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Barr-Klarman Arts Capacity Building Initiative Financial Health Evaluation Summary

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Introduction

This document provides an overview of a financial health evaluation TDC conducted in 2017 to capture the financial health trends of a Boston-based cohort of arts organizations who participated in the Barr-Klarman Arts Capacity Building Initiative (2012-2017), a joint grant program of the Barr Foundation and The Klarman Family Foundation. TDC's financial health evaluation was designed to impart a clear financial picture of the cohort at the program's end, as well as complement the qualitative evaluation of the Initiative (2016-2017) led by Diane Espaldon and Sara Peterson.

The financial health evaluation measured the growth and scale of grantees' operations over the course of the Initiative; assessed cumulative financial health; and observed capitalization literacy. TDC evaluators provided each grantee with a capitalization assessment reflecting their organization's balance sheet and income statement trends over the course of the program. Grantees subsequently participated in a follow-up phone interview with TDC to discuss their financial results, and answer questions regarding the impact of the Initiative's capitalization training program on their strategic decision-making and financial goal-setting. With a sample of 30 organizations, TDC evaluated grantee financial performance in the context of each organization's individual goals, not against a cohort-wide benchmark. Cohort-wide trends were elicited from an aggregation of individual performance.

This summary document provides an overview of the Initiative's capitalization program, the capitalization framework TDC employed, and high-level results from the financial health evaluation.

Capitalization in the Barr-Klarman Arts Capacity Building Initiative

The Barr-Klarman Arts Capacity Building Initiative ("the Initiative") was a partnership between Barr Foundation and The Klarman Family Foundation to further artistic vitality in the Boston area by investing in leading organizations and building connected learning communities. Over a five-year span, the Initiative infused over \$22 million in two cohorts spanning 30 mid-sized and youth arts mastery organizations.

In the years leading up to the launch of the Initiative, the landscape of funding for Boston-based arts organizations of all sizes had changed significantly. The change had been driven by many forces, including the Great Recession, the decision by several prominent foundation and corporate funders to stop supporting arts in the Boston area, and the continually changing demographics and preferences of Boston's audiences. Given this shifting landscape, the Foundations sought to focus on helping arts organizations adjust to this "new normal"—with the goal of improving both artistic quality and long-term financial strength of grantee organizations.

The Initiative focused on four key areas:

- Deepening an understanding of the role of effective capitalization;
- Diversifying audiences;
- Defining and achieving mastery outcomes with youth; and
- Growing proficiency in cultural competency.

The focus on capitalization in the Initiative, as opposed to program growth, was motivated by the core belief that capitalization is the glue that connects organizational mission, vision, and strategy; investment in the arts; risk-taking and innovation; and management of strategic and operating challenges (see **Figure 1**).



Figure 1 - The Central Role of Capitalization

The principal grantee support mechanisms included multi-year unrestricted grants for operating support; skills and knowledge building activities; and supplemental grants made through Technical Assistance and Artistic Risk Funds. TDC served as program manager for the Initiative, and provided technical expertise and training to both cohorts in the area of capitalization.

The Initiative posited that training and technical assistance in capitalization, coupled with grant-funded general operating support, could inspire a positive change in practices supporting improved financial health. On a more granular level, training and technical assistance could encourage organizations to build capital through surpluses of unrestricted funds. With increased agility through capitalization, the Initiative hypothesized that grantees would be able to better manage risks in operations and take risks in their art, thereby continuing to advance their mission, artistic vision, and relevancy. The Foundations' ultimate aspiration was that grantees would emerge from the Initiative better positioned to respond to Boston's shifting arts markets.

Initiative Capitalization Offerings (2012-2017)

Over the five-year Initiative, TDC addressed five distinct areas of interest and/or need on the subject of capitalization:

1. Understanding the core components of capitalization;
2. Incorporating capitalization into facilities planning;
3. Communicating capital needs to stakeholders;
4. Supporting risk management and risk-taking in a capitalization plan; and
5. Using capitalization to support right-sizing a business model.

An initial needs assessment survey, conducted by TDC in 2013, surfaced the first two interest areas noted above. Over the course of the Initiative grantees elevated the remaining three areas for support through direct feedback and an additional mid-grant survey, reflecting their real-time interests and efforts to implement their capitalization goals. Initiative support on the topic of capitalization resulted in the following interventions for cohort members, designed to further organizational knowledge and skills:

- *Cohort supports:*
 - Custom seminars on capitalization for each cohort (totaling 10 sessions);
- *Individual grantee supports:*
 - Presentations to Boards of Directors on the fundamentals of capitalization (held at regularly scheduled meetings);
 - Capitalization coaching to cohort members on grant applications to the Technical Assistance Fund and the Artistic Risk Fund;
 - A high-level financial health report presented to grantees after the first three years of the Initiative reflecting progress against stated grant goals;
 - Capitalization consulting and in-depth support to select grantees who received Technical Assistance Fund grants; and
 - A comprehensive capitalization assessment received through this evaluation.

Foundational trainings in capitalization were required for executives, senior finance staff, and a board representative; all other trainings were offered as ‘opt-in’ and did not specify roles invited to participate.

Financial Health Evaluation: Goals and Methodology

As the Initiative came to a close in May 2017, the Foundations requested that TDC conduct a financial health evaluation. The evaluation reflected back on seven years of data (incorporating two years prior to the launch of the program), reviewed individual results, and then aggregated those results to provide a report on progress across the two cohorts. The evaluation sought to evaluate the Initiative’s guiding question: namely, does training and technical assistance around capitalization, combined with unrestricted grant funding, change behavior around financial health?

The evaluation assessed organizations against three principal metrics:

1. **Growth and scale of operations** (measured through changes in net assets from operations, growth/decline in revenue and expense with a focus on unrestricted activity, and changes in revenue and expense composition)¹;
2. **Cumulative financial health** (measured through select balance sheet indicators defined below: available Unrestricted Net Assets, months of operating cash, and cash coverage of restrictions); and
3. **Capitalization literacy** (observation of adoption of capitalization language, and evidence of a capitalization strategy).

A detailed overview of TDC’s approach to assessing financial health is provided in the following section.

TDC led the evaluation in two phases. First, TDC prepared individual seven-year capitalization assessments for 29 of the 30 grantees, analyzing key balance sheets indicators and income statement trends.² Based on these results, each grantee was ascribed a “capitalization stage” reflecting its starting and ending capitalization position. Grantees received these assessments, along with a list of outstanding questions on the analysis, as well as points for discussion which were covered in phone interviews with senior leadership from each organization.

¹ TDC obtained a data export from DataArts to conduct the detailed revenue and expense analysis.

² The 30th organization does not have its own balance sheet, as it is embedded in a university, and therefore did not receive a capitalization assessment. However, representatives from this organization were interviewed for the qualitative evaluation.

In the interviews, grantees had an opportunity to discuss TDC’s assessment of their financial position at the Initiative’s conclusion, share retrospectively the capitalization strategies they had employed over the course of the grant program, and shed insight into the opportunities and challenges that lay ahead. Those interviews also afforded TDC an opportunity to hear organizations speak unprompted about capitalization concepts and assess their capitalization language proficiency. TDC is appreciative of grantees’ candidness in those interviews, and their direct feedback on the Initiative’s capitalization program.

TDC’s Evaluative Framework

TDC defines capitalization as the accumulation and application of resources on the balance sheet to support the achievement of an organization’s mission over time. Capital is designed to be built up, deployed, and replenished. Well-capitalized organizations strengthen their capitalization through operating surpluses, and often organize their capital resources into reserves or funds to differentiate purpose and use. These funds are sometimes accompanied by clear board-approved policies for deployment and replenishment.

Over time, TDC has come to understand the basic characteristics of organizations in different stages of capitalization and developed a four-rung ladder model (see **Figure 2** below) to support grantee learning in this area. As part of each grantee’s capitalization assessment, TDC offered its interpretation as to the organization’s capitalization stage at the outset and conclusion of the Initiative. Each stage depicted below represents a point along the path to robust financial health and is characterized by increasing strength across the following four criteria (each a column in Figure 2):

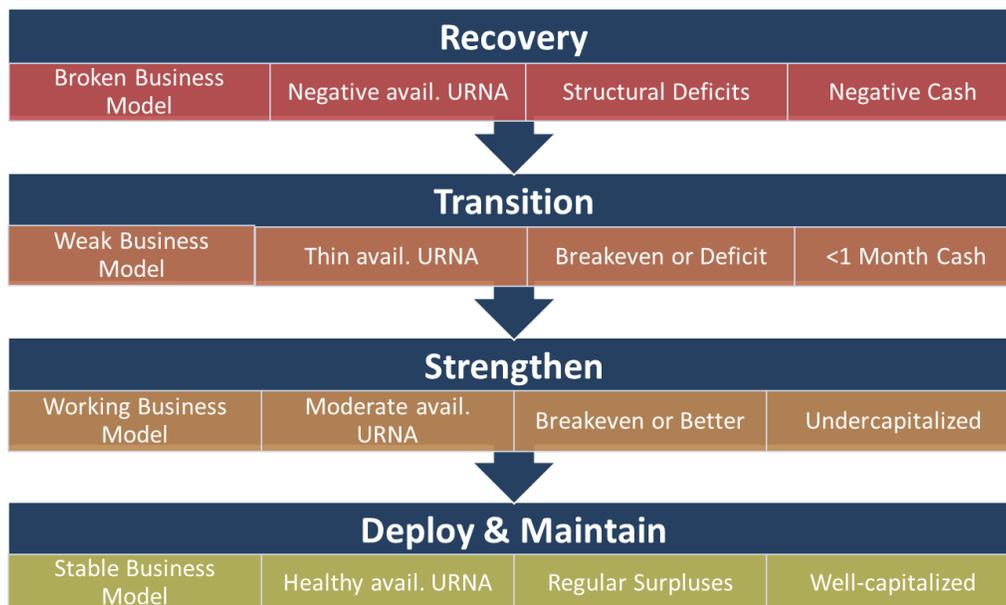


Figure 2 - Capitalization Ladder Model

1. **Business model drivers**

A business model refers to the balance of an organization’s funding streams, cost structure, and asset base. *Business model drivers are factors that significantly impact an organization’s business model (i.e. audience dependence, facility obligations, collections management, or other high fixed cost items such as a labor contract), and have implications for its capitalization structure.* The more commitments and fixed assets an organization accumulates, the more fixed costs it takes on, and the greater its need for working capital

to maintain financial flexibility. An organization's risk profile is also closely related to its business model drivers.

2. Available Unrestricted Net Assets (URNA)

Unrestricted Net Assets (URNA) are assets reflected on the balance sheet not subject to donor restrictions. Organizations have purview to deploy URNA in support of day-to-day operations and to cushion against unexpected changes in their operating environment. TDC examines URNA, net of Property, Plant, and Equipment (PPE), to quantify the liquid resources – resources convertible into cash in a year – that an organization has available to deploy to meet operating needs. This indicator is calculated as *unrestricted net assets – (unrestricted fixed assets less accumulated depreciation – facility-related debt)*.

3. Operating results

An organization's net income is calculated by subtracting total expenses from total revenue, and is reflected on the Statement of Activities. TDC looks at net income to understand whether an organization is generating deficits, meeting breakeven, or producing annual operating surpluses that can help build the organization's capitalization position. When examining net income, it is important to note that some deficits are planned or anticipated in the course of implementing a new strategic direction or making a major investment, but others can be structural, meaning there is something incongruous in the organization's business model resulting in year-after-year deficits. *TDC considers a deficit to be structural when an organization has run three years of operating deficits.*

4. Months of Operating Cash

Months of Operating Cash is an indicator that offers insight into true cash available to support operations, divided by a monthly "burn rate" as defined by the organization's operating budget (total expenses). It enumerates the months an organization can survive without additional infusions of cash. This indicator is calculated as *(unrestricted cash + unrestricted investments – deferred revenue) ÷ by monthly expenses*.

Organizations can move up and down the four rungs of the capitalization ladder. Movement up the ladder, such as from **Transition to Strengthen**, can feel dramatically different for organizations historically plagued by cash flow challenges. Sometimes an organization is able to grow available URNA and improve its capital position, but not to the extent that TDC might characterize it as on the next level. TDC sees these improvements within a rung of the ladder equally as important as jumps to the next rung, especially for organizations who require significant capital to make any notable changes to their capitalization position.

In some cases, movement down the ladder, such as a shift from **Deploy & Maintain to Strengthen**, suggests a measured decision to deploy available resources in support of a strategic goal (*i.e.* spending down an artistic risk fund on a new initiative). In other cases, however, downward movement may indicate new and/or increased financial pressures facing an organization. Organizations at the **Transition** stage are often still in a perilous financial position and are particularly susceptible to slipping between **Transition** and **Recovery**.

In TDC's view organizations need different forms of capital to strengthen their financial position based on their capitalization stage, as indicated in **Figure 3** below.

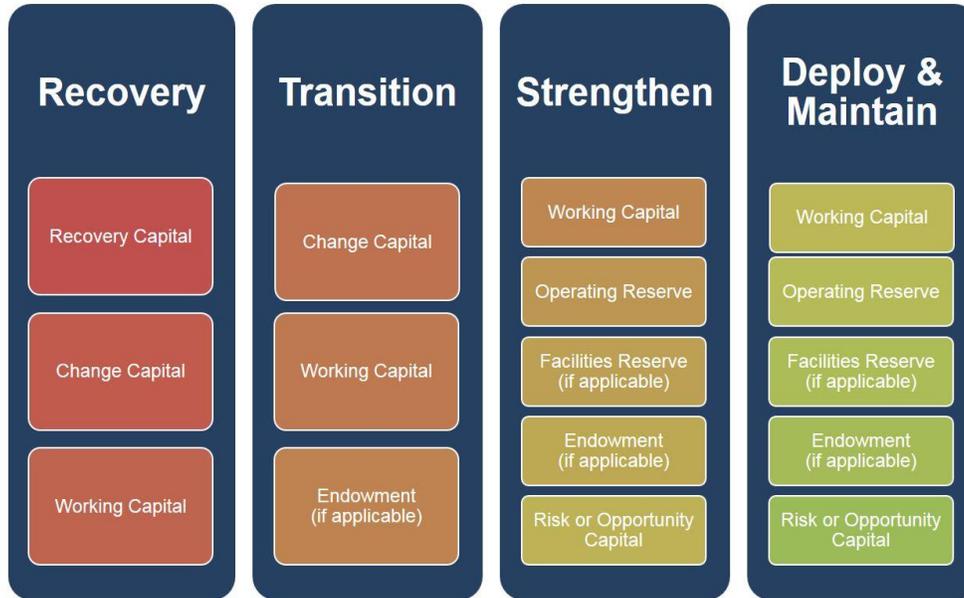


Figure 3 - Capital Funds Needed at Each Stage of Capitalization

The capital funds or reserves identified in Figure 3 above are defined in the two charts below.

Working Capital	<i>Funds set aside to temper cash flow bumps that arise from predictable business cycles.</i>
Operating Reserve	<i>Funds set aside to respond to unexpected external forces as well as smooth the natural risks associated with an organization's business model.</i>
Risk Capital	<i>Funds set aside to offset or insure against large-scale risk or support research and development for risk-taking.</i>
Endowment	<i>Funds set aside to ensure the longevity of organizations with long-term time horizons through investment earnings.</i>
Facilities Reserve	<i>Funds set aside that organizations with facilities or significant leasehold improvements maintain to realize facilities replacement plans.</i>

The five capital funds listed in the chart above support an organization's ongoing needs and, with the exception of an endowment, tend to be raised, deployed, and replenished. The two types of capital listed below are one-time infusions to support specific strategic efforts.

Recovery Capital	<i>Funds required by an organization with negative net worth to recover and maintain operations.</i>
Change Capital	<i>Funds set aside to design, test, and implement a new business model concept.</i>

To determine which of the capital funds above are required to support achievement of an organization's mission over time (*i.e.* a capitalization plan), TDC encouraged the Barr-Klarman grantees to investigate how their artistic vision, business model drivers, time horizon and lifecycle, marketplace, and risk profile

impact their need for capital. This investigation begins with identifying an organization's current capitalization position, and the opportunities and challenges that position presents.

Financial Health Evaluation Results

In an Initiative with cohort members representing a broad range of disciplines, budget sizes, and stages of financial health, organizations are most meaningfully compared against themselves, rather than against peer organizations in the Initiative. Therefore, what follows is a high-level summary of the financial health evaluation results, reflecting overall trends and themes across the cohort from 2010 to 2016. Because grantees were measured against themselves, and not against a universal cohort goal (such as all organizations reach the 'Strengthen' capitalization stage), most results were highly individual, and are therefore not shareable in this context.

Baseline position

The mid-sized arts cohort was comprised of **16** organizations with budgets between \$1.7M and \$35M, of which Initiative operating support represented 1-11% of total expenses. The youth arts mastery cohort included **14** organizations with budgets ranging between \$260K and \$4M, of which Initiative operating support represented 2-28% of total expenses.

Of the 30 organizations in both cohorts, based on financial positions in 2010 (two years prior to the launch of the Initiative):

- **15** started the Initiative with strong balance sheets (*i.e.* in the Deploy & Maintain or Strengthen stages).
- An additional **7** organizations started the Initiative with weak balance sheets (*i.e.* in the Transition stage).
- The remaining **7** organizations started the Initiative in the Recovery stage.
- **1** organization does not have its own balance sheet, as it is embedded in a university, and therefore did not receive a capitalization assessment. However, representatives from this organization were interviewed to assess their understanding of capital.

As one indicator of baseline capitalization literacy, TDC reviewed the target outputs and outcomes related to capitalization submitted by the grantees (then applicants) in their initial grant proposals to the Foundations in 2011 and 2012. This review revealed that these capitalization goals tended to be general, rather than actionable during the specific grant period, and many related to fundraising ambitions instead of balance sheet health. While most organizations could describe an accurate picture of their financial position and health, few did so through a lens of capitalization, suggesting a need for greater skills-building in this area. According to an initial needs assessment survey, **fewer than five organizations entered the Initiative with a cohesive capitalization strategy.**

Evaluation results

The results of the financial evaluation paint a **generally positive** overall picture of the Boston-based Barr-Klarman grantees as they endeavored to improve their financial health over the course of the Initiative.

Growth and scale of operations

Reflecting back on the seven year period, organizations grew budgets (total expenses) in response to programmatic opportunities and systemic pressures, such as:

- Escalating payroll costs;
- Challenging facilities issues; and
- Growing needs for more robust fundraising capacity.

All but two grantees grew budgets well beyond inflation over the seven year time period. The two organizations that did not grow budgets strategically downsized as a precursor to taking other bold organizational steps.

Cumulative financial health

Across the cohorts, organizations’ individual capitalization assessments revealed **23 of the 29 organizations experienced meaningful improvement** in their financial health:

- **13** organizations started and ended the Initiative with strong balance sheets;
- **5** organizations started with weak balance sheets and emerged with strong balance sheets; and
- **5** organizations made significant improvements in balance sheet health (*i.e.* growth in available URNA), but still ended the Initiative in an overall weak financial position.

As noted previously, while a demonstrated upward trajectory through one or several capitalization stages is a strong indicator of strengthened financial health, improvement within a capitalization stage is an equally valuable measure of stronger capitalization and a useful way for organizations to track their progress.

The graph in **Figure 4** below includes a breakdown of organizations’ placement in these capitalization stages by budget size, comparing 2010 and 2016.

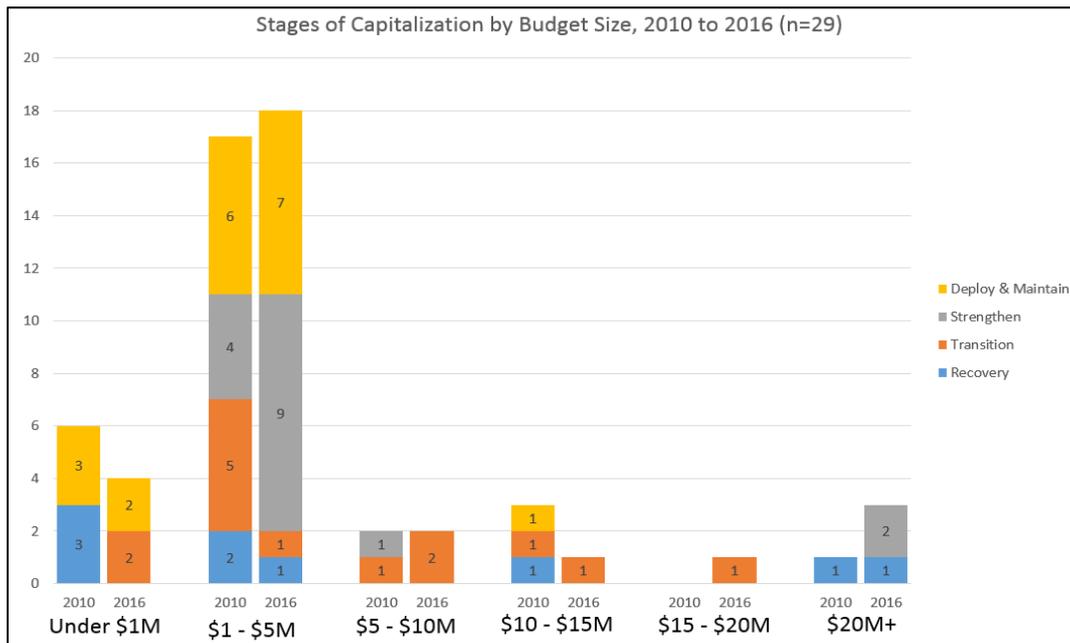


Figure 4 - Stages of Capitalization by Budget Size, 2010 to 2016 (n=29)

Several grantees who maintained strong balance sheets actually moved from the Deploy & Maintain to the Strengthen stage, or from the Strengthen stage to the Transition stage, which taken at face value could imply decreased financial health. However, in these cases, the downward movement between stages reflected deliberate decisions to deploy capital in pursuit of a strategic goal. In these instances grantees strategically stepped down the capitalization ladder, and evidenced a deep understanding of the rationale behind adequate capitalization to take a programmatic or organizational risk. This sort of risk-taking would not have been possible had they not had capital on the balance sheet for deployment.

The evaluation also revealed that **6 out of the 29 organizations experienced mixed or negative results** over the course of their participation in the Initiative:

- **5 organizations** had mixed results (*i.e.* they improved their financial health, but still faced business model challenges, including structural deficits, large fixed costs, and challenges in right-sizing); and
- **1 organization** experienced significant decline and a failed capitalization strategy.

These mixed or negative results happened in the context of organizational growth, which led these grantees to the insight that growing an organization’s budget does not offer a sustainable solution to alleviating entrenched business model challenges.

Across the cohort two trends emerged that, combined with interview responses, evidenced strategic financial decision-making by grantees:

- For the **23 organizations** who grew available URNA, the scale of growth kept pace with, or outpaced, budget growth (see **Figure 5**)³; and
- Growth in contributed revenue outstripped fundraising expense growth. **19 (66%)** organizations grew individual giving in particular.

These improvements suggest that grantees were building liquidity even as organizational budgets were growing, a finding which, in TDC’s experience, bucks trends among arts organizations in Boston and in other cities nationwide.

Capitalization literacy⁴

In interviews, TDC heard from cohort members about positive steps they had taken over the course of the Initiative to shift organizational practices toward improved capitalization.

- **17 (56%)** executives referenced in their interviews changes in internal organizational practices, planning, and strategy as a result of capitalization learnings through the Initiative. This figure,

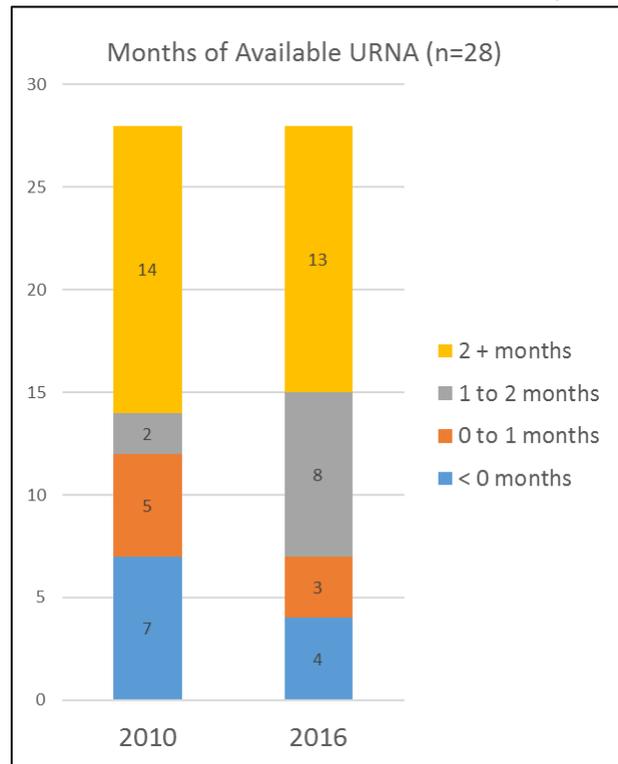


Figure 5 - Months of Available URNA (n=28)

³ For this calculation n=28; TDC used months of available URNA to get an apples-to-apples comparison across organizations of different scales and budget sizes.

⁴ For capitalization literacy n=30 as a grantee embedded in a university participated in a TDC interview even though it did not receive a capitalization assessment.

however, includes select organizations whose executives also acknowledged that they entered the Initiative with a strong understanding of capitalization and a clear strategy for implementation.

- **12** (40%) executives pointed in interviews to the creation of reserves during the Initiative.

Overall, the interviews revealed broad-based evidence of adoption of capitalization language and concepts among senior staff at the organizations; and many executives reported greater board engagement in conversations about financial health.

Looking Beyond the Initiative

On the whole, the evaluation revealed that at the Initiative's end, a majority of organizations had improved their financial health and/or further strengthened an already strong balance sheet. At the same time, the evaluation forecasted challenges for some participating organizations in the years to come. Several organizations anticipate constrained financial health due to unsustainable business models. In addition, many executive leaders articulated concern regarding the conclusion of the multiple foundation-driven initiatives that overlapped in Boston during the same five-year period, and some anticipate serious challenges locating replacement funding.

Faced with these challenges, however, Initiative grantees were hopeful that their capitalization learnings and near-term fundraising efforts would support their organizations in weathering these challenges and in pursuing improved financial health in the coming years.