
Nonprofit Growth Capital

Defining, Measuring and Managing
Growth Capital in Nonprofit
Enterprises

Part One: Building is not Buying

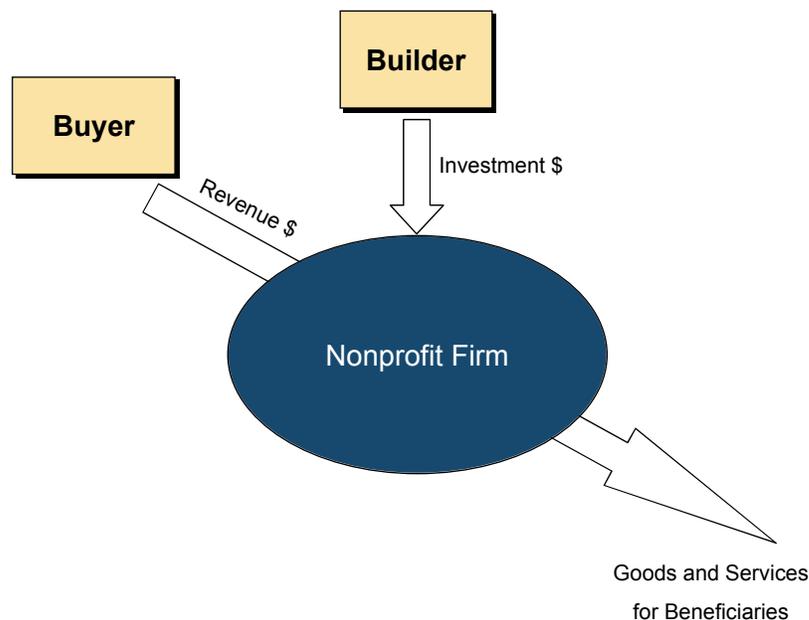
By George M. Overholser

Building is not Buying

Building an enterprise is fundamentally different than buying from an enterprise. And yet, standard nonprofit accounting sheds no light on the building vs. buying distinction. I believe that this missing distinction is a major reason why a market for nonprofit growth capital has failed to materialize. The good news is that the system can be fixed more easily than one might expect.

Building vs. Buying

Building the Enterprise (e.g. investing capital towards the creation of a tutoring outfit) requires growth capital and close stewardship. It requires a patient process of trial and error. It is highly technical and has a high risk of failure. More often than not, it requires major shifts in strategic direction, and major shifts in personnel. Also, it is an episodic thing – once an enterprise is built, the builders can go on to other projects. Indeed, it is precisely by dismantling their growth capital “scaffolding” that they prove they have built an enterprise that can stand on its own.



Buying from the Enterprise (e.g. exchanging revenue for tutoring sessions) is not about trial and error. It's about “what work will be done in exchange for my money?” It isn't about changing what the enterprise does; it's about asking the enterprise to do more of what it already knows how to do. So it's not about risk, or about shifts in strategy. It's about “show me what you do, and how you stack up so I can decide whether I should buy here or go elsewhere.” Finally, unlike building, buying is an ongoing thing, in the sense that if you buy something once and like it, then you might as well come back for more.

Investment

Investment is money from financial partners who join management's efforts to build a sustainable firm.

Among for-profits, investors are kept entirely distinct from customers. Their inflows are tracked separately (not as a part of revenues, but as paid-in capital), and an elaborate system exists to keep tabs on what percentage of the firm (their "stake") is linked to their contributions.

Among nonprofits the story is very different. Nonprofit accounting generally makes no distinction between investment-like and revenue-like funders (it's all captured as revenues) and there is no formal system for allocating firm-building credit among the various investors.

<i>Investment</i>
Flow of \$
Episodic
From financial partners who seek to build the firm
Expands the pool of Growth Capital

Revenue

Revenue is the money a firm receives from its customers in return for products or services rendered.

For for-profits, revenue is typically derived from customers who benefit directly from the purchases they make.

For nonprofits, the definition is less straightforward, since, in addition to being commingled with investment-like funding, revenue is often derived from third-party payersⁱ: Third-party payers use their money to pay for products and services, but they do so on behalf of others. For example, a donor might, on behalf of a homeless person, purchase a night in the shelter.

Throughout this paper I refer to these third-party payers as revenue-like fundersⁱⁱ.

<i>Revenue</i>
Flow of \$
Perpetual
From paying customers (often "third-party-payers")
Purchases the provision of goods and services

Growth Capital

***Growth Capital is used to build the means of production*^{iii,iv,v}.**

By way of example, imagine a for-profit management team that wants to open an ice cream shop. Long before they take in their first dollar of revenue, they need to spend money. They pay for real estate, they buy kitchen equipment, they hire and train servers – all of this before the first customer arrives. In this sense, growth capital is used to build the firm.

But it doesn't stop there. Even after the first customer arrives, there is not enough revenue to cover the shop's total costs. It takes time and effort to develop loyal customers, to perfect the menu, to reach financial "breakeven". For example, as the shop works to establish its base of customers, it may choose to offer special discounts. Eventually a reliable customer base is found, and prices can be raised to sustainable levels. But until that happy day, growth capital is used to provide a financial buffer.

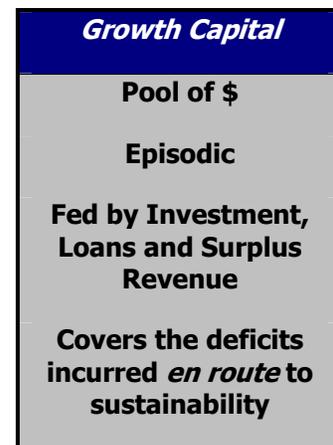
This brings us to a more accurate definition:

Growth Capital covers the deficits a firm incurs en route to sustainability.

If the ice cream shop never takes off, then the growth capital eventually runs out and the firm goes bankrupt. But if it does reach a point of sustainable financial performance, then the growth capital has done its job, and is no longer needed.

In this sense, growth capital is an episodic thing. Unlike customer revenues, which must be perpetual if the firm is to survive, growth capital acts as an initial catalyst.

This is not to say that growth capital only comes into play during a firm's start-up phase. Indeed, it can also be used to enhance a firm that already exists. For example, suppose the shop is a success – it "hits breakeven" after only six months. The remaining growth capital could be used to take the business to a new level, perhaps to open a second shop, or perhaps to attract more customers by improving the quality of the ice cream.



A discussion of "burn rate" and "take-off" should help to make this more clear.

Burn Rate and Take-Off

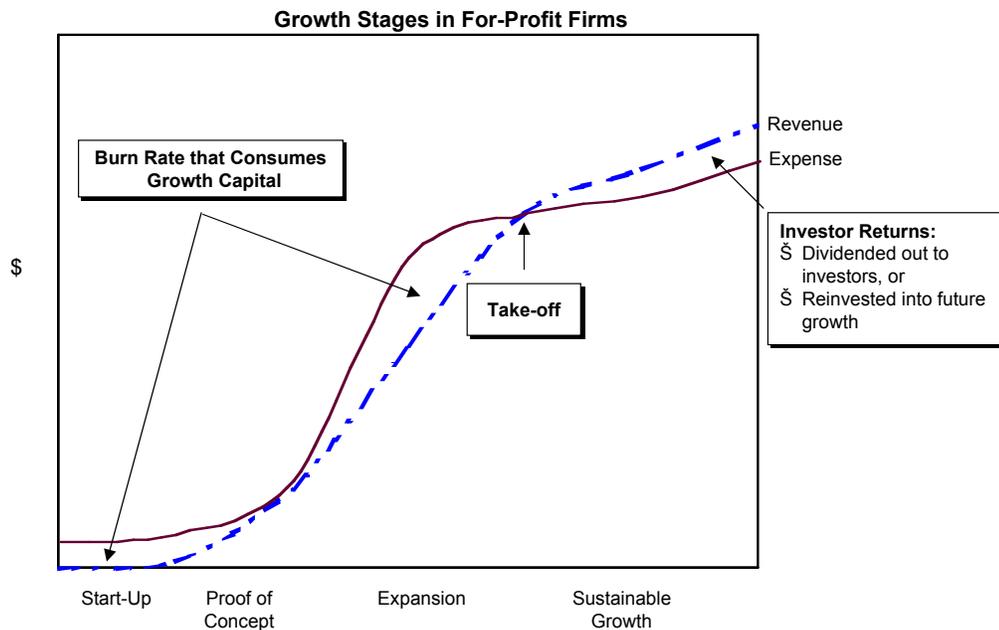
In the venture capital business, the rate at which firm consumes growth capital is called the "burn rate." For example, if a firm spends \$1 million a month but only takes in \$900,000 in revenues, it has a burn rate of \$100,000 that must be absorbed by its store of growth capital.

Growth capital and burn rates are closely monitored. Everybody understands that if the burn rate is too high, relative to the amount of remaining growth capital, the firm could go bankrupt before achieving take-off. Because the lead times on attracting further investment are long, much care is taken to forecast whether and when the growth capital is likely to run out.

The goal, of course, is to achieve take-off before investors are no longer willing to contribute growth capital. "Take-off" happens when there is enough cash flow from revenues to reliably cover the firm's ongoing expenses. This is the point where the burn rate goes to zero, and further injections of growth capital are no longer needed to sustain the firm.

In fact, to the extent that the firm generates revenue surpluses, it can be said to have a *negative* burn rate. And just as a positive burn rate depletes growth capital, a negative burn rate replenishes growth capital reserves for use in financing future enhancements to the firm.

Thus, while growth capital is most often created through investment, it can also be created by surplus revenues. Indeed, a healthy firm is able to grow indefinitely by retaining revenue surpluses and feeding them into growth capital.^{vi}



The Investor's Goal is Take-Off

Take-off marks the end point of an investment cycle, and thus the moment where an investor can begin to measure results. For example, if all goes well, the firm achieves take-off before the growth capital runs out, and survives thereafter on revenues alone – a sign that the investor has helped to build something of lasting value. But if take-off is not achieved, the firm falls apart and the investor's dollars have built nothing.^{vii,viii}

Taking it down another level: Investors partner with a management team to build a firm; if the firm learns how to offer compelling value, then customers happily sustain the firm's activities with their repeated patronage and revenues – homeostasis, if you will. But if the firm is not able to offer compelling value to each of its participants, then the participants^{ix} evaporate, and when the investors' money runs out, the firm ceases to exist.

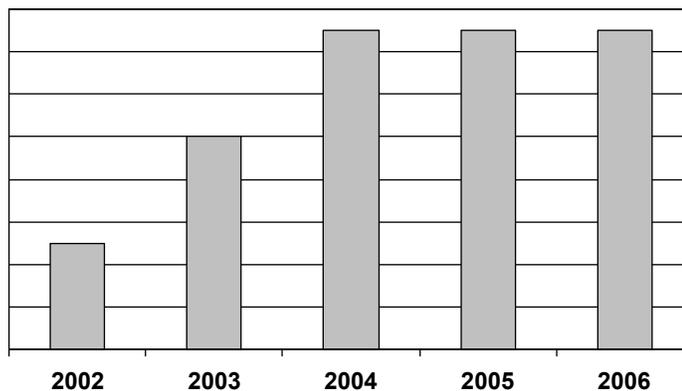
A key point here is that customer money, not investor money, (buy-from-the-firm money, not build-the-firm money) needs to be the source of sustainability. Otherwise, by definition, take-off has not happened and the investment cycle has not yet ended.

These logics hold true for for-profits and nonprofits alike: Take-off, sustained by satisfied customers, (both the paying kind and the beneficiary kind), is the goal of venture philanthropy investment. (Note that not just quantity, but also quality of social impact is a critical condition for satisfaction.)

The Problem with Commingling

The commingling of investments and revenues in standard nonprofit accounting makes it very difficult to determine whether take-off has been achieved. This leaves investors blind to the outcomes of their investing activities and is a major reason why a capital market for nonprofit growth capital has failed to materialize.

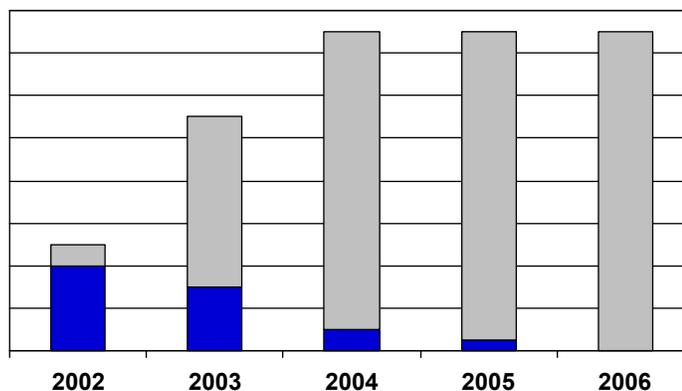
The Commingled View



To understand why, consider the chart to the left, which shows the revenues of a fictitious nonprofit, as reflected by standard "commingled" nonprofit accounting.

The story seems to be a good one. Revenues grew rapidly and were sustained at the new, expanded level. (We will assume that the organization is broadly recognized as having programs of high quality and positive social impact.)

Successful Take-Off

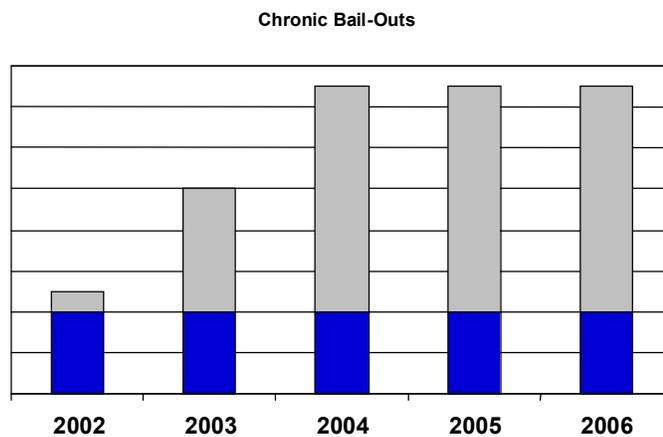


But how does the story look from the point of view of an investor? Answer: it is impossible to know without disentangling investment support from normal revenue-like funding.

For example, the second chart shows a disentangled view of what might have happened beneath the surface. (Blue reflects the consumption of investor-

furnished growth capital and grey reflects true revenue-like funding.) Here, after four years of covering deficits, the growth capital is no longer needed: Take-off has happened. (Note that the investors are now able to add up the cumulative investments to arrive at a measure of how much it cost to build the sustainable nonprofit enterprise.)

The third chart reveals an alternative version of what might have happened. Here, an unabated burn rate indicates take-off has not been accomplished, and the cost of building the firm (in blue), continues to grow with no end in sight.



Clearly, the second and third charts represent starkly different outcomes for the investor. However, using the standard commingled approach, both outcomes look exactly the same. The investors simply can't tell whether they have succeeded or failed.

Worse, imagine the case where each year's growth capital has been provided by a different investor.

How would this look from the investors' point of view? Using the commingled data, investors would be "blind" to the fact that they had been contributing to one another's chronic bailouts. Thus, they would tend to conclude that they had been successful in prompting sustainable growth, rather than guilty of keeping an underperformer afloat with money that would have been better allocated towards building a sustainable enterprise.^x

The commingled approach also stands in the way of measuring growth capital return on investment. Consider the question, for example, of how much did it cost to "build the firm?" For for-profits this is easy: How much, across all investors, was invested? But for nonprofits the answer is unknowable. With no distinction made between investment and revenues, there is no tallying of investments across multiple investors, and thus no way for any given investor to know whether the firm they helped build cost what they themselves had invested, or perhaps ten times that much.

Finally, consider the perverse incentives that the commingled approach places on nonprofit managers. I personally heard a nonprofit CEO who, upon receiving a venture philanthropy grant, announced that since the year's revenue goal had now been achieved, it was time to focus on other things. This is exactly the opposite of how it should feel to receive growth capital. Growth Capital should raise the urgency to grow sustainable revenues. Instead, the commingling approach lowers urgency by lulling management teams into a false sense of revenue security.^{xi}

An Easy Way Out?

I see no fundamental reason why nonprofits should not be able to account appropriately for investment and growth capital in their internal management reporting. In fact, several of New Profit, Inc's portfolio organizations have made a good start of it. The key lies in creating three categories of revenue. First is "Ordinary Revenue", second is "Invested Growth Capital" (a source of extraordinary revenue) and third is "Other Extraordinary Revenue".

Ideally, the Ordinary Revenue line would correspond to all payers who seek to exchange their money or in-kind donations for products and services rendered by the nonprofit firm. However, given the psychological reality that many funders do not think in terms of “buying” products and services, it is more practical to think of this line as containing all funders who are either repeatable or replaceable using the nonprofit’s existing methods of attracting revenues. This includes, for example, fee-for-service payers, as well as all recurring or “regular” unrestricted donors. Less obviously, it also includes “one time” grant-makers, so long as a case can be made that other, similar “one time” grant-makers can reliably be found to replace them in future years. Also less obviously, it includes customary grants that are earmarked to replenish capital items such as vehicles or computers that must be replaced from time to time as part of maintaining operations at a continued level of quality and

Long Range Operating Plan					
	2002	2003	2004	2005	2006
Lives Touched:	50	253	645	705	725
Ordinary Items					
Revenues:	\$ 10	\$ 110	\$ 505	\$ 619	\$ 632
Expenses:	\$ (200)	\$ (240)	\$ (581)	\$ (617)	\$ (631)
Ordinary Surplus (Deficit):	\$ (190)	\$ (130)	\$ (76)	\$ 2	\$ 1
Extraordinary Items					
Invested Growth Capital:	\$ 400		\$ 30		
Revenues:		\$ 15			
Expenses:		\$ (15)			
Cash Remaining (at end):	\$ 210	\$ 80	\$ 34	\$ 36	\$ 38

scale. Finally, it includes the usual array of restricted grants which, collectively, contribute towards covering the full cost of producing the nonprofit’s goods and services, as well as the ongoing efforts to develop or enhance individual programs.

The topic of program innovation deserves special mention. Just as product development is an ongoing “cost of doing business” for a for-profit company, program innovation is an ongoing function for a healthy nonprofit enterprise. For this reason, most program innovation grants are best categorized as repeatable/replaceable Ordinary Revenues, despite the one-time feel of any particular grant. Think of it this way: Growth Capital is an “enterprise” concept, whereas most program innovation grants occur at the “project” level.

The Invested Growth Capital line includes only those funders who consider themselves, and are considered by the management team/board to be in the business of investing growth capital. They can be high engagement philanthropists, and they can be contributors to a specific growth capital fund drive. Their common trait is that they evaluate the success or failure of their investment based upon whether the enterprise expands, with high quality, to an enhanced level of operations, sustained by Ordinary Revenues. (Take-off.)

Finally, the Other Extraordinary Revenue line includes grants that are neither repeatable nor replaceable by similar grants, and that are not intended as a means to enhance sustained operational scale. An example of this might be a one-time grant that funds a case study write-up of the nonprofit's experiences.

The chart above illustrates how this form of management reporting looks in action. Note the following:

- The organization grew quickly and then leveled off at a scale of serving roughly 700 beneficiaries per year.
- Initially, Ordinary Revenues did not cover the cost of running the program, hence the need for Growth Capital.
- By 2005, Ordinary Revenues "caught up" to Ordinary Expenses, providing a small Ordinary Surplus, and signaling take-off.^{xii}
- In total, "building the sustainable enterprise" cost \$430,000.
- The enterprise was able to continue mild growth thereafter, without requiring further Investment of Growth Capital^{xiii}.

The Benefits of Separating Revenues from Investments

I see several benefits in adopting management accounting treatments similar to the one described above:

- Requires no change in general external reporting. This is for management reporting only, and is made privately available to the small number of high engagement investors who seek to track the outcomes of their investments.
- Helps the management team and board to keep an urgent focus on growing the repeatable/replaceable Ordinary Revenue line, even as plenty of cash is flowing into the Invested Growth Capital line.
- Allows for clear measures of progress and trajectory towards take-off.
- Handles the issue of tallying investment across multiple investors, thereby exposing any chronic bailouts that might be taking place.
- Provides a basis for establishing the cost, across all investors, of building an enterprise to a given level of sustained operations. (This corresponds to the denominator of the Venture Philanthropy SROI calculation^{xiv}.)
- Appropriately puts pressure on investors to avoid funding nonprofit enterprises that repeatedly fail to make progress towards sustainability.

- Appropriately puts pressure on nonprofit managers to “wean” themselves from investor-type funding, unless they have the prospects of commensurate, sustainable growth to offer in return.
- Forces a clear identification of who is and who is not considered to be an investor of Growth Capital, and therefore who is entitled to certain high engagement rights and privileges, such participation in strategic planning and performance measurement activities. (It does not, however, negate the importance of one-time program innovation grants, which are best thought of as Ordinary Revenue, given the ongoing nature of program innovation over the life of a healthy nonprofit enterprise.)
- Helps to clarify the distinction between capacity-building grants that replenish capital items (treat them as Ordinary Revenue) vs ones that establish fundamentally new capacity to serve (treat them as Invested Growth Capital)
- Helps drive the enterprise and its investors towards adopting a single set of financial reports, and a unified set of strategic and financial goals.

Clearly, this accounting approach does not come without some costs. Most notably, nonprofit managers need to be willing to subject themselves to the prospect of actually striving to lose some of their most cherished funders. They also need to be willing to have sometimes-difficult discussions with funders who wish to be recognized as growth funders, but who would be better classified as part of the ongoing repeatable/replaceable pool of funders.

Nevertheless, on balance, I believe that Social Entrepreneurs in particular have found that the clarity that this approach brings to the task of attracting and managing growth capital outweighs any inconveniences involved. Indeed, I believe that a robust nonprofit capital market is unlikely to materialize unless we can begin to make a clean distinction between Building and Buying.

ⁱ “...just as many for-profit businesses such as HMO’s or auto repair shops, receive cash inflows from third-party payees (such as government revenues, insurance companies, corporations buying benefits for employees, etc.), nonprofits do as well. These revenues often cover the operating expense of an organization providing services, programs or support to others who often do not pay the full cost of such services. This fact and its impact upon the operation of the Nonprofit Capital Market are worth noting and clearly require further research.” **Jed Emerson**, “The U.S. Nonprofit Capital Market: An Introductory Overview of Development Stages, Investors, and Funding Instruments,” Roberts Foundation, originally published in 1998, re-released as part of the REDF Box Set, May 2000.

ⁱⁱ An important problem is that *psychologically*, most funders do not perceive themselves as third-party payers. This reduces their focus on outputs and outcomes, and increases their emphasis on the internal workings of the nonprofit enterprise, or on donor experiences that are largely unrelated to program cost or quality.

iii In contrast to Growth Capital, Working Capital is a cash buffer that absorbs timing differences between inflows and outflows in the normal course of a firm's operations. Even after growth capital has done its job, working capital is needed preserve a firm's liquidity. Suppose, for example, that our ice cream shop likes to buy supplies in bulk, once a quarter. This creates a situation where the business incurs expenses before it has customer revenues to cover them. Working capital provides the needed financial buffer. (One of the defining characteristics of sustainability is the faithful maintenance of adequate working capital reserves. To avoid liquidity crises, a firm must never forfeit its working capital. Once working capital has been depleted, even a minor cost or revenue mishap is prone to trigger a never-ending cycle of subsistence.)

iv Risk capital is a third (and overlapping) category of capital that bears mention, but mostly lies beyond the scope of this analysis. Risk capital plays two roles. First, Risk Capital provides collateral to debt holders. Thus, among for-profits, risk capital joins debt in comprising the full capital structure of the firm. Indeed, the ratio of debt to risk capital (called the debt-equity ratio) is a critical tool used by for-profit lenders, and a critical gap in the nonprofit financial lexicon. Second, Risk Capital buffers the firm from unexpected financial shocks. These are not the normal ebbs and flows that are buffered by working capital, but rather the extraordinary shocks that may or may not occur over the course of several years. Endowments often play the role of risk capital for nonprofits, as do tangible assets such as bricks and mortar. At any given time, portions of growth capital and working capital may also contribute to the firm's overall store of risk capital, although the bulk of risk capital tends to be harbored in separate, less liquid, forms. Sadly, most nonprofits retain far less risk capital than is optimal. This reduces their access to financial leverage via debt, and leaves them vulnerable to financial shocks. (For a more thorough discussion of other forms of nonprofit capital, refer to **William P. Ryan's** excellent paper, "Nonprofit Capital: a Review of Problems and Strategies," for the Rockefeller Foundation and Fanny Mae Foundation, 2001)

v Let us also note how growth capital is not defined. It is not defined in terms of specific cost areas, for example. Whereas capacity-building grants are often earmarked for specific items like management training or recruitment expense, growth capital tends to be used to cover more general cost areas, such as the cost of running a program in a new city up until the time that a dependable local network of funders can be established.

vi More precisely, any surplus balance of cash, over and above what is needed to cover working capital and risk capital requirements, can be safely designated as being available for use as growth capital.

vii I have left out some details, such as the practice of raising multiple rounds of growth capital before take-off is achieved, and the for-profit investor's ability to sometimes make financial gains by swapping shares in the secondary market, even though the firm has not yet reached take-off. These details do not change the essential point, however.

viii Note that the test of success is whether take-off can be achieved, not whether it has in fact been achieved. As a practical matter, growing organizations should not be "weaned" from growth capital, just so a particular investor can see proof of take-off. Much of the work at New Profit, Inc has dealt with the art of measuring progress towards sustainability, even as investments continue to pour into the still-growing enterprise. The framing question: Could this enterprise be sustained by its repeatable/replaceable revenues were growth capital to be withdrawn? NPI's "graduation checklist" is a vital tool that incorporates non-financial measures into this assessment.

ix For nonprofits, the word "participants" seems better than "customers", since not only payers, but also beneficiaries, employees and volunteers must be adequately satisfied by their experiences if homeostasis is to take hold.

x It is interesting to note that, in the limit, this pattern of repeated bailout investments is truly no different than revenue, in the sense that it becomes the money that reliably pays for the production of goods and services. Many a nonprofit is sustained by an endless succession of “one time” innovation grants. The problem, of course, is that the one-time innovation grants force the nonprofit into a pattern of never ending disruption, rather than one of focused production and replication.

xi The “low revenue urgency” problem is exacerbated by the practice of avoiding revenue surpluses, lest they be interpreted by prospective funders as a sign that the organization does not need their help. Ironically, this would seem absurd in the for-profit world, where a growth in revenues generally signals that there must be something worth buying.

xii Note that “Ordinary Surplus” and “earnings” are not the same thing. It is quite possible that this nonprofit has used its earnings to continue its mild expansion in capacity, thereby diminishing the size of the end-of-year Ordinary Surplus.

xiii This is akin to the for-profit business that continues to fuel its growth by retaining its earnings rather than paying them out as dividends.

xiv My next working paper is slated to address the Venture Philanthropy SROI topic.