The Risk of Debt in Financing Nonprofit Facilities

Why Your Business Model Matters
TDC is nonprofit consulting and research group, founded in 1968, dedicated to providing the nonprofit sector with the business and management skills critical to operating effectively. TDC believes that the nonprofit sector plays a vital role in society, giving tangible support to some of our country’s most cherished ideals and enhancing the quality of our lives. Elizabeth Cabral Curtis and Susan Nelson, TDC principals, are the article’s primary authors. Contributing to the study findings are Allison Crump and Anne Freeh Engel of the TDC staff.
THE GENESIS OF THIS STUDY

Recently, we had a call from a board member of a large nonprofit who told us the following story: About five years ago, the board member’s organization had created an exciting future vision for itself, the result of a new strategic plan. This new, vibrant programmatic vision was designed to allow the organization to engage and serve its constituents better than ever before. It included an improved facility. During the process of designing and constructing the building, however, the size of the organization’s project more than doubled, and though they had been successful in raising far more money than had been originally projected, the fundraising team ran out of steam, and the board opted to finance the remaining cost of the building.

On the face of it, this nonprofit organization would appear to have been a fine candidate for debt — they had a good earned income track record and the ability to build it further. They had donors who both cared, and had the capacity to give at significant levels on an ongoing basis. Finally, they had an excellent location to which they could draw the desired audience. All of these factors have played out as expected — both the programs and the facility opened to great acclaim and the audience they sought to serve has continued to come well beyond the opening. But, five years later, the debt payments are choking the organization’s ability to thrive, and dividing the board as to how best to address the problem.

This story is hardly unique. Rather, in TDC’s experience, it is an oft told tale. This organization’s story, and others just like it, lay at the heart of our motivation to undertake this study. Our more recent client experiences suggested that long-term debt has been yielding mixed results. In some cases the debt has been used to great advantage; but in other cases, organizations have struggled to meet their debt payments, and found their long-term vision and operations unexpectedly constrained. These mixed experiences reflect the fact that long-term debt is a tool, and, like most tools, it can be used to better and worse effect depending on the skill of the user. In this way, debt is like an axe, one observer wryly noted: “You can build a house with it, or cut off your arm.”

The last thirty years have seen a dramatic growth in the number of providers who are willing to provide long-term facilities financing to nonprofits, ranging from nonprofit financial intermediaries to commercial banks to quasi-public government agencies. Competition, coupled with historically low interest rates and innovative financial products, and a dramatic shift in attitude among board members have set the stage for a rapid expansion in the market. But if debt is now more broadly available as a tool to finance facilities growth and change, then what kind of impact is its use having on the nonprofits that are using it? And has the nonprofit sector developed the right types of business practices that allow it to fully understand the risks and rewards of long-term debt related to facilities?

THE RESEARCH APPROACH

Prompted by a few years of “anecdotal evidence,” we set out to learn more about the long-term debt experiences of nonprofits. We quickly became convinced that universities and hospitals had deep and widely shared experience in understanding how to best utilize debt. But for other parts of the sector a review of the literature surfaced nothing of real value. With support from two Massachusetts foundations, the Barr Foundation and the Fidelity Foundation, we began our own systematic assessment of facilities-related long-term debt.

In framing the research, we thought it might be helpful to understand the impact of such debt in the context of varying revenue and expense models, and looked at nonprofits that are reliant on earned income, another group that is dependent on government support, and yet another cohort that is reliant primarily on philanthropy. Having found organizations reflective of these characteristics, we cross-referenced them to organizations that were also dependent on a facility to deliver on mission. This analysis focused the study on arts and cultural organizations, human service providers and independent schools.

With the study group selected, we delved deeply into five years of IRS Form 990 tax returns, from 1998 to 2003, for 263 Massachusetts nonprofits with assets of over $5 million.

Our team also consulted dozens of market players, including banks, intermediaries, and foundation executives, as well as randomly selected staff and board members at the nonprofits themselves — all with relevant experience in facility-related debt.

Study Group:

- 263 Massachusetts nonprofits
- Independent schools, human service providers & arts & cultural organizations.
- Assets over $5 million

Notes:

1 IRS 990 reporting provides information on the annual gain or loss on investments and securities. For the purpose of this study, this number serves as a proxy for return on endowment. Actual endowment income draw will differ from the return based upon an organization’s spending policy.
LONG-TERM DEBT IS NOW COMMONPLACE

Massachusetts nonprofits studied, in the three target sub sectors—human services, independent schools, and arts and cultural organizations — have indeed expanded their use of facilities-related long-term debt, and nearly doubled total long-term debt holdings in the five-year period studied. Suppliers in the marketplace, banks and intermediaries, were actively marketing multiple products, many of which were highly sophisticated financial instruments that engendered complex deals.

Debt was present within organizations of different budget sizes, not just among the largest. With the advent of loan pools, small organizations and smaller projects now actively participate in the tax-exempt marketplace.

- By the end of 2003, two-thirds of the organizations studied held long-term debt in the form of bonds or mortgages.
- The aggregate long-term debt held by the 263 groups in the sample was $1.06 billion at the end of 2003, an increase of 131% over 1998; and,
- The average long-term debt held by the 179 organizations with long-term debt nearly doubled from $3.3 million to $5.9 million from 1998 to 2003.

ARTS AND CULTURE

Arts and cultural institutions, we found, are engaged in a “hundred year” cyclical reinvestment in facilities to support continued public engagement. Yet, the financial picture for arts and cultural organizations that have used long-term debt is mixed. Arts and cultural organizations saw the largest increase in total debt of the three sub sectors TDC reviewed. Half of the organizations with debt were running operating deficits which strongly suggests financial fragility.

The good news is that institutions with long-term debt have roughly the same amount of operating cash as their debt-free peers (15 months compared to 18 months). However, this does not hold true for the smallest groups in our sample: Organizations with budgets under $1.5 million that held long-term debt had less than two months’ operating cash on average, compared to 18 months for groups without debt. This lack of a cushion can be problematic in the arts & cultural sector, because these organizations have little control over earned revenues, and must rely on contributed income to support operations.

Many of the arts and cultural organizations reviewed have healthy endowments that could be used to repay the loan in a worst-case scenario: Half the groups had investments worth more than twice the value of their long-term debt. Some, we found, appeared to be using debt to take advantage of lower-interest rate mortgages or bonds while leaving capital invested in the markets with the hope of achieving a higher rate of return.

It is important to note that because arts and cultural organizations on the whole rely heavily on endowment income, this strategy could pose a correspondingly greater risk if it proves necessary to tap these investments for repayment. This risk is exacerbated by the high rates of deficits in this sub sector.

FINANCING A FACILITY – BONDS OR MORTGAGES:

- **Tax Exempt Bonds**: long-term financing for specified public purposes through a state or local government issuer, that carry lower than market interest rates due to the tax-exempt status of the interest to the investors. These are secured by a line of credit from a bank or through internal reserves.
- **Traditional Mortgages**: secured loans based on the value of real estate, usually designed to repay principal and interest within the life of the loan.

These figures suggest that financial tools such as mortgages and bonds have now become commonplace in many segments of the nonprofit sector. Additionally, we found growing willingness to consider debt as a useful tool among the nonprofit board members and managers interviewed, a dramatic change from years past. While the general growth trajectory was not such a surprise, we were startled at the pervasive use of debt and the rapid increases in average debt size in our sample. This pattern of growth plays itself out across the three sub sectors TDC examined, though not in a uniform way.

Arts & Culture Statistics

- Total debt grew 185%, from $38.6 million to $110 million.
- Average debt rose from $2.1 million to $3.9 million, over half of which was in the form of bonds.
- Thirty-six percent of the borrowers among arts and cultural organizations were new to debt. Overall, 42% had long-term debt.
HUMAN SERVICE PROVIDERS

Long-term debt is the norm for the clear majority of human services organizations studied, making it impossible to form a proper comparison between organizations with and without debt. We found that human service providers have consolidated using debt, and have also used it to build capacity to serve larger numbers of clients.

All groups in this sub sector present a mixed picture of financial health. The state-imposed business model of these groups allows them to function, though not thrive. Of the human services groups with long-term debt, one quarter were running deficits; on average, they held only five months of operating cash.

INDEPENDENT SCHOOLS

Overall, independent schools tend to rely on tuition to support their operations. Those we reviewed, including those with long-term debt, showed positive signs of financial health. Of the schools with debt, fewer than 15% ran operating deficits, and most had strong amounts of operating cash. Another indicator of financial strength is the prevalence of bonds in this sub sector, which speaks to schools’ capacity – both in terms of their assets as well as their income statements – to manage their operations within the covenants that are associated with bonds.

For many schools, endowments are strong, and an important asset. If worst came to worst, almost half (43%) of the schools with debt could pay it off and still have remaining investments that were equal to the original debt – or larger.

Human Service Statistics

- Human service providers saw an increase of 122% in total debt, from $172 million to $381 million.
- Average debt rose from $2.1 million to $4 million.
- Over one-third of the debt was in bonds; and
- Only thirteen percent of the borrowers were new to debt. Overall, 79% had long-term debt.

Statistics in Independent Schools

- Independent schools saw an increase of 131% in total debt, from $248 million to $572 million.
- Average debt rose from $6.2 million to $10.2 million
- Over 75% of the debt was in the form of bonds; and
- Twenty-nine percent of the borrowers were new to debt.
- Overall, 74% had long-term debt.
While the statistics are significant, not surprisingly, they only tell part of the story. When the study began, we, our funders, and many of our interviewees, had a great desire to formulate a set of conclusive rules about how and when to use debt. We soon came to realize that there are no simple rules when it comes to evaluating the merits and drawbacks of debt. Lenders, and many borrowers, reminded us again and again that debt is neither inherently good nor bad; it’s the planning and utilization of this tool that impacts the outcomes.

We have come to a deep appreciation for this viewpoint. Indeed, we’ve seen that debt at its most effective is part of an overall strategic decision that involves consideration of vision, mission, finances, and most importantly, risk. Organizations that have struggled, more often than not, backed into their decision through a limited, rather than thorough assessment of these complex issues. There are some lessons to be shared:

- **The Business Model Matters.** The mix and sources of a nonprofit’s earned and contributed income varies by type of organization, and directly impacts the organization’s ability to effectively use debt. We found that it pays to understand how using debt will play out in the context of the business model.

- **Understanding the Role of the Bank or Financial Intermediary Matters.** Lenders are not technical assistance providers, nor are they acting as financial advisors when it comes to making a deal; they are acting through the lens of their own risk. Yet, we found many organizations that relied solely on the advice of their lenders when putting deals together.

- **Ensuring that All Those in the Organization with a Fiduciary Role Understand the Deal Matters.** Typically, the details of a deal are held by a small group of individuals—perhaps the CEO—typically, the CFO or the business manager and a few board members. This means that over time the how and why of a deal can be lost and new leadership can find themselves in the dark, if and when the operating environment changes.

- **Understanding an Organization’s Risk Tolerance over a Long-Term Horizon Matters.** Financial institutions have a structured way of assessing risk, but most nonprofits do not have a fully developed and well articulated position regarding institutional risk that would allow them to explore the efficacy of a specific facilities project and the use of debt to secure its implementation.

Below, we explore each of these lessons in greater detail.

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**THE BUSINESS MODEL MATTERS**

In comparing the three sectors, we found that the business model of the organization matters and significantly impacts the financial health of these institutions.

Each sub sector analyzed has a distinct revenue model that impacts the efficacy of debt when used to build or renovate a new facility. We also learned that a business model that uses debt more efficiently can often withstand a nonprofit’s lack of sophistication when it comes to putting a deal together.

**WHAT IS A BUSINESS MODEL?**

When we speak of a business model, we mean the mix of earned and contributed revenue sources that drive the organization’s finances.

All nonprofits rely on some mix of contributed income, such as individual donations and institutional grants, and earned income, including user fees, contracts and retail sales. Each of the sub sectors in our study had a slightly different business model. Earned income is a key source of revenue for both schools (tuition) and human services (government contracts); arts and cultural organizations rely more equally on both earned and contributed income. Endowment income can also be a factor.

**Independent Schools**

**Business Model**

The business model of independent schools tends to rely on tuition. We found that the income profile is on average:

- 68% earned income
- 24% contributed
- 8% earnings from endowment.

This high proportion of earned income reflects the fact that schools typically offer a desired product — a good education with a strong brand name – for which there is high demand in the marketplace. As a result, many schools have the option of raising tuition prices to accommodate increases in their own costs.

Another key characteristic of these schools is that they have the advantage of an alumni base, which provides an easily identifiable, committed group of donors that support the school and its need for continued excellence.
While endowment income is a relatively small percentage of overall income, for the largest schools in the sample, the picture is different:

- 41% earned income
- 32% contributed
- 27% earnings from endowment.

Among the largest schools, endowments and the income they provide can be significant, reflecting the strength of the alumni base and providing flexibility to withstand any economic downturn as well as demonstrate compliance with loan covenants.

**Role of Debt**

Long-term debt is an integral part of the business model—74% of schools in the sample had some type of long-term debt on their balance sheets at the end of 2003. Debt is typically used to finance the expansion or upgrade of facilities, which is becoming an increasing priority as schools seek to enhance their competitive edge. Conversations revealed that there are significant peer-to-peer networks that allow leadership at independent schools to tap each other for advice and experience regarding debt.

Among independent schools, the average debt grew by 65% between 1998 and 2003, rising from $6.2 million to $10.2 million. Interestingly, a significant fraction of the schools studied—over one-third—had long-term debt of over $10 million in 2003. The rapid growth and larger debt sizes among this group of schools are consistent with what observers call an “arms race” among independent schools for better facilities. The combined long-term debt held by all these schools grew from $248 million to $572 million, or 131%.

Bonds are used by 59% of borrowers in the sub sector; 89% of the bond debt is held by schools with operations of over $10 million.

While schools could easily offer their facilities or endowments to banks as collateral, the lower interest rates on tax-exempt bonds are a clearly preferable choice to the higher interest rates usually charged on conventional mortgages or loans.

There also appears also to be a philosophical underpinning to utilizing debt in this sub sector. Debt provides a mechanism to “spread the cost” over several class years, reflecting the expected lifespan of the building the debt is financing. Tuition can be increased to reflect the facilities improvements. At the same time alumni fundraising assures a steady stream of supporters who continue to be invested in the good reputation of the school.

This suggests that independent schools may be wisely deploying their capital by borrowing funds at the tax-exempt rates while achieving higher rates of return in the market. Nonetheless, it is important to note that any move to cash out the endowment to repay the debt poses serious risk to schools that derive a substantial portion of their annual budgets from endowment income.

**Utilization of Debt**

- Overall, well-managed debt appears to be an effective tool for independent schools, who manage to both repay the debt and keep a healthy bottom line.
- Lessons learned are commonly transferred across schools through informal networks.
- At the high end of the marketplace, endowments offer a significant financial cushion and comfort; and,
- When conditions are favorable, the lure of a higher return on investments over the cost of debt is strong and the results can be positive.

**Human Services Providers**

**Business Model**

Of the three sub sectors in this study, the business model of human services organizations is most shaped by public policy. As a general rule, government has made a conscious choice to “outsource” human services; they believe that it is more efficient for the public sector to provide certain services such as care to the homeless, programs for youth, and addiction treatment centers through nonprofits.

The outcome of this policy decision is that human services organizations rely on state and federal government contracts for the bulk of their total revenue. Under these contracts, organizations are compensated based on the level and type of service they provide to their clients. Contracts and rate structures are typically negotiated for a set three-to-five year period.

The compensation rates set by the government are often priced right to the margin. In other words, the nonprofit receives an amount of funding that reflects some — but certainly not all — of their overhead costs. The expectation is that human services organizations will raise funds to make up the difference between what the service costs to offer, and what the government is willing to pay.

This results in the following income profile:

- 71% earned income
- 27% contributed
- 2% earnings from endowment.
It is interesting to note that the level of contributed income among organizations in this sub sector sample is being driven by the smallest organizations. Among organizations in the bottom third of the sample, the profile is quite different:

- 59% earned income
- 36% contributed
- 5% earnings from endowment.

For human service organizations, income from endowment is not a significant revenue source with only 2% of total revenues on average coming from endowment income.

Role of Debt

Long-term debt is also an integral part of the business model for human service organizations. By the end of FY 2003, 79% had some type of long-term debt (bonds or mortgages) on their balance sheets. Unlike their counterparts at independent schools, however, and despite the prevalence of debt, individuals at these organizations do not report regularly talking to their peers about long-term debt, either to share experience or seek advice.

Within this sub sector, debt is seen as a useful tool to finance the expansion of buildings in order to increase the capacity to serve client populations. Examples of such facilities include group homes, treatment facilities and youth centers. Government contracts are often structured to provide some reimbursement for the cost of facilities, including debt service payments. Long-term debt in this sector can be seen as simply a way to enable human services organizations to spread their facilities costs into the future. The hope is that contracts will continue to be renewed, creating a “steady” future revenue stream.

Like private schools, the funding mechanisms of human services providers suggest an apparent philosophical underpinning to utilizing debt for facilities that have government contracts as their predominant income stream. The cost of a group home, a nursing home, or a day care center can be spread over its useful life to reflect the fairest burden to the taxpayer. This, however, is not as true for the subset of human services providers where government funding plays a less significant role.

The total amount of long-term debt held by groups in the human services sector more than doubled over five years, rising from $172 million to $381 million. The average size of long-term debt correspondingly doubled over this period from $2.1 million to $4.0 million. Very large debt sizes were, however, less common: Only a small fraction (13%) of borrowers had long-term debt of over $10 million.

Interestingly, half of the long-term debt in this sub sector comes in the form of mortgages. Bonds are used primarily by organizations with budgets over $10 million. The prevalence of mortgages is perhaps due to two different factors. First, this sub sector tends to slender operating margins, which makes it more difficult for them to remain within bond covenants, and further, makes them less attractive to the bond market. Second, the main asset of a human services organization tends to be its building, which lenders are willing to accept as collateral for a conventional mortgage. Many of these buildings have the potential to be reconverted to other uses, which means that there is less risk to the lender that the value of the building will not keep pace with the market over time.

Utilization of Debt

- Both long-term debt and financial fragility are common among human services organizations.
- Overall, mortgages seem to be an effective and common tool for human services providers.
- Bonds in this sub sector are held by the larger groups, which tend to have the sophistication and scale of operations needed to support bond covenants.
- Current communication channels do not encourage human services groups to share experiences.
- Because endowments are not a key element of the business model, organizations are less likely to trade off a low-interest loan against the potential of a higher rate of return on investments.

Arts & Cultural Organizations

Business Model

By comparison with the first two sub sectors detailed above, arts and cultural groups rely far more heavily on philanthropic dollars for a large portion of their revenues. The income profile for arts and cultural organizations studied was:

- 44% earned income
- 47% contributed
- 9% earnings from endowment.

Unlike schools, which have a dedicated alumni base, arts and cultural institutions have no built-in funding constituency. Donors must continually be identified and cultivated.

The lower reliance on earned income speaks to arts and cultural organizations’ limited ability to raise ticket prices. Cultural audiences can be highly price sensitive; in other words, if these groups raise ticket prices too high, people will be less likely to come, resulting in lower income.

It is important to note that, as with schools, the role of endowment income is most significant among the biggest organizations. For these groups, the steady stream of income offered by endowments is often critical to annual operations, as well as to long-term stability.
Role of Debt

Within the arts and cultural sector, 42% of organizations held long-term debt in 2003, a somewhat lower level than that of other sub sectors in this study.

Average debt levels, however, almost doubled, rising 85% from $2.1 million to $3.9 million between 1998 and 2003. The total debt held by arts and cultural organizations nearly tripled, climbing from $38.6 million to $110 million. The higher debt levels here are consistent with observers’ comments that arts and cultural organizations in the state are in the midst of a hundred-year building cycle. While the growth rates have been rapid, few organizations hold large debts; only two borrowers within this sub sector exceeded $10 million in total debt in the period studied.

Mortgages are used by 75% of borrowers in this sector, making them the predominant form of long-term financing for facilities. Bonds, while only used by 25% of borrowers, as elsewhere across all three sub sectors, appear to be the tool of choice among the largest institutions: Organizations with budgets over $20 million hold 69% of bond debt in this sub sector.

When arts and cultural organizations take out long-term loans for facilities, additional collateral is often required. The design of physical spaces for cultural groups must be specialized to their particular art form — such as gallery space to hang paintings or stage space for performances. As such, these facilities are more challenging to repurpose for another user, and therefore have less potential value as collateral. For this reason, long-term debt in this sector appears to be often supported by other assets, such as endowment.

Arts and cultural groups also use capital campaign pledges to repay all or part of their long-term debt. When such pledges are secured, organizations tend to think of the long-term debt as essentially a bridge loan that allows them to incur building costs prior to receiving all pledges. Some organizations also use long-term debt when they wish to push forward with the project, but have not been able to successfully complete the campaign. Not all groups are successful in raising funds to repay such debt, and in some instances, find it difficult to retire the debt over time.

This sub sector has the most difficulty implementing the philosophy of spreading the cost of a facility over multiple years of use. The predominant revenue stream — contributions — must be constantly reinvented and cultivated. There is no guarantee that future supporters will be excited by the idea of “paying for debt”. In fact, there is much evidence in the sector that future donors resent “being made to pay for the decisions of the past.”

Efficacy & Benefits of Debt

- The use of long-term debt in this sub sector is becoming widespread, but is not yet predominant.
- Long-term debt appears to pose more of a financial risk to arts and cultural groups. The frequency of operating deficits — experienced by almost half of the organizations in the subgroup — suggests that the combination of reliance on contributed income, coupled with a reduced ability to raise ticket prices, leaves these institutions with less financial control and room to maneuver.
- While it appears that these groups are using endowment investments as a form of collateral, this practice poses risks for those for whom endowment income plays a key role in supporting annual operations. And, any move to use endowment funds to pay down debt would be likely to exacerbate any existing operating stresses.
- Using long-term loans as a strategy to bridge capital campaign pledges can be appropriate, but organizations may wish to exercise caution when such pledges are not secured. Raising funds to repay existing debt has consistently proven unattractive to donors over time.

UNDERSTANDING THE ROLE OF THE LENDER MATTERS

In this study we interviewed over 50 lenders and intermediaries, and nonprofits who had taken on debt. We asked questions about the financing and underwriting process, internal organizational analysis and what successful debt looked like from the viewpoint of both the borrower and the lender. This information — perhaps even more than the numbers — has helped to shape our thinking about what brings about positive results when nonprofits utilize debt for facility projects.

One of the most startling findings that emerged from the interviews is that nonprofits and lenders do not appear to hold similar ideas about their mutual roles. Many nonprofits believe some version of: “If the bank thinks it’s okay to borrow this much, it must be fine.” They take at face value a bank’s vigorous underwriting process or misinterpret an intermediary’s marketing efforts as business advice or technical assistance.

Lenders believe that nonprofit board members, in their role as “owners”, have the ultimate responsibility for defining the risk of debt for their organization. It is the owner’s fiduciary responsibility to determine if debt progresses or places at risk the mission of the organization. It is the lender’s responsibility to underwrite its own risk.

For many of those we spoke with, understanding — or misunderstanding — the role of the lender was critical to the successful or not so successful use of debt.
What is a Lender's Role?

Commercial lenders and underwriters agree that a bank's primary responsibility is to make a profit for its shareholders. As one interviewee put it, “The bank has to come first; it has a fiduciary obligation to its shareholders.” As a result, a standard due diligence process is designed to assess the bank's exposure to risks that may result in a loan default. Typically, banks look at the following risk areas:

- **Repayment risk:** Does the borrower have the capacity to repay the loan in the stated time? Is there a list of board members with the capacity and willingness to meet debt service payments in a worst-case situation?
- **Construction risk:** For loans involving facilities, key questions include: Have the construction costs been properly estimated? Does the nonprofit have the right players on board to ensure steady, quality progress on construction? Are the borrowed funds for construction being used for their stated purpose?
- **Political risk:** Does the nonprofit rely heavily on government contracts or funding? Are any of these programs slated for expansion or for cuts?
- **Reputation risk:** If the bank needed to foreclose on a loan to a nonprofit as a last resort, would a foreclosure result in negative publicity for the bank?

It is undoubtedly true that lenders through this analysis do consider, to varying degrees, how a loan may affect such fundamentals as a nonprofit's mission, strategic direction or long-term organizational strength. Lenders, however, are not – and can not – be responsible for assessing whether the loan is the best path possible for the nonprofit; that is for the nonprofit to decide. Commercial lenders are actually legally prohibited from providing technical assistance. They are in a business transaction and they expect that nonprofits have a sufficient capacity to evaluate the question of whether to take on debt.

Nonprofit Views

Many of the nonprofits we interviewed reported that they had relied on the analytics required by the lender to determine the efficacy of a loan. At the same time, many were uncomfortable with how these same analytics portrayed their business. “Our bank officer was great,” one CFO told us, “but I did not always think they really understood the true nature of my organization.” But, if the lender’s process suggested that the institution could indeed take on the debt, these nonprofit leaders were willing to live with their discomfort.

Most organizations interviewed had not undertaken worst case scenario planning. Those who had bond covenants rarely discussed what would happen if the covenants were not met. Nor did they often discuss the long-term impact of those covenants on current strategic goals (outside of the facility they were financing) or how the level of debt they were assuming positioned them to respond to new opportunities.

Those in the human services sector who held multiple mortgages often wondered if they were over leveraged but had no method for determining how this might impact their organization over the long run. One experienced human service director noted, “I hope for the best and pray that the bank does not want the hassle of foreclosing if things go bad. I have no idea if I should have more reserves and less debt.”

Among our sample, we found a few nonprofits who had indeed analyzed the impact of debt on both mission and operations. They had used their own internal diagnostics to determine the efficacy of debt and how best to leverage their balance sheet for long-term growth. For those who had conducted this kind of internal due diligence, they reported that they were able to get banks to compete for their business -- resulting in better rates and more flexible terms. Those who relied on the bank to drive their analytics rarely had banks compete for their business and many reported frustration with way debt had impacted their ability to manage their year-to-year operations.

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**Covenant Restrictions**

Bonds and some loans come with covenants, or performance benchmarks, that the organization must meet. Covenants can also be used to restrict a group’s ability to tap existing assets, add new ones or launch new initiatives. These are the lenders’ tools for reducing their risk. They also often keep the nonprofit’s financial performance positive.

Some organizations report feeling restricted by these covenants at some time, most typically when they believed they needed to make expenditures, such as:

- Running a one-year deficit to make needed investments to reposition the organization.
- Purchasing certain types of assets (art, equipment).
- Buying a building or expanding the current one.
- Increasing expenditures in stated budgetary areas, such as funding for new exhibitions or programs.
- Using unrestricted funds to address unexpected situations.
OWNERSHIP OF THE DEAL MATTERS

When making long-term decisions that impact the organization’s financial health, most nonprofits benefit from the board, the CEO and all senior staff leadership having a shared understanding of the decision.

Yet, in our interviews, we rarely found this to be the case. No matter what type of analytics a nonprofit relied on in deciding to take on debt, the decision to do so, we found, was often closely held by a few in the leadership structure.

This has had a negative effect in many organizations.

The Decision Making Process

So who is involved? The complexity of the transaction often pushes a nonprofit to delegate the decision making to a small group. In practice, the responsibility often falls to individuals with more financial expertise, such as the CFO and a few financially skilled board members. CFOs, thanks to their deep knowledge of the group’s finances, anchor the process by staffing the board committee, working out the details and managing day-to-day communications with the lender. We found that the CEO is often not deeply involved, and a full discussion by the board of the ramifications of the deal rarely occurs. This is what we refer to as a “small-group” strategy.

The small-group strategy is somewhat at odds with the board’s fiduciary responsibility, despite the widely held view that the board holds final accountability.

One way in which the small-group strategy may undermine the board’s role is that the skills of the few can inspire other less financially savvy board members to step back from the discussion. “It’s easy for board members who feel insecure about debt to defer to others who know or appear to know about debt,” said one interviewee.

The small-group strategy further ignores the need to bring along board members who do not have strong finance skills. Indeed, some observers were broadly concerned about a board’s ability to grasp these complex deals, as well as their overall financial sophistication. As one CFO put it, “Does the average board have strong nonprofit financial skills? Absolutely not! There are few auditors who understand it. So if the auditors don’t get it, the board won’t.”

Ironically, this process, no matter how well intended, forces most board members (and some CEOs) who are not inside the process to do the very thing lenders are expecting them not to do — rely on the reputation and analytics of the lender.

TDC learned that this lack of broadly held institutional ownership for entering into debt plays out in very negative ways when the following situations occur:

- A change in economic conditions shrinks revenue or increases expenses. Because debt payments are not optional, other budget items are cut disproportionately in response. This, in turn, limits the organization’s ability to achieve the strategic goal(s) the original building project was intended to support.
- A debt instrument has been utilized that has an adjustable rate which increases faster than anticipated, causing significant increases in debt payments. This has the same operational impact as a change in economic conditions.
- A new opportunity arises that the board is enthusiastically in favor of but because of the covenants of the letter of credit supporting the bond they obtained, the organization is not able to pursue it, even if several board members agree that they would cover the cost of the investment.
- The original analyses supporting both the building project and the financing were wrong. In some cases, the building does not end up meeting the long-term needs of the organization; in other cases, the operating costs were poorly projected and swamp the budget; and, sometimes the income projections were overly ambitious in terms of both utilization and price.

All of these reported results put an organization at great risk and, we learned, put the key stakeholders in an organization in conflict. The lack of a clear understanding and consensus about the type of risk an organization assumes creates an unsteady platform from which to reach consensus for how to resolve the problems when they arise.

The outcome for these organizations is a severely constrained ability to progress. In a few cases, it can bring the organization to a crisis point that can take many years to resolve.
UNDERSTANDING ORGANIZATIONAL RISK TOLERANCE MATTERS

Most of the nonprofits with whom we spoke did not have a coherent method for assessing or testing their organization’s tolerance to risk. Many of the nonprofits interviewed had not thought through all of the organizational risk posed by their building projects. Several of the organizations, we found, had “backed into debt” when their capital campaigns fell short of the goal or when the cost of the building had exceeded projections. And, when it came to assuming debt, most were utilizing the bank’s risk metrics rather than their own.

Very few organizations TDC interviewed for this study developed worst case scenarios that posited the impact that debt payments and/or covenant restrictions could have on the achievement of their institution’s long-term goals, and how that might impact their reputation with the public, key stakeholders and donors. Very few had assessed the impact of higher debt costs associated with rising interest rates. Very few had tested how well the organization would be positioned to quickly respond to external changes.

Further, among the few who had posited such worst case scenarios, an even smaller number had reviewed them with their entire board. This, we learned, leaves an organization quite vulnerable when things go wrong.

Without a shared baseline agreement about the level of risk an organization can undertake, leadership can flounder and the board itself can split as it attempts to right the ship. And for an unfortunate few to whom we spoke, this had indeed been the case. One of the most interesting comments we heard during the interviews came from a lender — “We as a bank have a highly defined theory of risk, I often wonder why nonprofits do not?”

This led us to the essential finding of this study. To truly understand an organization’s ability to utilize debt it must first have a clear view of the risk a facilities project, in and of itself, poses to the organization. Once these risks are understood then it must be determined whether the use of debt exacerbates these risks or mitigates them.

Elements of Risk
We, and the lenders we consulted, would have hoped to see organizations assessing a project’s risk by posing the following questions, first at the management level, and then with the board:

- **Mission** – How does this project support or further the mission? Does it have the potential to take us off mission? Could it subvert our mission?

- **Organizational Functioning** – Are the board and the senior staff in complete agreement about the importance of the project? If not, what risk does this pose to our organization’s ability to achieve this project? How would lack of agreement affect other key business functions?

- **Economic Model** – Does this project improve our economic model? Does it pose risks? What revenue and expense shifts could occur in a worst case scenario? Is there enough balance sheet strength to withstand any potential negative impact if we are forced to reposition?

- **Project Risk** – Does the project itself have inherent risk? Are there potential design problems; what is the potential for construction over runs? Environmental issues? Neighborhood issues? Political issues? Time constraints?

How do the worst case scenarios in each of these areas impact the ability to complete the project? How might they impact our ability to deliver on mission?

- **Financing Risk** – What are the financing options available — for example, fundraising, borrowing from reserves, and debt financing? What are the costs and benefits to the organization associated with each of these? How would we cope with the worst case scenario that each might generate? For example, if we raise funds for the project, will annual operating support be reduced? Or, if we finance a portion and the economic model shifts, how will ongoing debt payments affect the organization?

- **Reputation with Supporters and Stakeholders** – If the mission drifts, the organization loses cohesion, the economic model stumbles, and/or the project stumbles, how might this affect an organization’s reputation with key supporters? Does decreased reputation pose additional revenue risks? And, if so, for how long?

So, what is the best approach for a nonprofit to evaluate its own risk in undertaking a facilities project with a long-term loan? Because a long-term loan touches all aspects of the organization — revenues, costs, assets, programs, operations and, most importantly, mission — there are no cookie-cutter approaches to evaluating risk. A checklist of metrics will not yield the nuanced understanding needed to assess risk.
We offer below a framework for evaluating risk to nonprofits when they take on facilities project and consider how to finance it. This list, while not comprehensive, represents both advice from interviewees as well as lessons derived from their experiences.

**START WITH THE MISSION**

Because a nonprofit’s mission is the core of all its work, it is a natural place to start – and end – any analysis of risk. Ideally, any project undertaken with a long-term loan will enhance the mission rather than detract from it.

At a first level, it’s helpful to take a quick “gut check” by asking the question: How does the project for which we are taking the long-term loan support our mission? It should be easy to articulate how the project will lead to better outcomes for the populations you serve. If it’s hard to find a compelling answer, pause to consider.

It can also be helpful to ask: How might our current ability to deliver on the mission be compromised by this project? New initiatives that require a significant infusion of capital will soak up time and energy. Be realistic about how well you will be able to maintain focus on your current work over both the short and long term; a loss of focus can cascade into a series of poor choices.

**EVALUATE BUSINESS MODEL RISK**

Before taking on long-term debt, it’s also important to get a firm grasp on the strengths and weaknesses of your organization’s current business model. What works today may not work as well tomorrow, or thirty years from now, so think carefully about what changes may be afoot.

**Current Revenues**

Evaluate the business model: What is your group’s mix of earned income and contributed income today? Is this model allowing you to thrive or make ends meet, or is there a regular pattern of deficits?

If your business model leans more heavily to earned income, take a close look at market dynamics. Is demand for service increasing or deceasing? How has the number of providers changed? Is there a trend towards consolidation or new providers? How much control do you have over setting prices? Is your organization a price taker or a price maker?

If your business model relies more on contributed income, identify changes in the philanthropic market, and your current position within it. How is philanthropic interest in your field changing? Take a hard look at your own donor base: Do you have a steady annual group of donors, or does your organization need to reinvent the donor base?

**New or Expanded Revenue Lines**

Because long-term loans are by-and-large used to fund growth, nonprofits naturally anticipate some changes in revenue as they look to the future. A thoughtful review of the business model and current market trends, can go a long way to helping you assess whether you are likely to be successful in a bid to increase current revenue types.

It’s important to also look closely at any plans the organization to go after a new type of revenue. Beware of the “grass is always greener” syndrome. If your group is familiar with the hard work and challenges of one type of revenue source, there is a temptation to assume that it’s easier to increase the other type of income (because of course anything is easier than what you are doing now).

This may not necessarily be so, and this view can create problems when groups assume that one of the new revenue lines will be the one to pay off the loan. A museum that relies heavily on fundraised dollars may assume it’s easier to push up admissions revenues; a social service group that has lived on government contracts may assume it’s easier to find a few big donors.
A smaller number had attempted to ask the harder question: If the worst happens, how could we continue to meet loan payments? By worst case, we do not mean a complete doomsday scenario, but rather a conceivable case in which several factors break the wrong way for the organization.

By examining the risks inherent in your current and future business model, your group should be well placed to identify the critical assumptions about revenue and cost that need to hold for you to succeed, or at least stay in the game. Examples include expectations of increasing tuition at a certain rate, or winning a large grant or contract. Pay special attention to the assumptions you make about any revenue lines that are earmarked for debt payments, most especially in the case of capital campaign pledges. In an ideal world, all donors would honor commitments, but in the real world, they do have the option of walking if their own financial situation changes or the market falls.

The next step is to ask: Which of these key assumptions have the greatest potential to go awry? And if they do, what is the size and shape of the net loss that could hit the bottom line? If several of these went awry within a short span, what could be the range of the total potential deficit?

While sizing the worst-case deficit may seem like a glum task – who wants to imagine bad things that may never happen? – it is a critical component of fiduciary responsibility. Without understanding the rough scope of the risk, it is very difficult to develop a meaningful contingency plan, or to have an informed conversation about the risks involved.

DEVELOP CONTINGENCY PLANS

A contingency plan for debt repayment involves identifying what resources the organization would tap in order to meet its loan obligations in a worst-case scenario.

Interviewees at organizations with long-term debt described a few different contingency strategies:

- Set aside a reserve fund in advance to cover debt service payments in the event of an unexpected deficit.
- Agree in advance to tap unrestricted funds at the discretion of the board as needed for debt service.
- Defer scheduled repairs and routine capital replacements until the crisis passes.
- Negotiate agreements with a set of board members who agree to help cover repayments up to a certain level for a period of time.
- Identify specific programs that would be likely to be reduced in scope or cancelled entirely.
- When there is some flexibility to change the scope of the project after it is begun, determine what additional cost reductions could be made.
Contingency planning can – and probably should – include a discussion about whether your organization has an emergency exit strategy for loan repayment. In other words, is there a path that would enable you to immediately settle your obligation with the lender and still survive intact as an organization?

Potential exit strategies include paying off the loan from unrestricted funds; selling the space; or, in some cases, handing off the programs (and the financial obligations) to another organization with sufficient resources. For the latter two options, it may be helpful to do some high-level identification of potential buyers or partners.

A major benefit of thinking about an exit strategy up front is that it helps identify when you don’t have one. When no exit strategy exists, the organization, and especially the board, should be fully aware that there is a risk that the organization will go out of business if it cannot manage to carry the debt payments.

**EVALUATE CONTINGENCY PLAN RISK**

It is a bit of a truism to say that contingency plans are generally unattractive; no one would be pursuing a contingency plan unless something went wrong. That being said, contingency plans can have varying degrees of unattractiveness, and the difference in degree often lies in the level of risk that plan poses for the organization.

While contingency plans can pose many risks, they tend to have the largest impact on a few major assets: unrestricted endowment, buildings, programs and donors.

**Unrestricted Endowment**

Several of the contingency strategies take as a given the use of unrestricted endowment, or the investment funds that the board is allowed to tap at their discretion. These funds – unlike their close cousin, restricted endowment – are not legally restricted by donor intent for specified uses.

An organization that relies on unrestricted endowment as a backup strategy faces a few different risks. The largest of these is the challenge of managing short-term and long-term income needs. Most organizations think of their unrestricted endowment in two ways: First as a source of annual operating revenue (income from investments), and second as a rainy day fund (unrestricted funds).

If the contingency plan involves using unrestricted funds, remember that if you have to draw them down, your income from investments will also fall, creating an additional strain on the annual operating budget. There is no free lunch where unrestricted funds are concerned.

It’s also important to note that even the act of setting aside funds for repayment also has a cost to the organization: If this is the policy, the organization will not be able to spend these funds on other initiatives – or crises – in the interim.

**Buildings**

If delaying repairs and maintenance is part of the contingency plan, you may wish to consider for how long this strategy will be feasible. Even the best-maintained building can not sustain an indefinite maintenance and repair holiday. As the building quality slides due to lack of ongoing investment, to what extent will the organization’s capacity to fulfill its mission be compromised?

**Programs**

For any contingency plan that puts forward the idea of cuts to programs, be sure to look carefully at how this step could compromise your ability to fulfill your mission. While there are no right answers here, the key thing is to know where you are comfortable making trade-offs. Questions to consider here include: Can the population that you serve withstand a reduction in these services if you need to cut the program? If the project for which you took the debt goes forward, will you be able to provide a higher level of service even after cuts?

**Donors**

When the contingency plan rests on promises of help from a few donors or board members, remember that such promises will not hold for the full life of the loan. As the individuals who made these pledges roll off the board, the organization will have to find new ones to fill their shoes in order to maintain the same level of risk.
NEGOTIATE COVENANTS

When a lender proposes covenants for a loan, remember that its focus – rightly – is on reducing its own risk. A lender’s covenants are aimed at making sure there will be enough cash in the system to ensure that it is repaid. A lender won’t be able to tell you what it will feel like to live with certain covenants over decades; only you can.

For that reason, it’s critical to assess the potential impact of covenants on both your current operations as well as your own contingency plans. A few of the key questions to look at are:

- Does the contingency plan call for using any funds that the lender has already earmarked for collateral? If collateral funds are required, how might that affect daily operations or contingency plans?
- What budgetary restrictions, either operating or capital, are reasonable for the organization to commit to over the long term? For example, if the goal is to expand the organization’s reach by setting up shop in new communities, a restriction on any new building may run against the long-term organizational vision.
- Do you need the flexibility to be able to pay back the loan early? What penalties are you willing to accept?

There is sometimes a tendency to accept lender covenants as a given, or tinker with them at the edges. A more proactive approach would be to go into negotiations with a clearer sense of what you feel you can and can’t live with.

END WITH THE MISSION

As you look back over the contingency plans and covenants, be sure to turn back and do a final “gut check” to see that they don’t accidentally compromise the mission.

While this may sound obvious, it’s all too easy to forget the people you serve as you try to balance the books. In other words don’t put your organization in a position where a building changes your mission – rather than supports it.

To analyze the benefits and risks requires thoughtful strategies for both gathering information and involving key stakeholders in the process.

Here are some ideas.

CREATE A WRITTEN DEBT POLICY

Because most of the people who make the decision to take on a 30-year loan will not be around for the duration, the rationale for the debt can slip from the organizational memory. “With the regular turnover on the board, there are now some people who believe we have too much debt, while others believe it is an appropriate part of our capital structure. Turnover means we have to continually communicate with the board and provide assurances that the debt isn’t hurting us,” said one interviewee.

For that reason, consider creating a written debt policy for the organization, so that future leadership will understand the history and the obligations that are being passed to them. Such a policy might include: the stated risk tolerance; the strategy for repaying the debt; back-up strategies as needed; reserve fund levels; the overall risks and benefits; and the process for monitoring the loan’s impact on organizational health. For each loan entered into, complete a narrative on why the loan was needed and how it complied with your debt policy.

TALK IT THROUGH UNTIL EVERYONE GETS THE DEAL

The entire board, and the executive director, needs to be fully informed. While a small group will still likely be quarterbacking the loan transaction, they need to work to ensure everyone has an understanding of the benefits and the risks of the loan.

It may be a good idea to ask the CEO and CFO to make a joint presentation to the board that includes the structure of the proposed loan, repayment strategy and other loans considered; descriptions of worst-case scenarios; potential back-up strategies; and the implications of loan covenants.
Make sure to present all information so that the least financially savvy board member or CEO can understand and participate. Also keep reminding everyone of the old adage, “There’s no such thing as a stupid question.” Be encouraging of questions, and answer them.

The bottom line is: If the deal can’t be presented to the board, then chances are you shouldn’t be doing the deal.

FOR ANY PRODUCT, ASK UNTIL YOU UNDERSTAND

Because lenders have done a great job at creating a variety of loan products to meet every need (derivatives, credit enhancements and loan guarantees, to name a few), chances are you will encounter a sophisticated financial product in the marketplace. Never assume that the product is too complicated to understand; keep asking questions until you get it. It’s not brain surgery – it just feels that way.

TALK TO PEERS WITH DEBT

Because experience is the best teacher, seek out peer organizations with debt and ask them for advice. Make sure to gather a full enough sense of their business model, and the loan structure, to be able to draw the most appropriate lessons for your organization. It also may be helpful to pursue multiple levels of conversations — such as board to board, CEO to CEO and CFO to CFO — since each group brings different perspectives to bear.

TAKE ADVANTAGE OF OUTSIDE EXPERTISE

Lenders and underwriters noted that often the smoothest transactions are the ones in which the nonprofit has one or more outside advisors counseling them on the deal. There are many types of outside advisors available, such as accountants, bond counsels, consultants, lawyers, mortgage brokers, and other technical assistance providers.

Outside counsel brings both subject matter expertise as well as a different perspective to the table; both can be valuable especially to smaller organizations with less time and organizational capacity. As you consider this option, assess whether you need a team advisor, a team leader, or a combination. Some advisors will have terrific specialized subject matter expertise, but may not be as skilled in putting together the whole picture; select accordingly.

SHOP AROUND

With a multitude of lenders in the nonprofit marketplace, be sure to shop around the deal and take advantage of the competition. You may not only wind up with a better financial deal, but also a better relationship with the lender.

TREAT YOUR LENDER AS A PEER

As you go through the loan process, and move into loan repayment, remember to work with your lender as a peer in a business transaction. Both lenders and borrowers commented that a candid, forthright relationship benefits everyone. Remember that you are not in a poker game; both sides are pulling to the same end. Lenders appreciate being kept abreast of risks to the organization and the sub sector, and will seek to return the favor by working with borrowers to resolve the problem.

REVIEW RISK REGULARLY

Risk shifts over time in response to environmental changes. Be sure to review your situation periodically and update your risk mitigation strategies accordingly.