



Putting the Profit in Nonprofit: Increasing Cash in Social Enterprises in Order to Make Them Sustainable

from the series **Building Sustainable Organizations**

By Ben Nichols and My Trinh



About Enterprise

Enterprise is a leading provider of the development capital and expertise it takes to create decent, affordable homes and rebuild communities. For 30 years, Enterprise has introduced neighborhood solutions through public-private partnerships with financial institutions, governments, community organizations and others that share our vision. Enterprise has raised and invested more than \$11 billion in equity, grants and loans to help build or preserve nearly 300,000 affordable rental and for-sale homes to create vital communities. Visit www.EnterpriseCommunity.org to learn more about Enterprise's efforts to build communities and opportunity.

Acknowledgements

The authors would like to thank the Enterprise Community Leadership Council and Enterprise staff for their support in developing this paper.

Copyright © 2012, Enterprise Community Partners, Inc. All rights reserved. The views presented in this paper are those of the authors and Enterprise, and should not be attributed to its trustees, related organizations or funders. No portion of this report may be reproduced without permission from Enterprise.

Please send questions regarding usage of this information to:

Enterprise Community Partners, Inc.
Knowledge, Impact and Strategy
American City Building
10227 Wincopin Circle
Columbia, MD 21044

Tel: 800.624.4298

Fax: 410.964.1918

mail@enterprisecommunity.org

www.EnterpriseCommunity.org

Table of Contents

3	Introduction
5	Section 1 — The Bottom Line: Making Money From Operations
9	Section 2 — Raising Equity and Debt
12	Section 3 — Reputational Risk
14	Section 4 — Charitable Contributions
15	Conclusion

Introduction

Nonprofit corporations providing affordable housing are unique entities. While they share some characteristics with government agencies and the corporations which they are increasingly being asked to emulate, the ways in which they are different from these entities must be reflected in their business models in order for them to survive and continue to serve their missions.

All nonprofit organizations have been shaped by history and law to do important public work beyond the government's ability and capacity. It is widely believed that they enjoy a tax-exempt status for playing a complementary role to government, engaging in activities from which government and society both benefit. And, they are like government in two key ways. First, they provide "public" not private benefits which have proven to be difficult to measure financially. Second, it is widely perceived that self-sustenance is of secondary (if any) value. To some, the objective of a successful nonprofit is to, "work itself out of existence," much like government shrinking at the end of a war. These similarities to government may explain the hesitancy of funders to provide continual operating support to housing organizations, preferring instead to fund circumscribed activities or projects.

Unlike their counterparts in education, medicine and religion – which have built endowments to sustain themselves – housing nonprofits have historically functioned on short-term funding. At the same time, they have acquired long-term stewardship responsibilities for the housing they have built and the investments they have attracted, and need to attract sufficient resources to carry out those duties for the long-term.

In the last several years, there has been a push for not-for-profit developers to adopt the business management practices of successful for-profit corporate entities. High-performing for-profit corporations know how to generate cash and grow businesses, and employ many practices which nonprofits should replicate, especially during this age of austerity. The resulting trend has raised awareness around practices like how to make equity equivalent investments, implement change management, and interpret and present financial data in a concise and transparent manner. In light of the current trend, it is appropriate to reflect on how nonprofits differ from their for-profit counterparts, especially as it pertains to organizational growth. By appreciating these

differences, we can better evaluate which for-profit practices are most practical for nonprofit organizations to adopt, and what policies can facilitate the process.

One of the main components of organizational growth is generating and maintaining cash. According to Harvard Business Essentials' *Finance for Managers*, corporations can only raise cash by: 1) generating profit from operations, 2) selling an asset, 3) taking on debt and 4) issuing stock. The last of these is not available to nonprofits because investors are not allowed to benefit from equity investments (stocks) in nonprofits under the *inurement prohibition*. As a result, nonprofits only share three methods of raising cash with their for-profit counterparts, and none are simple. Some of the complexity arises from the public perception of nonprofits as entities that do not need to sustain their own operations, and some complexity is related to risk. In this paper, we will examine the obstacles that nonprofits face in raising cash and make recommendations for removing these obstacles. We will also discuss a cash raising option that is only open to nonprofits—charitable contributions—and its importance in making an organization sustainable.

SECTION 1

The Bottom Line: Making Money From Operations

Operations is the one method of generating cash over which management has the most influence. Their ability to generate revenue and control expenses should be one of the key criteria for evaluating an organization's success; however this is rarely the case.

The Nonprofit Misperception

The moniker “nonprofit” often does the nonprofit industry a disservice. Social enterprise is perhaps more apt. To grow, let alone stay in business, social enterprises must earn a profit; yet many adhere literally to the nonprofit descriptor. Throughout our research and experiences, we've seen local government officials 1) question why social enterprise property developers need to earn developer fees, 2) believe a self-managing social enterprise property owner should be charging lower property management fees, even though these revenues may be insufficient to cover costs and 3) suggest that social enterprise owners should not receive compensation for staffing and other direct costs related to providing resident services despite the fact that public sector funders require resident services. These misunderstandings occur frequently and carry beyond fee disputes.

With respect to projects, many funders and interested parties expect social enterprises to undertake the most difficult-to-develop deals or serve the hardest-to-house. Completing these projects may meet an organization's mission, but the organization's financial wherewithal may be exposed to excess risk during development (cost overruns) or operations (minimal if any positive cash flow). These projects, if not structured properly, will continue to erode an organization's equity and cash positions until the organization and its entire balance sheet are at-risk. They may undermine economic sustainability and hinder growth, thereby preventing an organization from meeting its mission.

Recommendation: *Vigilantly educate funders and other interested parties about the operations of social enterprises that develop and own housing and what risks they face. Gaps in development financing, social service provision and property operations cannot simply be filled by charitable contributions.*

Government Contracts

Many social enterprises earn a significant portion of their revenue from government contracts. The organizations perform various services for these contracts including: weatherizing homes, providing social services to residents and improving safety in their service areas. Frequently, government contracts are cost-reimbursable, meaning that social enterprises pay the expenses and subsequently bill the government for the allowable charges. The social enterprise may add a certain percentage of costs to be charged for administration. This charge, along with the allowable program expenses and total budget, is agreed upon with the government agency at the outset. If there is a change to the cost structure of the organization or higher demand for the services, they are not renegotiated. At no time do the parties include a profit in the budget. In fact, the organization may not even recover all of its administrative costs to run the program depending on what rate the government agency accepts, thereby requiring the organization to subsidize the program's operations.

Recommendation: *Allow social enterprises to charge a profit margin on their contracts above an administrative rate. This rate could be in line with the 2 to 7 percent that many U.S. Department of Defense contractors earn on their government contracts.*

A second issue centers on holding costs. As discussed, government contracts are typically cost-reimbursed, so the social enterprises pay the expenses before receiving payment from the government. As government budgets tighten at all levels, social enterprises are facing increased delays for reimbursements. For example, when a social enterprise with \$12 million in annual contracts faces a reimbursement delay that increases from 30 to 60 days, the organization must now float \$2 million instead of \$1 million in costs as it continues to operate and pay expenses in the second month while awaiting payment from the first. The social enterprise must cover the extra \$1 million either from its organizational cash or a line of credit, placing a greater strain on the organization's working capital. If the organization uses a 6 percent line of credit to cover the \$1 million increase, it has added \$5,000 worth

The moniker "nonprofit" often does the nonprofit industry a disservice. Social enterprise is perhaps more apt. To grow, let alone stay in business, social enterprises must earn a profit.

of interest expense for the second month – or \$60,000 annually. There is no other source for this \$60,000 interest expense, so it must come from the social enterprise's operating funds. This is a substantial sum for many social enterprises as it may cover 50 percent of the personnel costs for a senior management staff member. Ironically, a government agency may be creating a fundamental cash problem for a social service provider that is helping the government agency to meet its mission.

Recommendation: *Allow holding costs due to increased reimbursement lag time to be an eligible cost covered by a government contract. Also, permit advances at the start of a contract. Some agencies do consent to this like the Ohio Housing Trust Fund.*

Property Performance

As we wrote in *Building Sustainable Organizations for Affordable Housing and Community Development Impact*, many social enterprise owners cannot keep all the cash generated by its properties because of cash-flow contingent or residual receipt loans. The lenders on these loans are typically local municipalities or state housing agencies. Instead of building its cash or equity position, the organization must split its compensation with the local government. Yet, when properties face negative cash flow, most local governments do not contribute any additional funding. This places social enterprises in a difficult situation as they must subsidize poorly performing properties, but cannot receive cash flow from strong properties to build reserves for these subsidy needs at the organizational level. Instead, the social enterprises must use short-term funding (operating support or, worse, a working line of credit) to support a poorly performing property. In essence, this creates an unsustainable case of negative working capital where short-term financing is used for a long-term asset. Incidentally, this is the same business model that got Wall Street bankers in trouble in 2008 – financing mortgage-backed securities with commercial paper. Also, cash-flow contingent loans disincentivize optimal property performance. Since surplus cash must go to the lender, social enterprise owners may not benefit much from operating these properties to maximize cash.

Recommendation: Restructure cash-flow contingent lending to incentivize long-term affordable housing ownership. While it would be better to allow social enterprises to use cash earned from properties for organizational operations, particularly to create reserves to deal with long-term asset stabilization, at the very least, secondary lien holders should allow cash flow that would repay their loans to be used for weak properties on which they also have debt. The latter is a best practice of the city and county of San Francisco.

As shown above, a social enterprise's ability to raise cash from operations is limited, and some of its hardships come from systemic structuring rather than the social enterprise's performance. Because raising cash from day-to-day operations creates the best opportunity for an affordable housing social enterprise to build its equity and eventually leverage this equity, this is a key issue. Equity is the best intermediate- to long-term source of funding available to social enterprises.

SECTION 2

Raising Equity and Debt

Unsecured Lending

In order to comply with the *inurement prohibition*, social enterprises cannot issue equity; the closest they can get is an unsecured or deeply subordinated loan, or a program-related investment (PRI) from a foundation. Unsecured lending is a risky business and is more in line with equity underwriting than traditional debt underwriting. Even strong organizations can be seen as a risk as the lender has no collateral and rarely a personal guaranty. In the for-profit world, the principals of the corporation sign their names to the guaranty and these principals' financials are evaluated closely for the ability to repay. The leadership equivalent at a social enterprise is the executive director and boards of directors, who are not likely to sign their own names to a social enterprise loan. Lenders have approved unsecured working-capital loans to social enterprises but the amounts are quite conservative. Large social enterprise developers often have lines of \$1 to \$2 million, which are inadequate for their development pipelines. Though it limits a lender's risk, it hinders the social enterprises' growth. Organizations with significant cost-reimbursable government contracts may have larger lines of credit as the lender can underwrite to a repayment source. These lines can run as high as \$6 million or more depending on the organization's size.

Foundation PRIs are generally long-term (up to 10 years) and low interest (3 percent or less), providing a great vehicle for nonprofits to build organizational equity. The PRI and interest must be repaid and foundations underwrite nonprofit capability to repay the investments. In some instances the foundation underwriting is more rigorous than conventional lender underwriting. Unfortunately PRIs are very limited in availability and do not provide an industry-wide solution to the problem.

Many years ago, the banks came up with the equity equivalent investment (EQ2) to give social enterprises an investment that may mirror equity. While it is similar to equity, the EQ2 is still a loan. In many cases, they have automatic or multiple renewal options (assuming the loan covenants are met), and the repayment of the EQ2 loans are expressly subordinate to the repayment of all other loans (except for similar EQ2 loans). An EQ2 loan is often categorized as debt on the organization's

balance sheet and therefore negatively impacts an organization's leverage or debt-to-equity ratio. Additionally, the bank expects its EQ2 to be repaid at some time in the future. If the leverage ratio grows above three or four, the developer is seen as a higher risk entity since many investors set their leverage underwriting benchmark between three and four. Surpassing this ratio could also activate debt covenants on other debt and put the organization in dire financial straits.

Question: *When looking at unsecured lending, PRIs and EQ2 investments, should lenders and investors assume that unsecured lines of credit and EQ2 investments signal confidence in a strong organization? If so, should they consider an adjusted leverage ratio where the lines and EQ2 are treated as equity, mezzanine or deeply subordinated debt instead of conventional “must pay” debt? This can be seen as risky reliance on other investors but could help generate more of an equity appearance. There is no easy answer to creating equity investments for social enterprises.*

Recommendation: *Social enterprises should develop a business plan to use unsecured loans, PRIs and EQ2 investments to increase their capital base, not just to pay for the costs of one or two projects. A disciplined approach would be to set aside a portion of the development fees received from each project to grow a reserve for future development, which will minimize the need for future borrowing and create organizational equity. This approach requires discipline, commitment and long-term budgeting, and recognizing that all income from the projects will not be used for operating costs. In addition, lenders and investors reviewing balance sheets of social enterprises with equity-like debt should be encouraged to treat that debt differently for leverage evaluation purposes.*

Selling or Refinancing Corporate Assets

The last way to grow an organization through a cash infusion is to paradoxically sell an asset – growing by shrinking. For social enterprise developers and owners, affordable housing properties are marketable assets. But selling property has many ramifications. First, generating cash from the sale of property is an option that is mostly limited to developers who work in strong, appreciating real estate markets. An affordable housing property may have negative value when the property's primary

and secondary debt are taken into account. On the other hand, a profitable sale will not only generate cash but, from an accounting standpoint, will also increase an organization's equity position as the gain of sale is recorded on the income statement. Even if equity is decreased, there is a possibility that cash and liquidity will improve even if the organization's net equity decreases. Many sales will generate equity, which will give the organization a lower and less risky leverage ratio.

Finally, selling an affordable housing property on the open market may reflect negatively on a social enterprise's image. Organizations are seen as the stewards of affordable housing and a property sale could put the affordability of units at risk, especially in gentrifying markets. A social enterprise can negotiate with the buyer to retain affordability restrictions on units at the point of sale, but its reputation as a "sell-out" may take hold. In addition, negotiated restrictions will decrease the sales price and could therefore erase the property's market-rate equity.

An alternative to selling assets is refinancing debt on the assets. This vehicle can raise equity for a property located in strong markets or when current interest rates are significantly lower than the existing mortgage interest rate (the current interest rate environment is ideal for refinancing debt). However, a key barrier to refinancing to raise equity is often the requirement that subordinate public lenders be paid off with any surplus cash once the transaction costs and first mortgage are paid. Public lenders should be willing to subordinate their loans to the new mortgage to encourage refinancing, particularly if the new debt service is comparable to the former debt service and the equity take-out is used to strengthen the owner/guarantor.

Recommendation: *Funders should allow a social enterprise owner's subordinate debt to be forgiven (or assigned to the new purchase along with similar or reduced or re-negotiated use restrictions) at the point of sale in real estate markets where affordable rents are similar to market rate rents. In these markets, the need to protect affordable units may be less dire as more affordable units exist. In exchange, the secondary lender can then put long-term affordability deed restrictions on the property, thereby preserving the units from future gentrification. For refinancing, funders should allow the subordinate debt to be subordinated to the new loan rather than requiring repayment.*

SECTION 3

Reputational Risk

Social Enterprise Property Dilemma

Acquiring a poor reputation can sink a social enterprise even faster than a corporation. In taking on the hardest-to-develop properties and the hardest-to-serve populations, social enterprises already begin with more risk than their for-profit counterparts. Failure of one of these projects can tarnish a organization's reputation beyond repair. Legitimate or not, the tarnished reputation may arise from the belief that the organization misused taxpayer money or squandered precious public resources. Once an organization's reputation is tarnished, political and financial support will disappear. For-profit owners can close their doors and the principals can start a new organization. This is not the case for social enterprises.

Many funders and investors put on their corporate hats and ask, "Why doesn't that social enterprise simply turn over the keys?" or "Why do they keep funding beyond the operating deficit guaranty?" From a corporate viewpoint, both questions are valid and the cost benefit analysis is obvious. However, reputational risks raise the stakes for social enterprise executive directors and boards. Walking away from a project is a tough choice and the ramifications may linger for years. If a social enterprise stops funding an operating deficit, it runs the risk of being blacklisted by a lender or investor and losing all future financing opportunities. In many cities where the number of funders is slim, social enterprises have no choice but to continue funding a property's deficits.

Research from the first *Building Sustainable Organizations for Affordable Housing and Community Development Impact* report revealed a willingness by social enterprises to fund above-deficit guaranties due to reputational risk. In the case of certain HUD or U.S. Rural Development properties, the organization, its management and potentially its board members – all of whom are included as participants on the organization's Previous Participation Certification (HUD-2530) – may be "flagged" and barred from participating in future HUD transactions, even though they personally did not financially benefit from the property. HUD 2530s are updated and submitted to HUD for review and approval whenever there is a transfer of physical assets, a change of control (including a change in board or organizational composition), refinancing with FHA insurance, buying another HUD property, applying for project-based Section 8 assistance or other project-based subsidies, or bidding on a HUD property.

Recommendation: Organizations should vigilantly educate funders and other interested parties that reputational risks to social enterprise developers and owners differ from for-profit organizations. In addition, lenders and investors should allow for an orderly transfer of control or disposition of troubled assets to other owners, including foreclosure or deed in lieu transactions, if the original sponsors can no longer serve as proper owners or stewards of the properties.

Many funders and investors put on their corporate hats and ask, “Why doesn’t that social enterprise simply turn over the keys?” or “Why do they keep funding beyond the operating deficit guaranty?” Reputational risks raise the stakes for social enterprise executive directors and boards. Walking away from a project is a tough choice and the ramifications may linger for years.

SECTION 4

Charitable Contributions

Charitable contributions are unique to social enterprises. Social enterprises may accept donations, gifts and grants tax-free in order to operate their organizations and meet their missions. In addition, the donor receives a tax deduction for making such contributions. Charitable contributions are a form of equity from an organization's constituents and stakeholders to be used for operations or capital investments and to ensure that the organization fulfills its mission. The funds fill gaps in an organization's annual budget or help capitalize projects like new office or service space.

As mentioned in the introduction, the best known exceptions to this practice are colleges and universities, hospitals and religious organizations that all have more perpetual missions. These institutions ask for contributions from their alumni or constituents in part to grow their endowments, which are great sources of equity. Service providers and housing organizations on the other hand are judged annually on their administrative rates, impact on their communities and direct investment into programs. Online charitable watchdogs monitor and share organizational administrative rates. Donors may request that their donations directly fund programs, though direct program expenses are often covered by government contracts while administrative and overhead costs have few sources.

Fundraising is vital for social enterprises. In order to successfully raise funds, an organization must have the capacity, marketing tools, talent and money. Recruiting and budgeting for the talent are significant hurdles, especially for small organizations where the executive director and board of directors often double as the fund development department with few or no marketing tools. Finally, a stellar reputation begets more donors. Like investors, donors tend to reward larger organizations with greater community impact. This presents a catch-22 for smaller organizations that need the contributions to grow, but are not as appealing to most funders until they have already done so.

Recommendation: *Social enterprises should treat charitable contributions as a separate cash raising technique and not simply cash generated by operations. Charitable contributions, whether for capital or operations, are a great way for an organization to build equity. Social enterprises must make fundraising a priority and philanthropic funders should consider providing seed capital for fundraising and marketing efforts to grow social enterprises.*

Conclusion

Because social enterprises differ from government agencies and for-profit corporations, they must employ business practices that are optimal for their unique characteristics. By employing the recommendations in this paper, social enterprises and their funders can take the first step in this process.

Recommendations

	FOR NONPROFITS	FOR FUNDERS
<i>Making Money From Operations</i> NONPROFIT MISPERCEPTION	<ul style="list-style-type: none"> Educate funders and other interested parties about the operations of social enterprises that develop and own housing and what risks they face Use the term social enterprise to remove the “no profit” connotation 	
GOVERNMENT CONTRACTS		<ul style="list-style-type: none"> Allow social enterprises to charge a profit margin on their contracts above an administrative rate Allow holding costs due to increased reimbursement lag time to be an eligible cost covered by a government contract Permit advances at the start of a contract
PROPERTY PERFORMANCE		<ul style="list-style-type: none"> Restructure cash flow contingent lending to incentivize long-term affordable housing ownership
<i>Raising Equity and Debt</i> UNSECURED LENDING	<ul style="list-style-type: none"> Develop a business plan to use unsecured loans, PRIs and EQ2 investments to increase capital base, not just to pay for carrying costs for one or two projects 	<ul style="list-style-type: none"> Lenders and investors reviewing balance sheets of not-for-profits with equity-like debt should treat PRIs and EQ2s differently for leverage evaluation purposes.

CONTINUED

Recommendations, Continued

SELLING OR REFINANCING CORPORATE ASSETS		<ul style="list-style-type: none"> • Allow a social enterprise owner's subordinate debt to be forgiven at the point of sale in real estate markets where affordable rents are similar to market rate rents • For refinancing, allow the subordinate debt to be subordinated to the new loan rather than requiring repayment
<i>Reputational Risk</i> SOCIAL ENTERPRISE PROPERTY DILEMMA	<ul style="list-style-type: none"> • Educate funders and other interested parties about the reputational risks to social enterprise developers and owners and how they differ from for-profit organizations 	
<i>Charitable Contributions</i>	<ul style="list-style-type: none"> • Treat charitable contributions as a separate cash raising technique and not simply cash generated by operations 	<ul style="list-style-type: none"> • Consider providing seed capital for fundraising and marketing efforts to grow social enterprises

The underlying assumptions in this paper are that organizations need to grow and to do that they must raise cash. In a future report from the *Building Sustainable Organizations* series, we will challenge these assumptions and ask the question, “Do all social enterprise organizations need to grow?”