Collateral Matters :

How two nonprofits are using credit-based strategies to stabilize their finances.

By Richard Linzer

Like death and taxes, borrowing inspires dread—especially among nonprofits. Which may explain why volumes have been written about grantseeking and various forms of fundraising, but little has been published on the role that credit can play as a fiscal resource for nonprofit agencies.

Despite the trepidation with which most nonprofits approach the subject, and despite the sometimes irrational strictures imposed by traditional funders with respect to debt avoidance, borrowing can be an extremely useful tool for nonprofits. And as more and more nonprofit organizations find themselves relying on a relatively inelastic source of gifts and grants, borrowing may prove to be not just useful, but—like death and taxes—inevitable.

A recent report issued by the Statistics on Income Division of the Internal Revenue Service suggests why this is so. The IRS study, which examines income and asset allocation in the nonprofit sector over the last several decades, shows that the pool of all gifts and grants has remained relatively constant. ("A 20-Year Review of the Nonprofit Sector, 1975-1995," *Internal Revenue Service, Statistics on Income Bulletin*, Fall, 1998). Because the number of nonprofits continues to grow, and because the largest organizations tap into the pool again and again (to fuel capital campaigns and to build endowments), the availability of working capital for smaller institutions is likely to shrink. As a result, more and more nonprofit organizations may be compelled to use credit as an accompaniment to traditional modes of fundraising and earned revenue.

Is that cause for concern? Not necessarily. After all, for-profit businesses routinely use lines of credit to resolve many of the same timing and working-capital issues that seem to bedevil nonprofit organizations. Outside the U.S., non-governmental organizations, schools and universities have been successfully debt-financed for decades. In fact, as an alternative to capital accumulation in the form of cash reserves, endowments, and property ownership, the skillful use of credit can make a nonprofit's resources go further and work harder. Prudent borrowing can mitigate the management-by-crisis mode that too many organizations have come to accept as standard operating procedure.

With a line of credit and immediate access to working capital, management is able to stabilize cash flow, ensuring that payroll checks are issued on time and vendors won't cut off supplies. The organization isn't left hanging on tenterhooks, nervously awaiting that elusive check in the mail.

So why doesn't every nonprofit set up a line of credit with the local bank? Usually, it's because nonprofits lack the sorts of assets that bankers want as collateral. Before bankers are willing to make a loan, they require two guarantees of repayment: assets to serve as collateral and cash from operations. Most nonprofits don't have a problem coming up with cash from operations—in the form of gifts, grants or earned revenue. What they generally lack is collateral.

One way to overcome this hurdle is to produce cash collateral, generated by what are called credit holders. These are friends, associates, supporters, family members, staff members, or constituents who place a small amount of their savings into a special interest-bearing account at the bank. The money may be used to purchase certificates of deposit, which are pledged to the bank as collateral so that the organization can borrow against it.

Based on the amount that he or she has deposited, each credit holder receives interest, which is paid out annually or rolled over into the account. By allowing the money in the certificates of deposit to be earmarked during a finite period as a secondary source of repayment, credit holders enable the organization to borrow at a rate of interest that is usually well below prime.

Before credit holders' funds are pledged as collateral, the organization should be able to demonstrate its capacity to repay the loan from operations. Ordinarily, the degree of risk to credit holders can be kept very low as long as there is solid financial reporting by staff and prudent oversight by the board. As a first step, the organization's board of directors can establish a clear policy stating that the line of credit will be used only to cover fluctuations in cash flow, not to incur further debt or to serve as venture capital. Once the organization has learned to used its line of credit appropriately, there may be situations where other credit instruments, such as long-term loans, can also be used to the institution's advantage.

In any event, board and staff members should always hold face-to-face meetings with potential credit holders, explaining the organization's borrowing policies in detail and outlining any possible risks. This is done with the understanding that, even when the risks are low, losses can occur.

(In addition, it's wise to have any new plan for borrowing vetted by a knowledgeable attorney.)

What's in it for the credit holders? After all, they can earn comparable interest with complete security in a federally insured savings account. By placing their funds in a special account for the benefit of a nonprofit, however, they are helping the organization operate more effectively, at no cost and with little risk to themselves.

In fact, all the parties involved have something to gain:

• Credit holders gain an opportunity to help a cause they believe in.

• The bank gains the collateral it needs to justify a loan.

• The organization gains a stable resource that can be used to mobilize credit whenever it can be shown that other sources of revenue will repay the loan.

The following two cases, drawn from my own work as a consultant to nonprofit organizations, illustrate the principles of forming a credit holders group and using credit-based strategies effectively.

Northwest Folklife: Managing a Defecit

Through tireless volunteer effort and strong community support, the annual Northwest Folklife Festival has become a Seattle tradition. For many years, the small nonprofit that operates the free event had managed to sustain itself on income from concessions, underwriting from a small number of corporate sponsors, and a handful of grants from local arts councils and foundations. Those who flock to the festival every Memorial Day weekend also contribute by buying buttons and by making small donations on the festival grounds.

Five years ago, a large national foundation awarded Northwest Folklife a substantial multi-year grant. The original grant proposal had been written by the founding director with the aim of enabling the festival to expand into a year-round program, with an entrepreneurial twist. Educational activities, bazaars, publications, record releases, and product sales were envisioned as new revenue sources that would support the organization and bankroll the annual festival.

Board members were delighted with the grant and new staff was hired to develop the array of money-making ventures.

As the organization set about ramping up its human capital to take advantage of the multiple markets its new divisions were designed to tap, costs began to climb. But, the board assumed, that was only to be expected. The foundation grant did cover salaries of the newly-hired personnel, and foundation officials were encouraging even more aggressive market-oriented activities. It was only a matter of time before all these new ventures would start paying off. Or so it seemed.

When bad weather over the Memorial Day weekend kept the crowds home, revenues from the festival fell sharply. Despite the hard work and long hours put in by staff, most of the money-making enterprises failed to perform as hoped. The returns were just not there.

An unsecured line of credit with a branch of a national bank was now fully extended. The bank's president, who was a longtime supporter of the festival, had been the one to urge the local branch to extend credit without collateral.

Vendors were demanding to be paid. The director and the business manager spent more and more time fending off their concerns. The finance committee met and met again, but all they could come up with was a call to raise more money. As preparations for the next year's festival went into high gear, everyone's hopes were pinned on the weather—glorious, sunny weather.

Memorial Day, 1998, turned out be one of the wettest, coldest weekends on record. The rains were relentless. The crowds never showed. The festival took a bath.

Management had purchased a limited weather insurance policy, but for the policy to pay out, a fraction of an inch more rain would have to have fallen that day.

Faced with a growing fiscal crisis, the board brought in Val Silveira, a woman with considerable corporate experience, to clean up the books. What she discovered was alarming. The organization had maxed out its line of credit at $160,000. The deficit was approaching $430,000. On a budget of less than $1.3 million, that was simply unacceptable.

The staff groused. The bank called its line of credit. Vendors threatened to sue. The board asked for and received the resignation of the director. And the local media ran stories hinting at the festival's demise.

Under the leadership of board president Irene Namkung and her husband John Ullman, the board rallied. They hired a new director, Michael Herschensohn, a respected expert on architectural preservation and the former director of Seattle's Museum of History and Industry. As a consultant who specializes in the use of credit by nonprofit organizations, I was called to meet with the board. I suggested that they consolidate their debt and ask their bank to grant them a long-term loan.

To provide collateral for the loan, I recommended forming a credit holders group. Within weeks the board was able to secure credit holders' deposits amounting to more than $500,000. Normally, this would have been enough for any bank to offer a term loan covering the $430,000 deficit. But this bank began imposing more and more conditions, until the credit agreement had grown into a massive, Byzantine document with enough sub-clauses to make a reader's teeth itch.

After conferring with the board and staff, we decided to approach another bank, one that was smaller and more aggressive. Two business days after meeting with the loan officer, a deal was finalized using a standard collateral agreement. Once the line of credit and the long-term note were secured, Northwest Folklife was able to pay off its other debts.

The return to solvency prompted favorable publicity, and that made the organization more attractive to donors. One credit holder even issued a $200,000 challenge grant. Suddenly the pendulum was swinging the other way.

With a vigorous fundraising campaign and improved weather (at least by Seattle standards) at the 1999 festival, Northwest Folklife was finally able to recoup much of its earlier losses. The organization ended the year with a surplus and is now carefully paying down its loan, making sure to sustain its operational needs while meeting its obligations to the bank.

By using term debt wisely, the stability and vitality of Northwest Folklife was restored. Access to collateral made it possible to deal with the organization's deficit in a measured, responsible way—and to renew public confidence in a venerable institution's long-term survival.

West Sound Academy: Stabilizing a New Venture

After years of teaching in the public school system, Ed Frodel wanted to establish a school of his own—a small, student-focused academy that would bring the best of the arts and sciences together.

A popular and energetic teacher, Ed succeeded in recruiting an influential group of local businessmen, educators, and administrators to serve as a board of directors. Together they set about planning for the launch of the new private school.

They found a temporary facility at a nearby private camp and hired a headmaster, Nellie Klinikowski, an art historian with plenty of teaching experience and strong skills as an administrator. Several other talented teachers signed on, and 18 families enrolled their children in the inaugural program. West Sound Academy was on its way.

Tuition was set at $10,000 for the first year—admittedly steep, though not out of line with what other private schools in the area were charging. Initial plans had called for 40 students, but it soon became clear that fewer than that would actually attend. A brand new school, still untested, was no easy sell.

Nellie and Ed thought about finding new board members, hopefully with very deep pockets. But those were in scarce supply, so they began to examine some of the financial assumptions underlying the enterprise. While enrollment would probably grow over the next four years and a break-even budget was possible by year five, even the most concerted fundraising efforts would not guarantee the school's survival until then.

I was called to help Nellie and Ed review West Sound Academy's situation. To clarify the relationship between ongoing income and expense over time, I asked them to prepare a flow budget. Piecing together the school's cash flow, the figures emerged on a monthly basis, using total income, total expense, and a monthly cumulative total as a guide. These figures pinpointed the month when, unless something truly miraculous happened, the school would be unable to continue.

As that truth sank in, both Nellie and Ed realized that all the faculty members under contract could not be paid out of tuition alone. Unanticipated costs, such as improvements to the country lane leading to the camp in order

to accommodate the school's mini-vans, had cast the budget completely askew.

With class sizes as small as one teacher for two students, however, the school was working academically, if not financially. The children were dazzling their parents with their enthusiasm, interest and learning.

Ed and Nellie, in concert with the board, decided to establish a long-term, cash-flow budget, at least seven years out, that would indicate when the projected income from enrollment would finally intersect with the expenses of the program. Two forms of borrowing seemed appropriate. First, the establishment of a line of credit to meet current short-term obligations, such as payroll; and second, a plan for long-term debt until the school could break even.

As a preliminary step, Ed and Nellie began an assessment of the resources of parents, friends, anyone who could help fundraise—on the off chance that an individual with considerable wealth and a willingness to take risks might step forward. Quickly it was evident that no "angel" was on the horizon. Some board members and a few parents had significant assets, but no one felt comfortable donating at the levels required to bail out the school.

And so, after pulling together their financial projections and talking to the board, Nellie and Ed scheduled a meeting with the branch manager at North Sound Bank, an institution with strong ties to the community. That meeting was cordial and hopeful. The manager had himself attended a new private school as a youngster, and he remembered his own parents' struggles to help establish it. Their work had paid off, and that school was now very successful. Nellie and Ed knew they had found a sympathetic ear.

Since West Sound Academy had no assets of interest to the bank, Ed and Nellie proposed that individuals—parents, friends, members of the board and others—could collateralize the loan. They would purchase certificates of deposit at the bank and pledge these funds to the school for use as collateral. The bank would pay each individual the interest due on his or her certificate of deposit, but the entire pool of funds would be available for the school to draw on as a secondary source of repayment.

The banker loved the idea. If West Sound Academy was willing to mobilize the collateral in a highly liquid form—and cash is as liquid as money gets—then, with approval from his bank's credit committee, he was ready to lend.

Two weeks later, parents, board members, and staff met at the home of a couple whose child attended the school. Nellie described the plan for a multiple-year loan and explained the credit holders concept. She pointed out that credit holders need not be donors, although many later do become contributors. They are individuals with a desire to help by parking funds, or in some cases by pledging stocks and bonds to a cause that they deem worthwhile. Using mechanisms such as certificates of deposit, the credit holders retain possession of their funds and earn interest. At the same time, the nonprofit may borrow against those funds, which have been designated as a secondary source of repayment.

In the case of West Sound Academy, the business loan would require commitments of several years. The assembled parents enthusiastically supported the idea. Some were even willing to make pledges on the spot.

Once the West Sound Academy credit holders group had raised an amount equal to the first year's loan, that amount was deposited in the bank. The loan was made and the school was in business.

Today the school is heading into its third year, successfully meeting its enrollment forecasts and sustaining its credit. Investing in Ed Frodel's dream, the credit holders group is making that dream a reality.

Richard Linzer is a management and financial consultant to nonprofit organizations, businesses, and government agencies. He can be reached at P.O. Box 374, Indianola, WA; tel. (360) 297-8331; e-mail: rlinzer@krl.org.