THE KRESGE FOUNDATION

Capitalization Philosophy and Terms

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This guide describes the capitalization philosophy of The Kresge Foundation's Arts and Culture Program and serves as a glossary of terms.

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Institutional Capitalization

Kresge's new grantmaking initiative is designed to look at an organization's overall level of capitalization and capital needs. Institutional Capitalization will address capitalization through facilities, building on Kresge's years of experience working with facilities projects. While facilities may be the lens through which organizations look at capitalization, the required analysis will be much broader and require a deep understanding of how facilities and building reserves fit within and support an organization's long-term sustainability and achievement of mission. We believe that helping organizations become better capitalized will ultimately produce higher quality products and make organizations more impactful, innovative and relevant in and for their communities. Institutional Capitalization is a first step in helping organizations think about capitalization best practices, the methods to determine need and the resources necessary to achieve adequate capitalization.

Capitalization

Capitalization is the accumulation and application of resources in support of the achievement of an organization's mission and goals over time. A well capitalized organization has the ability to access the cash necessary to cover its short- and long-term obligations, to weather downturns in the external operating environment, and to take advantage of opportunities to innovate. All capitalization is represented on the organization's balance sheet, primarily in the Net Assets section (see definition below). An organization's appropriate scope and scale of capital structure only can be determined after an examination of an organization's time horizon, business model drivers and lifecycle (see definitions below), all of which are interwoven.

Time Horizon

Time horizon is the projected length of time for an organization's operations and is a key determinant of capital needs.

Short-term–Organizations dedicated to addressing current needs or realizing a single person's innovative idea or artistic vision. May be low budget and require flexible capitalization.

Medium-term–Organizations invested in a logic model, brand, or regular audience or membership.

Long-term–Organizations committed to the stewardship of buildings and collections and investing to meet the needs of future audiences. These organizations require permanence and stability, which impacts capitalization needs.

Business Model Drivers

Multiple factors can drive a nonprofit's business model. Each of these drivers is associated with a different time horizon and, therefore, different capitalization needs. Many organizations will have multiple business drivers. Understanding the interplay between the differences is essential to understanding capitalization and determining capital needs. Below are a few examples of business model drivers and their characteristics.

Facility Business Driver–Facilities increase an organization's risk profile. Ownership of a facility and the responsibility to operate and maintain it require higher levels of capitalization to achieve stability and create pressures on the operating budget that can be outside the control of management. One form of pressure is the need to reinvest over time to ensure that the value of the asset is preserved and the institution can continue to benefit from a safe and welcoming home for its programming. While leased facilities can sometimes create a quasi-ownership condition in terms of operating costs, the pressures are reduced without the need to protect the underlying asset.

Collections Business Driver – Organizations with collections must plan for perpetual care, housing and conservation of objects. They often have or plan to raise an endowment and need to maintain a facility to address these non-negotiable needs.

Audience Business Driver – Organizations that are highly dependent on audience rely on earned income from attendance and ticket sales for financial support as well as an indicator of success in finding a supportive and appreciative constituency for the stated mission. Audience-dependent organizations frequently invest in brand building to sustain interest and commitment over time.

Visionary Business Driver – Organizations primarily established to realize the artistic vision of a single artist or group may not include permanence among their organizational goals and may succeed in achieving their mission despite lack of capital.

Organizational Lifecycle

Organizational lifecycle is a map of an organization's development and evolution. An organization's place in the organizational lifecycle is a key determinant of capital needs. Organizations' lifecycles are relative and must take into account time horizon and the business model drivers. In other words, an organization with an artistic vision committed to the short-term realization of this vision may define "growth" differently than a museum with a long-term commitment to a collection. It can be counterproductive to imagine that all artistic vision organizations must someday grow into facilities-owning institutions, which would require very different capitalization needs. Typically, an organization will have more intensive capital needs during transition stages: start-up, growth, transition, decline and renewal. (For more information on organizational lifecycles, see “Nonprofit Lifecycles” by Susan Kenny Stevens.)

How to Determine Capital Needs

To determine an organization’s capital needs and adequate levels of resources, the organization should have a deep understanding of its time horizon, business drivers, key audiences and stage in its organizational lifecycle. Organizing this information through the lens of strategic planning allows an organization to set its short- and long-term goals and better understand and articulate its needs. A good strategic plan defines the strategies an organization needs to adopt to successfully achieve its goals and the capital structure required to implement the strategies.

Strategic Plan – An effective strategic plan is a document that articulates an organization’s vision. A strategic business plan also identifies and incorporates resources needed to achieve this vision. A comprehensive strategic business plan includes the following:

- Detailed articulation of the organization’s mission, programs and target constituents.
- Appropriate market research (knowledge about an organization’s marketplace and operating environment) that has tested demand for programs and sized the organization’s market.
- Key goals, strategies and tactics for how an organization will achieve its vision and fulfill its mission.
- Financial projections that outline all programmatic and operational expenses, and the resources required from different sources to achieve the vision over the trajectory of the plan.
- Research that supports earned and unearned income projections.
- Pragmatic projections for the new operating model.
- Realistic consideration of growth.
- Honest assessment of internal and external risk factors.
- Fallback or worst-case scenarios if any risk factors are realized.

- A planning process that engages staff, board and other key constituents around achieving and implementing the new vision for the organization.

Building Systems Replacement Plan – For organizations with buildings, additional analysis is necessary and helpful in determining capital needs. A building systems replacement plan/capital needs assessment is an organization's projection of the cost and timing of future facilities maintenance needs. If required investment needs are not met, deferred maintenance eventually may prohibit effective operations or pose a financial challenge to an organization in the form of an emergency repair need.

Shift in Business Model – Occasionally, an organization faces systemic or environmental issues that require a dramatic adaptation unanticipated by its strategic plan. In these cases, a shift in the business model may be required. It is a response to a profound change in the operating environment, and one that requires an organization to rethink its strategic direction and approach, business model and drivers, and necessary resources.

Both of the above circumstances can demand a major investment of capital in addition to levels required to support ongoing operations.

What Do We Need To Be Well Capitalized?

Organizations have varying levels and types of capital need depending on their business model, time horizon and lifecycle. Capitalization approaches are not one size fits all; what is appropriate for one group may not be right for another. Below are a few resources that are recommended for organizations as general best practices but are not required by all. Rather, the analyses described above – strategic planning, an analysis of organizational positioning and articulation of goals – are ways for organizations to determine their own needs.

Capital Funds

Six types of capital funds are used to maintain organizational health. Each of these funds addresses a distinct need. A capitalization strategy and/or strategic business planning process that includes an analysis of an organization's time horizon, business model drivers and lifecycle will identify the appropriate funds for an organization.

Operating Funds – funds used by organizations to pay for their reasonable, planned, day-to-day expenses to operate programs as stated in their current strategy.

Working Capital – funds to maintain ordinary business operations during cash flow challenges that arise from predictable business cycles. Each organization is unique in its need for working capital due to annual patterns of cash inflow and outflow. Having a working capital fund allows the organization to borrow internally when expenses are made before the income is received. When the income is received, the working capital fund can be refilled, much like a line of credit. In fact, for organizations with access to a line of credit, use of that line is an acceptable substitute for working capital, as long as the line is not used to finance debt. While there is no single standard benchmark level for working capital, organizations should maintain enough working capital to address the potential low points in cash flow.

Operating Reserves – funds held in order to protect against unexpected downturns, for example, the "rainy day." Frequently, such reserves are designed to cover operations for a specific period should ordinary income be disrupted, to survive the disruption or respond to changing circumstances. Unlike working capital, an operating reserves fund cannot be satisfied with a line of credit, as the source of the revenue to pay back the line is not often clear in the event of the fund's use.

Capital Building Reserves – also called capital improvement reserves or capital replacement reserves, these funds are held by organizations with facilities to realize long-term facilities replacement plans. For more detail on appropriate levels of building reserves, see A Guide to Building Reserves, located in the Resources box in the upper right-hand corner of the Kresge Institutional Capitalization web page.

Endowment – a fund that ensures the longevity of organizations with long-term time horizons through investment earnings dedicated to ongoing costs, such as maintenance of a collection or historic building. In general, the endowment corpus is composed of permanently restricted donations, although boards can create quasi-endowments not restricted by donor intent. The endowment ratio measures the level of endowment relative to an organization's operating expenses by dividing total endowment by total expense. An increase in the ratio over time indicates endowment growth at least in proportion to the growth in operations.

Innovation Fund/Risk Capital – An innovation or risk capital fund givesan organization the freedom to try out new ideas, such as product extensions, earned income ventures, major growth or a new strategic direction. Risk capital also is used to address large environmental shifts that demand a change in strategic direction.

Net Assets

Net assets are an organization's net worth. Net assets are most frequently explained mathematically, as the difference between an organization's assets and liabilities. Net assets are an important indicator when determining an organization's level of capitalization, for two reasons:

Net assets represent net worth as a result of an organization's cumulative surpluses (and deficits) since its inception. This makes the net assets an indicator of past financial success, stability and resources for the future.

Net assets can provide a more accurate picture of an organization's financial position than the budget. Determining net assets available to support organizations takes into account organizational capital that is locked up in illiquid investments, and is therefore not readily available to support the organization's operations. This is calculated by subtracting the net equity position in fixed assets from unrestricted net assets. Net equity is the net fixed assets (capitalized assets less accumulated depreciation) less associated debt.

Net Asset Mix

Net asset mix isan indicator of the degree to which an organization has flexibility over the use of its cumulative surpluses and the resources it has accumulated for specific purposes. Net assets are classified into three broad categories – unrestricted, temporarily restricted and permanently restricted. These categories reflect intentions of the donor, rather than any decision internal to the organization. Except for endowment, which is often permanently restricted, sources of organizational capital usually reside within the unrestricted net assets. Specific uses may be identified through board-designated funds within unrestricted net assets, although not all organizations formally partition their unrestricted net assets. While these designations can be set aside by board action, they can function effectively to instill discipline and remind the board and staff of the importance of honoring the principle of maintaining capital reserves.

Temporarily Restricted Net Assets

Temporarily Restricted (TR) activity includesTR contributions that are restricted by the donor for a specific purpose or specific time. Some examples of temporarily restricted net assets are gifts for specific programs or productions, pledged gifts for operations for future years and capital campaign gifts for facilities that are not yet built. When the restriction is fulfilled, the net assets are released to the unrestricted operating statement. "Net TR Activity" is the sum of all new TR contributions minus those released to unrestricted.

Permanently Restricted Net Assets

Permanently Restricted (PR) activity includes PR contributions that are restricted by the donor in perpetuity. The most common example is a gift to an endowment fund (see the discussion of endowments above).