforward.

How and When Do You Replenish Working Capital?

Barring unusual circumstances (e.g., the failure of a show), income from normal operations should replenish the Working Capital Fund in the same budget cycle in which it is spent. Therefore, a one-time capital infusion should be sufficient to fund an organization's Working Capital needs.

What Happens When Organizations Don't Have Enough Working Capital?

One of three things happen to organizations with insufficient working capital:

- They borrow, using credit that may be needed in an emergency and sending a message to funders about the organization's financial discipline.
- They approach donors with last-minute requests for temporary funds, which can be annoying and "burn" favors unnecessarily
- They delay payments to creditors (and sometimes to staff)

These consequences can be expensive, stressful, and distract from mission fulfillment.

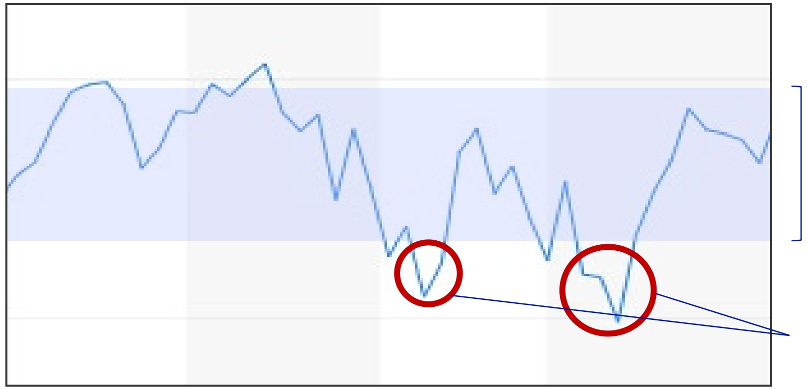
② An Overview of Operating Reserves

Operating Reserves are the proverbial 'rainy day' fund for arts organizations. They may be used to cover externally driven shocks (e.g., pandemic, recession) or organization-specific issues (e.g., programming flops, major-donor departure, unexpected legal expenses).

To serve its risk-hedging purpose, it must be liquid, unrestricted and untouched as part of normal operations. It's important for the board and leadership to agree on what warrants tapping into Operating Reserves (versus finding money elsewhere in the operating budget).

Prevalence in Arts Organizations: Rarely exists. Typically, organizations raise capital quickly just after a shock occurs.

Illustration of Operating Reserves



How Much Money Should Organizations Hold in Operating Reserves?

Experts advise non-profits hold between 3 and 6 months of operating budget in reserve, with some advising significantly higher levels. Determining the right Operating Reserve should include an analysis of the frequency, duration and intensity of past shocks as well as an assessment of any organization-specific issues that might add to the risk of unexpected shortfalls (e.g., new leadership). Virtually every organization should have *at least* three months of working capital on hand as a buffer.

In practice, few arts organizations hold Operating Reserves at those levels. **At a very minimum, experts advise holding enough in reserve so that, in the early stages, leadership can focus on actions to manage through the disruption competently** rather than focusing on raising emergency cash.

How and When Do You Replenish Operating Reserves?

Ideally, Operating Reserves are built up over time from operating surpluses and replenished through those surpluses. In practice, many arts organizations do not have operating surpluses, so should replenish Operating Reserves as soon as is prudent through fundraising.

What Happens When Operating Reserves Are Insufficient?

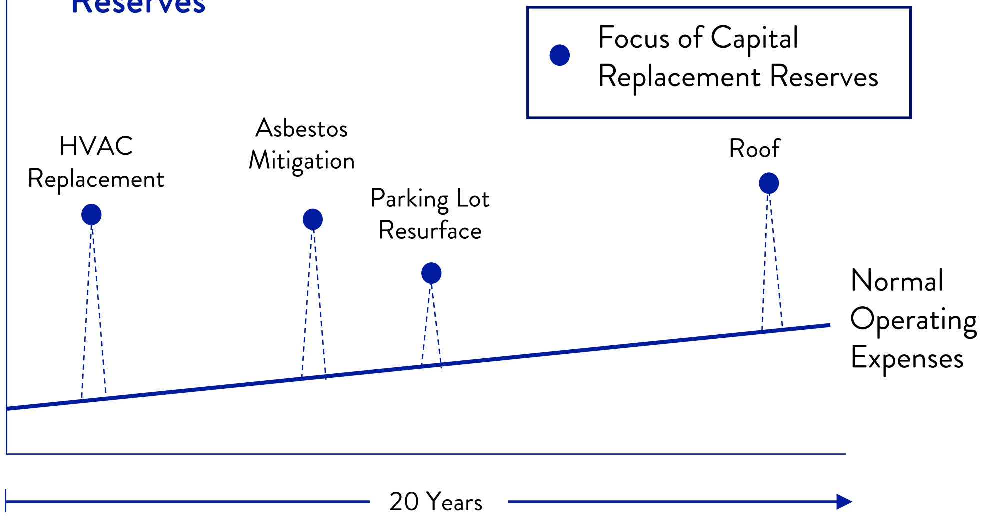
Beyond the immediate risk to operations, organizations with insufficient Operating Reserves face reputational damage with donors (emergency requests for funds), audiences (canceled programming)and suppliers (defaults, missed payments), as well as, ultimately, threat of permanent closure.

❸ An Overview of Capital Replacement Reserves

Capital Replacement Reserves fund major repairs, upgrades and replacement of items (e.g., roof, HVAC, parking lot resurfacing) that wear out more quickly than the capital assets of which they are apart While these expenses occur irregularly, it's possible to predict and fund them over time.

Prevalence in Arts Organizations: Presence is inconsistent and, where it does exist, is **often underfunded.** Rather than set aside funds over time, organizations often borrow funds or raise capital for major capital replacement as needs arises.

Illustration of Capital Replacement Reserves



How Big Should the Capital Replacement Reserve Be?

The size of the Capital Replacement Reserve Fund depends on the value and age of capital assets—usually facilities—owned by an arts organization. Inspection of capital assets provide the basis for a long-term capital replacement plan that includes large, irregular expenses that fall outside of routine maintenance over an extended period (e.g., 20 years). It's important that the Reserve be used to fund only items on the capital replacement plan, or funds will be drained before those expenses occur.

How and When Do You Replenish the Capital Replacement Reserve?

Ideally, money for the Capital Replacement Reserve should be included as part of the capital campaign for new, large capital items, such as new performance space. In practice, this rarely occurs. Organizations should fund the Capital Replacement reserve through annual budget set-asides equal to the annualized cost of items on the capital replacement plan. If new capital replacement items are identified, annual budget set-asides should be adjusted accordingly.

What Happens if the Replacement Reserve Is Insufficient?

When organizations don't set aside reserves for capital replacement, they must either borrow money or ask donors in the moment to fund them. They may also defer maintenance, leading to higher risk of unexpected expenses (e.g., roof leak), capability degradation (e.g., aging sound system) and audience experience (e.g., rundown facility).

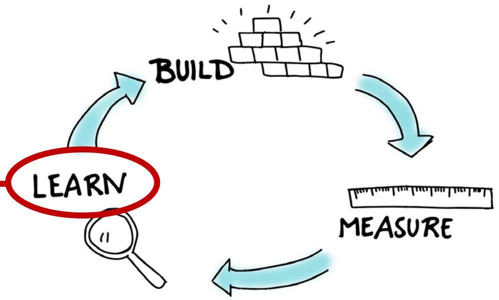
4 An Overview of Opportunity Capital

Opportunity Capital enables strategic experimentation needed to maintain organizational relevance and fuel growth within the existing business model. Opportunity Capital allows the organization to experiment and learn without placing organizational stability at risk with each 'bet.'

Prevalence in Arts Organizations: Rarely exists. While organizations may experiment with innovative programs and experiences, they rarely set aside dedicated funds to protect the organization against potential failure of experiments. The result is limited learning and more-cautious innovation than is needed in today's environment, where audience and community tastes have changed significantly.

Illustration of Opportunity Capital

The "return" that organizations should expect when using Opportunity Capital to experiment is at least as much about learning as it is near-term revenue.



How Much Should Organizations Devote to Opportunity Capital?

The amount of Opportunity Capital an organization needs depends on its mission, its strategy, its marketplace and financial condition. Organizations would be well-served to devote at least two percent of their operating budget to fund experimentation, but the amount could be much higher for organizations testing full-scale programming. Successful deployment of opportunity capital requires that the organization build test-and-learn capabilities and that its board appreciate learning, not just immediate financial returns.

How and When Do You Replenish Opportunity Capital Funds?

Ideally, Opportunity Capital fund would be self-replenishing—revenue from successful innovation would fund future experimentation. In practice, returns on experimentation are unlikely to align to budget cycles, so organizations should replenish the fund annually, either as part of the budgeting process or by appealing to funders inspired by the kind of innovation the organization is undertaking.

What Happens if the Replacement Reserve Is Insufficient?

Without sufficient Opportunity Capital, experimentation risks financial stability. As a result, organizations may gravitate to safe programming that guarantees current audiences, but that may resonate less with future audiences and is unlikely to progress the artform.

Prioritizing Capital Needs

While arts organizations need capital to maintain operations, protect against disruptions and maintain relevance with audiences and the community, few have sufficient capital to address all of their needs. As a result, they must choose where to allocate scarce capital and in what sequence.

Meeting payroll and paying vendors understandably takes precedence, and, for many organizations, these obligations consume all liquid cash (and sometimes more). Once an organization has met its immediate obligations, it can begin to set aside reserves to protect against disruptions. The Great Recession and the Pandemic create an urgent case to set aside at least 3 to 4 months of "rainy day" operating reserves.

After setting aside a base level of operating reserves, the next priority is to accumulate funds for predictable long-term capital replacement. While the conservative approach is to fund all long-term capital replacement requirements before funding innovation experiments (what we call "Opportunity Capital"), it is possible to borrow against assets to fund replacement of depreciating assets and pull forward some innovation funding. Practically speaking, organizations will need to fund innovation experiments outside of normal operations before they have completely funded long-term capital replacement needs.

Meet immediate financial obligations		Protect against operational disruptions		Meet predictable long-term obligations		Refresh value proposition
1		2		3		4
Working Capital Fund	THEN →	Operating Reserve	THEN →	Capital Replacement Reserve	THEN →	Opportunity Capital
Can we meet our cash flow needs at predictable times in the year where spending outstrips revenue?		Do we have enough money to weather disruptions or at least give us time to make cuts and raise funds in an orderly fashion?		Are we setting aside money we know we're going to have to spend eventually to maintain existing capital?		How much risk do we need to take to stay relevant to audiences, the community and the artistic community?

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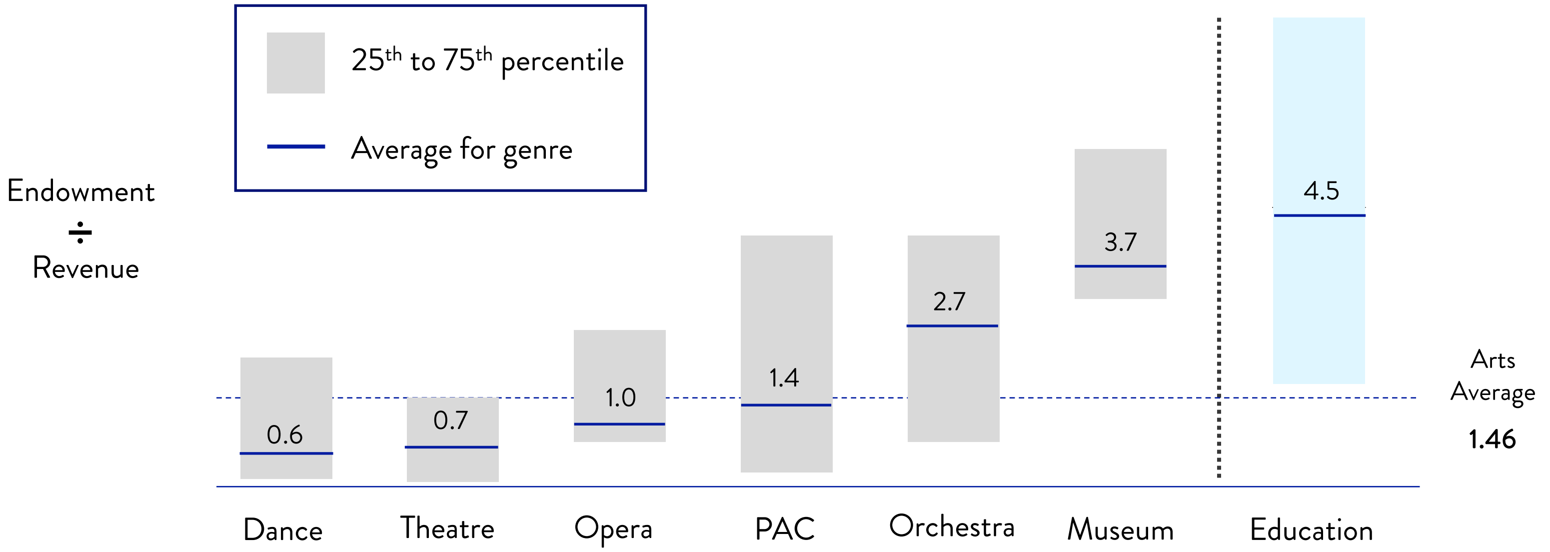
Arts Genres Vary in Endowment to Revenue Ratio

The data on this page provide a snapshot of endowment levels for different genres of arts organizations along with a benchmark for educational institutions for comparison. Within each genre, the gray bars represent the spread between the 25th percentile arts organization and the 7

Endowment to Revenue Ratios

by Genre--2021



Benchmark includes 85 organizations from six arts genres and the education sector:

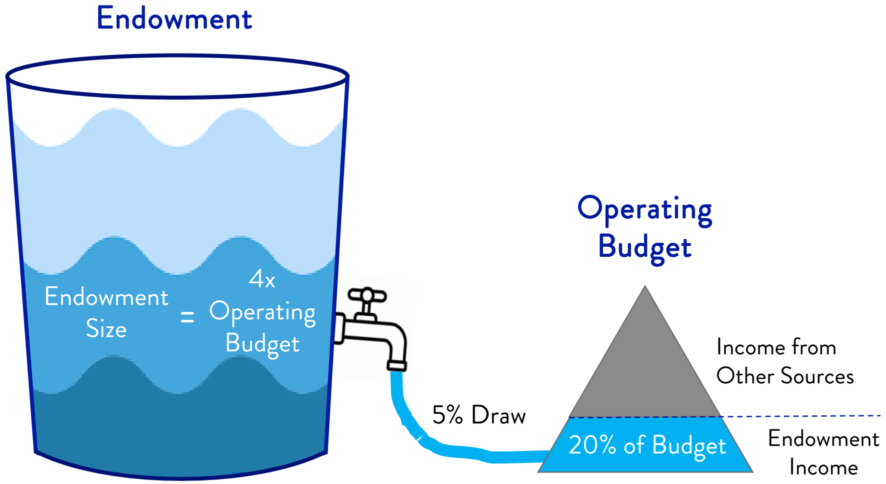
- Performing Arts Centers (10)
- Theaters (13)
- Museums (14)
- Orchestras (15)
- Operas (11)
- Dance (12)
- Education (10)

Source: ABA research and analysis.

5 How To Think about Endowment Size

Organizations with endowments typically draw income equal to about 5% of endowment's total value. So, a nonprofit with an endowment that is four times the size of its annual operating budget can expect the endowment to provide around 20% of its annual operating income.

The most directive **rule of thumb** we've seen comes from Susan Nelson, a Principal at TDC, a nonprofit management consulting firm. Based on her analysis of endowment performance at arts nonprofits, she advises that it's not worth the trouble of creating and fundraising for a permanently restricted endowment unless you have the ambition that it can yield a **draw of at least 20% of your operating budget**.



"According to the data, the smaller the corpus, the less likely you are to beat inflation and the less likely it will be invested in a way that gets the returns you seek and that you'll get the attention you want from investment managers."

Susan Nelson
Principal
TDC

The Skeptic's View on Endowment Size

Andrea Kihlstedt, Co-founder of Capital Campaign Toolkit (a resource for nonprofits conducting fundraising campaigns) argues that, to keep organizations in touch with the communities they serve, endowments should be no more than twice the size of an organization's operating budget (yielding an annual draw of no more than 10% of operating budget).

"More than two times the amount of your annual budget and organizations run the risk of becoming fat and lazy. Less than that, and it's hand to mouth every year."

Andrea Kihlstedt
Co-Founder
Capital Campaign Toolkit

Source: *Capitalization Fundamentals: Performing Arts Institutions*, TDC.

Source: *Endowment and your Capital Campaign: How Big Should Your Endowment Be?*, capitalcampaigntoolkit.com.

The Grasshopper or the Ant: A Contrarian View on Endowment

In 2006, the Doris Duke Foundation commissioned a deliberately provocative paper, titled the Grasshopper or the Ant (after an Aesop's Fable) on the role of endowments in arts organizations with the aim to catalyze conversation within the foundation about how its support of the arts could have the greatest impact. Specifically, the foundation asked the author to reflect on the following question: Do endowment gifts most effectively advance the mission of the Doris Duke Charitable Foundation Arts Program going forward? The paper provides a point of view on alternatives to endowment funding and poses questions about how endowments help organizations achieve their mission. The following excerpts summarize the paper's key points:

Strong Interest In Endowment as Hedge Against Rising Costs

"The arts, particularly the orchestral world, has in some measure staked its future on amassing enough money in endowments to protect it from fixed costs that increase every year."

"Today, a sizeable endowment is the "Holy Grail" for every struggling arts organization… falling somewhere between a rainy day fund and the guarantee of immortality, endowment is seen as a way of ensuring that, come what may, arts organizations will still be in business."

Concern #1: Endowments Prioritize Future Benefits over Current Health

"Endowment funds [are] a clear statement that either the needs of future beneficiaries or our own drive for perpetuity at any price outweigh our obligation to make the maximum progress on mission today."

"Most organizations have a greater operational need for liquidity… than they do for other types of financial security with regard to achieving mission."

Concern #2: Endowments Disconnect Organizations from Market Need

"It is possible for too large an endowment to "anesthetize" an organization to the needs of its market, although there are very few if any arts organizations that grapple with this problem."

Concern #3: Restricted Assets Reduce Agility

"Using an operating budget in which one can spend money as one chooses to secure money that can only be spent in limited ways not only reduces the nimbleness of the organization, it increases its financial risk.

"Endowment gifts… lessen the maneuverability of the organization in times of trouble, they do not cover the full overhead costs of managing grant activity, and they may take leadership time and attention away from core activities."

Important Board Considerations Regarding Endowment-Building

"For the performing arts, boards need to carefully consider the opportunity costs of raising permanent endowment funds (which are more expensive in tie and money to raise) to the need for substantial reserves which are unrestricted."

"Consideration should be given to the organization's capacity to manage an endowment, to the need for appropriate cash reserves before the accumulation of an endowment, and to the specific gain in mission achievement that endowment makes possible for an organization."

"It would be flawed to say that arts funders should consider endowment unnecessary in all cases. However, it may be that endowment grants should be the gift of last resort, rather than the first. "

Source: The Grasshopper or the Ant: A Review of Endowment Giving Policy Options for the Doris Duke Charitable Foundation Arts Program, Russell Willis Taylor, December 1, 2006. ABA Analysis.

Question: When is Endowment-Building the Right Approach?

It's hard to argue against having a large endowment. An endowment provides much needed stability, frees staff from a constant fundraising treadmill and reduces stress on staff. The real question is whether to focus on raising ***new*** endowment money, especially right now when so many organizations are facing liquidity challenges. While no right answer exists, the questions below are worth considering organizations debating the question.

Organizational Need

Does the organization's mission require stewardship of long term assets (e.g., facilities, collections)?

Does the organization long-term stability right now more than it needs liquidity?

Has the organization identified :

- Specific operational risks that endowment will reduce?
- Specific strategic risks that an endowment will enable?
- Predictable cost-increases that an endowment will offset?

Has the organization identified right size for the endowment (as opposed to "bigger")?

Organizational health

Has the organization shown that its value to the community has grown over time (rather than shrunk)?

Has the organization demonstrated financial health and discipline capable of engendering confidence that it will use endowment funds responsibly?

Has the organization addressed the risk that endowment funds will insulate the organization from the changing needs of the market, making it less responsive?

Has the organization experienced multi-year losses that raise questions about the sustainability of the current business model?

Availability of Funding

Do large funders exist who are likely to give only to endowment?

Would acquisition of endowed funds divert development resources needed to raise funds for more urgent short term needs (e.g., working capital, operating reserves)?

Might the presence of a large endowment (or endowment-building campaign) dissuade annual-fund donors, who regard the organization as less needy?

Community Perception

Is there risk that the endowment will dissuade future giving (especially in emergencies) in favor of organizations without a net?

Is there risk that raising endowment funds at a time of struggle for many arts organizations will be perceived negatively by the community

Might endowment fundraising hurt relationships with other arts organizations who perceive it as reducing funds available to address urgent liquidity needs now?

Source: ABA research..

Endowments Not a Substitute for a Sound Business Model

BALTIMORE SYMPHONY ORCHESTRA

In 2019, the leadership of the Baltimore Symphony Orchestra (BSO) and musicians entered into intense contract negotiations, culminating in a musician lockout and 14-week work stoppage. The major point of contention was management's demand to shorten the contract from 52 weeks to 40 weeks annually. The labor dispute was exacerbated by the orchestra's difficult financial position. The organization had borrowed millions from its endowment, and an audit concluded that the organization may not have enough money to continue for another year.

In response to public pressure by BSO musicians to tap the endowment, the Chairman of the BSO Endowment Trust penned an OP/ED in the Baltimore Sun explaining that the endowment is no substitute for a sound business model. The story serves as a cautionary tale about the role of endowments in the financial health or arts organizations. Endowments may be an important source of capitalization for organizations whose model is fundamentally sound, but, in organizations that are steadily losing audiences and or donors, capital is likely better spent transforming the model.

THE BALTIMORE SUN

Endowment chair: BSO musicians are the best, but we can't ignore financial woes

… The Endowment Trust wants to be part of finding the path to a resolution to the BSO's current concerns but we are not and cannot be the only answer to an unsustainable business model. Larger draws from the endowment would not fix the problem, they would just kick the can down the road and ultimately impairs the Endowment Trust by depleting its foundation.

Sadly, what is happening in Baltimore has become common in performing arts communities in many other American cities. Orchestras across the country have made adjustments to reflect market demand and economize…

Source: Endowment Chair: *BSO Musicians Are the Best, but We Can't Ignore Financial Woes*, The Baltimore Sun, July 126, 2019

Not Every Organization Should Continue in Its Current Form

Organizations facing chronic financial stress must at some point ask the difficult question of whether the organization should continue with it's current mission, product set, and cost structure. And distressed organizations that can't or won't entertain major changes to the mission and business model must ask whether they should continue to operate. Organizations that are willing to undertake fundamental change to the business model benefit from raising **Change Capital,** which organizations can use to fund exploration and mitigate associated risks.

Is my business Model Is Unsustainable?

POSSIBLE INDICATORS

- ❑ Long-term audience decline
- ❑ Contributed income concentrated in fewer (and older) hands
- ❑ Running consistent deficits
- ❑ Using all cash to meet immediate obligations rather than fund future needs
- ❑ Regular borrowing against assets and/or endowment

My Business Model Is Unsustainable

Close/Merge	An unfortunate option, but necessary to consider for arts organizations where market oversupply exists, demand is too low or where required changed is antithetical to mission.
Use Endowment Principal	Almost never a prudent option, as it doesn't solve underlying issues and, even when it does fund necessary change, leaves the organization in a weakened state.
Build Endowment To Cover the Gap	Almost never a prudent option, as 'trapping' money in endowment limits funds desperately needed now to turn-around the existentially threatened organization.
Run Planned Deficits	A risky but potentially workable option for a limited, defined period *IF* a clear turnaround plan with testable interim goals exists and experienced talent is in place to carry it out.
Divert Capital Toward Change	A risky but potentially workable option that demonstrates to the board and potential funders the seriousness of intent to change, but risks current revenues.
Raise "Change Capital"	The most financial sound approach to business-model change, but depends on support of funders with 'venture philanthropist' mindset.

Source: ABA Analysis.

6 An Overview of Change Capital

Opportunity Capital Provides funding to transform the business model to provide more sustainable sources of long-term funding . Opportunity Capital allows the organization to undertake transformation without risking current sources of income, especially audiences and donors attached to the current model

Prevalence in Arts Organizations: Sometimes exists as part of a strategic plan focused on business model transformation. In practice, few arts organizations undertake largescale efforts to change their business models.

Example of "Change" Capital: Mellon Foundation

Nonprofit Finance Fund®

THE ANDREW W. MELLON FOUNDATION

Digital Humanities Leaders Working with Nonprofit Finance Fund Receive "Change Capital" from The Mellon Foundation

February 15, 2022

> "Change capital" is how NFF defines money that supports an organization's planned period of change and allows the nonprofit to emerge financially stable. Recipients will use the grants to sustainably adapt their organizations and deepen the impact of their work.

How Much Should Organizations Devote to Opportunity Capital?

The amount of Change Capital an organization needs depends on the stability of its current business model and the magnitude of the transformation it wants to make. Determining the amount of change capital needed requires the creation of a thorough business case that includes a realistic assessment of the unmet needs in the market, the sources of income available if the organization is able to meet that need, and the costs, capabilities and other resources required to make the transformation.

How and When Do You Replenish Opportunity Capital Funds?

Ideally, Change Capital doesn't require replenishment. If successful, business model transformation will yield a more sustainable funding stream for the organization. In practice, few organizations undertake business model transformation, so the likelihood that the first attempt fails or requires "booster" funding is relatively high. In those cases, it's important to evaluate whether current staffing is well suited to the required transformation.

What Happens if the Replacement Reserve Is Insufficient?

Organizations that attempt to transform their business models without sufficient funding are likely to fail. The risk to current income of diverting funds from the current model is high and likely much higher because of resistance of fund reallocation by stakeholders wed to the current model.

Source: https://nff.org/news/digital-humanities-leaders-working-nonprofit-finance-fund-receive-change-capital-mellon. ABA research.

How To Think about Change Capital

The decision to raise **Change Capital** (versus Endowment or unrestricted cash) is a judgment call. Is there a path to financial stability under the current model? Even if the organization were 100% endowed, is the current model providing enough community impact to warrant funding at current levels? Even if Change Capital is warranted, an organization must have both a vision and capabilities to employ Change Capital productively. The following questions can help organizations determine whether it makes sense to take the significant step to fundamentally change its product, customers, revenue sources and/or cost structure.

The Need for Business Model Change

The pandemic aside, have you experienced consistent decline in demand for your core product over an extended period?

Is the organization having a hard time attracting younger audiences?

Are large donors increasingly turning their focus toward non-arts causes (e.g., social justice)?

Are the growing arts and culture organizations within your genre approaching the 'product' in fundamentally new ways?

Has the organization used long-term debt vehicles to pay for short-term liquidity needs?

Has your organization considered tapping endowment principal in order to shore up persistent financial troubles?

Vision for Change

Has the organization identified a new 'customer' group and/or unmet market demand?

Have you assessed the size of the potential market and sources of revenue (e.g., large customer set, donors motivated by the new opportunity?

Would the new model complement or replace your current model? Can you cut costs associated with the current model, or will new costs be additive?

Has the organization clearly identified 'certainties' (e.g., market potential, nature of market demand) and uncertain aspects that require experimentation (e.g., product attributes that will resonate)?

Have potential funding 'champions' been part of the visioning process?

Capability for Change

Do stakeholders understand the difference between business model change and financial recovery (to the same business model)?

Does the organization have a track record of taking calculated risks and learning from them?

Does your brand have market "permission" to expand into product area(s) you'd like to own?

Is there at least one disruptor within your organization with passion for the new direction?

Does the organization have the necessary contract flexibility and trust with artists and other stakeholders to make the necessary change? Is there a realistic path to work around 'blockers?'

Source: ABA Analysis.

What Does Business Model Change Look Like?

Business model transformation can take many forms. It might involve fundamentally thinking the product for current audiences, identifying new customers and markets, or serving the community in some new way up to and including revisions to the mission. It could also take the form of fundamental revisions to the cost structure. All of these options require access to capital from sources that understand the investment required and risks involved.

	New Product	New Customers	Different Community Needs	Different Cost Structure
Description	Overhaul the value proposition to address previously unmet needs or to satisfy current needs more fully, resulting in new customers or more loyalty.	Identify of large new groups likely to value the current product, new ways to reach those segments, and new contributors (if those new customers cannot provide sufficient revenue).	Modify/rethink organizational mission to appeal to community needs favored by funders (e.g., social justice, safety net, economic mobility), using art as means not an end.	Retool the cost model by fundamentally questioning the artistic content required to create value, channels of delivery and/or overhead required to deliver value.
Example	Leveraging staff expertise in history of the arts, create educational material and **license content** to other organizations to educate audiences in advance of attendance.	In a market with too few enthusiasts, convert to a **festival model** to attract enthusiasts from other regions to attend during a specific period.	Focus organization on **reducing crime** or recidivism of prison inmates through participation in the arts.	**Merge** with a mission aligned entity, stripping out duplicative administrative or production functions. **Sell** or donate large facility.
Risks	Organization ‘doesn’t know what it doesn’t know’ about the capabilities needed to launch a product outside of traditional product set.	Cost of cultivating new customers takes longer than expected.	Believers in the current mission may disassociate before the organization able to build capabilities needed to serve new mission.	Organization may take some time to figure out delivery of value under more-efficient cost model.

Source: ABA research.

Table of Contents

Further Reading

Critical Steps Toward Capital Health in the Cultural Sector, Rebecca Thomas (Nonprofit Finance Fund) and Holly Sidford (Helicon Collective).

Argues for more aggressive capitalization of cultural organizations and provides guidance for funders about providing adequate capitalization for their philanthropic targets..

Digital Humanities Leaders Working with Nonprofit Finance Fund Receive "Change Capital" from the Mellon Foundation, Nonprofit Finance Fund, February 15, 2022.

Describes concept of "change capital" to support financial sustainability through periods of largescale change and examples of organizations receiving change capital from the Mellon Foundation..

Endowment and Your Capital Campaign: How Big Should Your Endowment Be? Capital Campaign Toolkit, Andrea Kihlstedt, Co-founder.

An alternative take on endowment size, arguing that endowments that provide greater than 10% of operating budgets cause organizations to lose touch with their markets.

Frequently Asked Questions about The Baltimore Symphony's Contract Negotiations, Updated, September 13, 2019.

Organizational example of the purpose and limits of certain types of capital in the arts. In this case, the BSO Endowment Trusts defends why endowment funds cannot be used to fund ongoing budget deficits.

Getting Beyond Breakeven: A Review of Capitalization Needs and Challenges of Philadelphia-Area Arts and Culture Organizations, TDC (Commissioned by The Pew Charitable Trusts and the William Penn Foundation).

Analyzes the financial literacy (high) and capitalization adequacy (low) of Philadelphia arts organizations using an approach that can help others diagnose their capital situations.

The Grasshopper and the Ant: A Review of Endowment Giving Policy Options for the Doris Duke Charitable Foundation Arts Program, 1 December 2006.

The paper was commissioned to provide the foundation with a provocative reflection on the role of endowments (vs. more liquid funds) in helping arts organizations fulfill their missions.

Hidden in Plain Sight: Understanding Capital Structure, Nonprofit Quarterly, March 21, 2003, Clara Miller.

Explores the relationship among the drivers of capital structure: mission, business model and programs, including the harm to the capital structure that can occur when project and facility funding don't include funding for new operational costs.

National Capitalization Project 2010 Summary, Elizabeth Gabral Curtis, TDC, funded by Grantmakers in the Arts, September 2010.

Analysis of the undercapitalization and oversupply of arts organizations, along with an analysis of needed behavioral change by both arts organization and funders to ensure adequate arts capitalization.

Profiles of Risk Taking: A Conversation with David Devan, General Director, Opera Philadelphia, Susan Nelson and Ashley Berendt of TDC, Barr-Klarman Arts Capacity Building Initiative.

Study of the business case put together by Opera Philadelphia to establish a Risk Capital Fund to fund the (inherently risky) innovations needed to fuel growth.

Staging A Comeback: How the Nonprofit Arts Sector Has Evolved Since the Great Recession, Eileen Cunniffe and Julie Hawkins, Nonprofit Quarterly, February 9, 2016..

Documents the hit arts organizations took during the Great Recession along with the structural weakness in arts capitalization highlighted by the economic downturn.

Working Capital Report: Do Arts Organizations Have Enough Cash to Meet Day-to-Day Needs, SMU DataArts, 2019.

Analyzes the working capital (cash to meet immediate needs) of arts organizations by size and genre. The study highlights just how tenuous the cash positions of many arts organizations is right now. In addition to this report, SMU DataArts has a wide range of data and other resources on working capital in the arts.

Appendix

Case Example: An ‘Opportunity Capital’ Fund at Opera Philadelphia

Change Capital is not often thought of under that name, but it .

Situation at Opera Philadelphia
Circa 2008

Just after the creation of a plan to stabilize operations and establish a new strategic direction, the Great Recession hits, placing the opera in immediate financial peril.

The executive team decides to freeze spending on subscription revenue, creating a $1 million cash hole.

The group informs its landlord that it will need an extension on rent payment and seeks to raise $1 million in six weeks.

Opera Philadelphia’s Recovery Story

The First Six Weeks

The opera raises $1 million in Recovery Capital from the board and foundations based on demonstrated financial discipline.

Staff Reduction

After rating entire staff on openness to change, the opera lays off 20% of staff and asks remaining staff for commitment to speedy implementation of strategy.

A Capitalization Plan

In 2009, the opera announced a $3 million capitalization plan, including:

- Commitment to a $100K annual budget surplus
- Decision to forego an endowment
- A $1 million **Opportunity Capital** fund

Opportunity Capital at Opera Philadelphia

The fund finances strategic initiatives outside normal programming to raise the organization’s artistic profile.

Seeded by foundations that gained confidence in the financial discipline of the organization through its crisis period.

David Devan (General Director): Risk Capital available only when the board and funders are energized by the strategic direction. Asking for Risk Capital is not possible without demonstrating financial health and discipline.

Source: *Profiles of Risk Taking: Stories from Three Arts and Culture Leaders. A Conversation with David Devan, General Director, Opera Philadelphia*, Susan Nelson and Ashley Berendt, Barr-Klarman Arts Capacity Building Initiative. Presented at a conference hosted by Theatre Communications Group. Graphic created by ABA (not part of original presentation).

Source: ABA Analysis.