Whole Enterprise Finance: Value Investing for the Social Sector

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Everybody has a favorite nonprofit. Maybe you started funding yours when it was small, headed by a charismatic young leader, adored by the kids he taught. You joined other funders to help him buy a building. He had a powerful vision for a new kind of school. You hate to admit it, but just when you thought the coast was clear, the challenges started. The building was done, the program was supposed to be sustainable. But the things you applauded at the ribbon cutting—clean and spacious classrooms, a gym, new systems—faded from view. The founder became hard to reach. An air of breathlessness prevailed. Calls about cash flow crises became routine. The new systems were subject to frequent snafus. Then came worsening financial results, the departure of three chief accountants in a row and the messy firing of a disastrous CFO. The academic results declined for the first time since year one, and to top it all off, the founder abruptly announced he had decided to go to business school.

They're not your favorite any more? Don't feel alone. These problems are typical, even epidemic in any growing enterprise, for profit or nonprofit. In our sector they are most likely to affect the "best and the brightest:" growing, innovative programs with big ambitions; dedicated, idealistic staff; rapidly mounting demand; and enthusiastic startup supporters. Yet these problems can be anticipated, even managed (though seldom avoided completely), with intentional changes in practice, through what I'm calling "whole enterprise finance." But more about that in a minute.

Part of the impetus for this conference grew out of a conversation I had with Lew Feldstein at a Council on Foundations meeting a few years ago. We were looking at the program and I said, "Do you realize that the word 'money' is completely absent from this?" We scanned the text. It was chockablock with words like *leadership, innovation, passion, justice, transformation, impact, strategy*. But no 'money.' No 'finance.' Zip. I asked Lew, "Why don't we ever talk about money? It is, at the end of the day, the main reason people come to foundations." Lew said, simply, "It's not what we care about."

This conference is about why we should care about money, and what that means. It's about why it's not enough to be passionate about a cause. Great ideas, deep caring for those in need, creativity, resourcefulness and an expansive vision for the future are abundant in the sector. We most predictably lack execution capacity, and our financial habits undermine efforts to build it. It's not enough to think 'finance' is a muddle of fund development, budget monitoring and overhead rules compliance. At every stage of development—innovation or start-up, expansion, restructuring, and ongoing operations—managers need to attract and deploy money. We must

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build skills and systems, measure if we are efficient, if we can grow, if we can get better. I call this new possibility "whole enterprise finance." It's not what we're doing now.

It would be difficult to find a better object lesson than our current financial pandemonium to demonstrate the power and integrity of whole enterprise finance, or the fallacy of the opposite. We might even call it "social value investing," in honor of Warren Buffet who has successfully taken the long view through "value investing" in for-profit companies. We lack the long view in our social sector financial practices.

The current, tough environment can spur needed change in our sector as well. Now, understanding money concepts like risk, leverage and—well—accounting, seems to be a moral imperative!   Never did grantmakers, board members, government officials and managers of social sector organizations need so urgently to understand and skillfully wield money as a tool. To do so empowers us all to connect finance with social sector success now and in the future. That's why we're here.

I will outline some principles and practices that can move us toward whole enterprise grantmaking. Much of what I'm outlining here will be covered in more depth by presenters today and tomorrow. My purpose here is to sketch our underlying commercial proposition—the assumptions that underlie nonprofit finance; a few illustrations of our current habits; and a couple of ideas on how we can hit the reset button on some habits that undermine whole enterprises, and with them, our sector's success.

We're in a Looking-Glass World

There's a reason we have a nonprofit sector, and it's commercial: you can't make any money doing this mission stuff! This fact impairs the usual for-profit commercial expectations, and means we require an even higher level of enterprise savvy. Here are three examples:

I. Going to scale requires surpluses and focus. Revenue for the mission-related part of our business (let's say preschool for families living below the poverty level) rarely, if ever, covers all costs. That's why we (like many for-profits) have tax advantages: to allow profitable, i.e., sustainable, operations. Sector habits that strip out surpluses limit sustainable operations and undermine quality and future growth. In the current environment, the impulse will be to do more with less. This will overexploit the enterprise and undermine the future.

II. Ever heard about "too ***big*** to succeed?" Too bad Alan Greenspan hadn't. Another reason our work is tax-advantaged is that for many, quality considerations make economies of scale (getting more efficient as growth takes place) subject to the laws of diminishing returns. Bigger means more, but may not mean better, quality. If we scale a pre-school by increasing class size to 60—we have quality issues. The teacher will run screaming from the room.

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Quality protects our mission outcomes. Enterprise growth ***alone*** can be counterproductive. The current financial uncertainty spurs us to explore new ways of working: networks, technology, and new business models that allow us to achieve the appropriate scale, maintain excellence, and serve more people.

III. Remember **leverage?** Everybody wants it. One version relies on borrowed capital. A "DUH" moment in the current economic mess is that leverage is circumscribed by any borrower's ability to generate reliable revenue for repayment. Debt is a powerful tool for nonprofits in all phases (and we, banks and our fellow CDFIs can attest to this). But with many of the "smartest guys in the room" on Wall Street revealed as simply reckless and overleveraged, we should learn as well. Debt cannot be substituted wholesale for "equity capital" in the form of philanthropic grants. We have an urgent test for failure: the most virulent risk in our world is not to the lender, nor to the borrower, but to the people we serve.

Capital Supply Fragmentation Hollows out Enterprises

As an art major with an English minor to fall back on, I never thought I would become passionate about the power of mathematics. But math is a life force: we ignore it at our peril. We all know that we are small relative to the mainstream. Over the years we've heard a variety of voices bemoaning the lack of capacity and scale among nonprofits. But we have met the enemy and "they is us!" Math, and human nature, predicts our predicament. Here's what happens.

The average grant of the 100 largest foundations is $50,000, and for a wider sample, more like $20,000 according to a recent GEO study. Small, promising organizations—let's say those with annual revenue of $500,000 (remember your favorite nonprofit?) find a $150,000 grant over three years to be—well—transformative. These are the ones that show that "our money really made a difference." Yet from the 'enterprise' level, $50,000 may be just enough to move a cherubic, promising child (remember your favorite nonprofit?) with great results, staff working extra hours, and break-even financial results to the brink of raging adolescence (slipping results, high turnover and burnout, cash crises). But it falls short of the trip to adulthood. We encourage our sea of too-big-to-be-smalls and too small-to-be-bigs. They're stuck.

The math is eloquent: Helping a teenager grow to adulthood is complex and more expensive than startup. The two most common paths for relatively healthy growth are first, incrementalism, with small investments of 'saved' capital via surpluses. This takes a long time. The second is rapid growth via growth capital. Promising 'teenage' organizations need $10 or $20 million over three to five years to get up that challenging growth curve quickly, not $150,000. What can graduate them to adulthood? To fight the feared "failure to launch" syndrome?

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It's a capital campaign focused on building sustainable impact. If successful, the proceeds will create an enterprise that can reliably attract revenue and deliver quality program over the long term. Kenneth Boulding said that we are our genes' idea for producing more genes. Well, capital is our enterprises' idea to attract more revenue and therefore, more quality, efficiency or output! All those wonderful foundation aspirations! And in these times, nonprofits looking to become more effective and efficient, to merge or even to downsize, require substantial capital as well.

So what can a funder do about all this enterprise math?

Enterprise Friendliness in Action #1: Are You a Builder or Buyer?

One useful way to describe the role of a funder from an 'enterprise' perspective is to divide it into 'builders' and 'buyers.' My colleague George Overholser (who, with Maria Blair from Rockefeller Foundation and Ed Skloot from Duke University, will explore this concept in a panel this afternoon) described it in his seminal working paper, "Buying is Not Building."

Buyers provide reliable *revenue* to pay for 'current services' – whether it's in the form of a grant, government contract, tuition, or bingo receipts. 'Buy' revenue is usually unrestricted. You're buying literacy, or performances or health. If they deliver, you'll keep buying. And this is fundamental to continued high quality delivery of services. If you want them to do more (like double), reliably, the grantee will need another kind of money: capital, in addition to the reliable 'buy' revenue, or it will falter. Growth or change takes investment in addition to revenue. And the aspirations—scale, innovation, transformation—will never stick without it.

And so that's what a builder is. Builders provide *capital* (not revenue) so an organization can *change* something—get larger, use a new technology system, respond to changing market conditions, merge, downsize, expand capacity, buy a building or develop new work (i.e., product) to name just a few. 'Build' capital allows managers to both expand capacity *and* build the revenue engine that will attract more buyers and thereby support the new cost structure. Anything less—a project grant to train staff on technology, for example—is a 'build' project in 'buy' clothing. To make it sustainable, we have to pay for *BOTH* the initial installation *AND* the capacity to attract reliable revenue to sustain it.

Here's where the enterprise math comes in. In the philanthropic world, everyone wants to be a builder. But the majority of foundation grants are too small to get their favorite organization all the way up the growth curve. In this uncertain environment, some nonprofits will be called upon to grow quickly, others to downsize, merge, or change their business model. Philanthropy can fill a crucial financial role—change agent. But if you want to be a builder—math predicts that most of you need to call your buddies. If you mainly do start-ups, get to know the requirements of graduation. Money math says that we need efficient, concerted action—syndications and participations—to finance sustainable change.

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Enterprise Friendlliness in Action # 2: Think Outside the Grant

When you're thinking about program (before you think about enterprise), it's easy to believe that grants succeed or fail, or are risky, in and of themselves. It's not true. We make grants into enterprises and they are fungible. They interact with other forms of revenue or capital, the field, the economy. Especially in the high-risk environment we face, we need to acknowledge that. Here's how.

I. Think about risk outside the grant. *The real risk in any of our work, nonprofit and funder alike, is to the ultimate beneficiary*: that a child fails to get a polio vaccination, goes home to an abusive parent or never learns to read, to name three simple and obvious ones. All other risk is minimal. If we focus on the ultimate risk, enterprise-friendly finance will follow.

II. Avoid unfunded processes and mandates. Think 'net grants.' How much did it cost your grantee to acquire a grant from you? Subtract it from the grant, and that's the 'net grant.' This is the amount available to serve the public. This is especially important in this crisis, when grantees and the people they serve are very much at risk.

III. Fund the enterprise. Avoid making the grant special unless asked to do so by the grantee. Buy the outcomes the grantee plans (rather than focusing on inputs). Understand, with the grantee, the full cost of those outcomes. Be careful about paying buy prices for a build job.

Accounting is Destiny: Focus on the True Elements of Success

These days, the front page of the paper reliably dishes out powerful examples of the dangers of bad accounting. It can also drive us toward positive ones. The way we account for money and results is a powerful determinant of outcomes. A business model that pays foster care residences only when kids are in beds will mean that more kids will be in beds. Nonprofit accounting masks knowledge that will help us learn outside the "bell jar" of grants, and our own enterprises. Actions for grantmakers?

I. Encourage an accounting treatment that separates capital infusions and expenditures from ordinary revenue and expense (for more on this, George Overholser's session on 'Buyers' vs. 'Builders' and the SEGUE accounting treatment will be instructive).

II. Encourage metrics and reporting that support peer comparisons rather than assume a single standard of health. This requires focus on reporting of outcomes (i.e., units delivered, improvements, quality indicators) rather than inputs (i.e., budgets, overhead rate). Financial

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metrics are important, but when we connect them with actual delivery, quality and 'build' capacity, everybody can learn and go "up the curve."

III. Focus more attention on reports (actual results) than on applications (inputs, like plans or budgets). This helps everyone see what has actually happened. Plans can be reviewed in this context, which is a great route to transparency: Imagine a single report for all funders, that connects finance and capacity to outputs (production), outcomes (change) and, if possible, impacts (shifts of entire fields or problems).

This is a lot of information. But I wanted to provide a set of assumptions, and a direction toward a new paradigm for grantmaking: "whole-enterprise finance." Many, if not most of you in the room have already done terrific work moving in this direction, and I will not try to recognize everyone, or we'd be here all day. We worked on some steps in this direction in a symposium at Harvard's Hauser Center in 2007 called "Capital Ideas," which NFF co-convened with Kathy Buechel and Liz Keating, also ably facilitated by Andrea Levere. We hope that with contributions from a larger group, we can move our shared agenda forward.

Today, we not only have an opportunity, but also an imperative for improvement. With the financial system in chaos, our sector will be required to do more, with or without increased resources. Adversity fosters innovation, and battlefield medicine will be very much in order. The conversations we hope to have over the next two days will inform forward motion. You will hear from people—in sessions and in the corridors—who are making real progress. And it is our shared intention to develop and move toward large and small action steps to achieve the goals we share. Thank you.

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