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Philanthropy & Funding

Time to Reboot Grantmaking

Social sector organizations need a "healthy diet" of funding to achieve maximum impact, a concept neatly captured by the Grantmaking Pyramid now used by the Ford Foundation.

By Michael Etzel & Hilary Pennington | Jun. 27, 2017

Communities in Schools (CIS) is the largest and most effective US organization dedicated to keeping disadvantaged kids in school and helping them succeed in life. Founded in the 1970s, today CIS serves 1.5 million students in 25 states and the District of Columbia. Some 91 percent of these students graduate from high school, a success rate that has earned CIS widespread acclaim. Yet, in the early 2000s, CIS found out the hard way that grant-fueled growth does not ensure operational efficiency or financial health. Just the opposite.

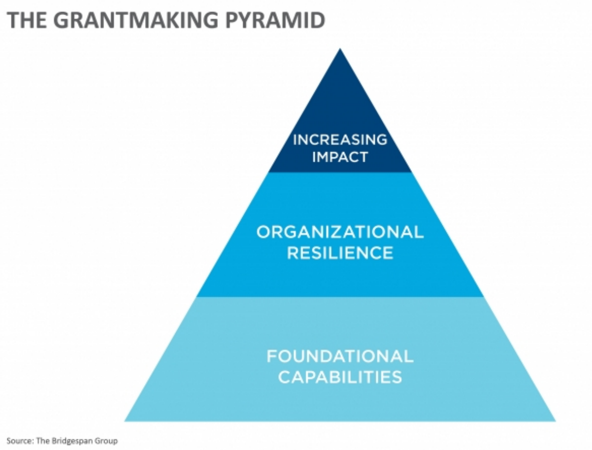
CIS ran deficits most years between 2000 and 2005.[1] With no reserves in the bank to make up the difference, CIS's 990 Forms show the organization dipped into restricted accounts to meet expenses—an ill-advised practice. Meanwhile, vital functions, such as technology upgrades, financial planning, program evaluations, and staff training, went begging while CIS pressed ahead with grant-fueled program growth. "We were a classic example of the starvation cycle," says Dan Cardinali, president of CIS at the time. "We had plenty of public and private resources to fuel program growth, but no strategy for sustaining operations at the national office." It took a wrenching reexamination of priorities for CIS to pull back from expansion to patch its foundational cracks.

Unfortunately, new Bridgespan Group research shows that the struggle CIS faced is all too common, even among the most established organizations. Inspired by partnering with the Ford Foundation to understand its grantee portfolio, Bridgespan examined the financial health of nearly 300 grantees that account for a third of the combined spending of the top 15 US foundations. We reviewed nearly 1,500 financial statements spanning the years 2009 to 2014 from organizations with big budgets, professional staffs, and successful programs.[2] Given the prominence of these nonprofits, many of which are household names, the results came as a surprise. More than half (53 percent) suffer from frequent or chronic budget deficits—defined as at least two of the past five years. And 40 percent have fewer than three months of reserves (specifically, liquid unrestricted net assets) in the bank to cushion financial shortfalls.[3] In fact, 30 of the 300 organizations showed no reserves—making them technically insolvent.[4]

Numbers like this should give funders and nonprofits pause. Organizations pour money and attention into social programs with the aim to help as many people as possible, but the underpinnings of those programs—organizational infrastructure, and financial health—suffer from neglect. "The more foundations fund program growth without funding growth capital (or even acknowledged), the worse it is," says Clara Miller, president of the Heron Foundation. "So the best and brightest nonprofits, programmatically, suffer the most."

It's time to end Potemkin philanthropy that builds the façade of successful organizations that, in fact, teeter on the brink of collapse. We believe there is a better way—one that supports strong programs *and* strong organizations.

Inspired by this belief, Bridgespan developed, and then refined with the Ford Foundation, a simple Grantmaking Pyramid that reframes how funders and their grantees should think about building successful, resilient organizations. Like the pyramids of old, ours rests on a sturdy foundation that builds upward toward a single point—an organization's core impact proposition. It reflects our belief, informed by years of research and experience, in a hierarchy of needs:



The Grantmaking Pyramid reframes how funders and grantees think about building organizations.

First, nonprofits need to build strong foundational capabilities. This requires securing adequate funds to cover the actual costs of core functions, such as strategic planning, information technology, staff development, utilities, rent, and travel. In addition, nonprofits have certain differentiating capabilities essential to fulfilling their missions (for example, an advocacy organization requires excellence in strategic communications, and a medical research lab requires specialized facilities). These differentiating capabilities also need funding and should be the basis of conversation between grantee and funder on where to focus investments. This combination of foundational and differentiating capabilities is the hidden strength or weakness of any nonprofit, and provides the platform for deploying effective programs.

Identifying and investing in these capabilities is not just a matter of securing money to cover costs. It takes ongoing organizational commitment to devote the time and energy to ensure that organizations address these issues.

Second, nonprofits need organizational resilience based on financial health. That means accumulating unrestricted net asset balances. For decades, groups like the Nonprofit Finance Fund and Fiscal Management Associates have called attention to the importance of strong balance sheets in the social sector.[5] Nonprofit leaders agree. They have told us over and over that without sufficient unrestricted balances (both working capital for predictable timing issues and operating reserves to cushion unpredictable shortfalls), they can't devote adequate attention to the most critical, strategic questions facing their organizations. One nonprofit CEO told us:

> One of the most profound differences between living close to the edge versus having adequate reserves is on the management culture of the organization—the constant vigilance required to make sure the organization is "okay," punctuated by frantic fundraising to fill holes. It is a corrosive dynamic that eats away at the whole organization, diverts attention from the core work, and is frankly emotionally exhausting.

Many nonprofits compound this problem by failing to articulate what they actually need—conditioned by a long history of donors not supporting core functions. Even when they know, many nonprofits don't ask. "A lot of organizations haven't learned how to ask for this support," observed a major foundation program officer. "They first need to understand that this is something that can and should be funded." Nor do funders and nonprofits routinely discuss the need to fund facility renovation and repair projects, or the myriad needs for reserve funds.[6]

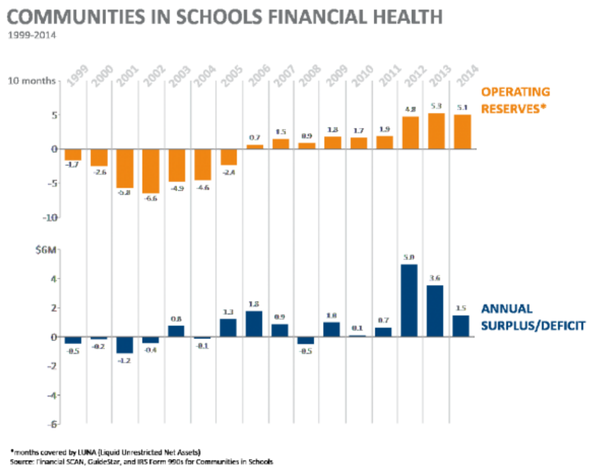
Third, nonprofits need to deliver effective programs, the springboard for increasing impact. The peak of the Grantmaking Pyramid is the public face of nonprofits and the place where, understandably, funders and grantees focus their attention. Every nonprofit starts with a program or service goal in mind. Funders are eager to support those goals. While outright growth or scale is not always the right goal for nonprofits, success fuels a desire to increase an organization's impact against its ambitious mission. But all too frequently, money designated for programs trickles down the pyramid to fill the foundational cracks caused by routine neglect of core capabilities and financial health.

The Grantmaking Pyramid

Admittedly, shoring up foundational capabilities and balance sheets isn't easy. Funders too often leap to invest at the top of the pyramid, whether it's a sexy innovation in scaling, or sustaining successful programs and services. But overemphasis on the top of the pyramid effectively hollows out the rest.

Unfortunately, organizational capabilities too often fall into a catchall, indirect-cost category typically limited to a 10-15 percent reimbursement cap. This all but guarantees a shortfall. In Bridgespan's research, median indirect costs are almost triple the typical grant allowance.[7] Without a strategy for recovering actual costs, organizations are forced to spend scarce unrestricted dollars to fill funding gaps rather than meet other critical priorities, such as staff development, collaboration with sector partners, or IT infrastructure. The inability to cover operating costs shows up in persistent annual deficits. Those deficits tap and quickly deplete the modest operating reserves nonprofits manage to squirrel away, which can force borrowing from restricted funds.

This is the situation that gripped CIS in the early 2000s. The organization had built a highly successful growth strategy propelled by government grants and philanthropic dollars. But the grants limited what it could spend on operational functions in the national office, and its balance sheet hovered in the red (see chart below). Breaking that "starvation cycle" meant having some "really difficult and painful conversations with funders," recalls Cardinali.[8]



Communities in Schools frequently ran short on cash and ran up deficits.

First, Cardinali sought outside advice to craft a way forward.[9] Next, he secured several million in capacity-building grants from the Bill & Melinda Gates Foundation, the Robertson Foundation, and The Atlantic Philanthropies. Those three grants played a catalytic role with the board and other funders. The board now believed that CIS's leadership had a workable plan to address its operational and financial challenges. The grants also emboldened Cardinali to pitch new funders on the need to support capacity building, not just program building. For those that balked, he could now observe: "Your peers are already on board … so you are kind of lagging behind."

What did CIS do with its new capacity-building resources? It paid off debt that had piled up over a number of years, restoring health to its fragile balance sheet. Looking to resume growth, CIS's leadership believed that future success would be grounded in the ability to demonstrate effectiveness. "So most of our fungible resources went to building our capacity to be a learning organization," explains Cardinali. That meant upgrading technology, and hiring people with research and analytical skills that gave CIS "an enormous competitive advantage." CIS also made a major investment in professional development and performance management. That process "really accelerated our momentum," says Cardinali.

Though CIS successfully emerged from this turbulent period by 2006, Cardinali recalls that it took hard work: "It was challenging to sell this [capacity-building] strategy to funders. But those investments allowed us to manage our hundred-plus affiliates and take advantage of the learning across the organization. Without those investments, we would be serving a fraction of the kids we are today."

National borders don't bind the issues CIS successfully overcame. A Kenyan NGO received a $5 million growth-capital grant but failed to build its fundraising capacity. As a result, the NGO faced a funding cliff at the end of the grant. We've heard similar stories from global foundation program officers in the United Kingdom, Western and Eastern Europe, Sub-Saharan Africa, Mexico, Brazil, and Australia. Underinvestment in staff capacity and critical infrastructure is a global issue. As one program officer put it: "This has led to a hollowing out of civil society institutions … at a time when they are critically important to democracy."

Akshaya Patra, one of India's leading NGOs, recognized the effects of operational and financial underinvestment, and boldly charted a solution that reflects the Grantmaking Pyramid. Six years ago, the organization's leaders hit pause on growth. At that point, Akshaya Patra already laid claim to running the nonprofit world's largest lunchtime meal program for schools, serving some 1.3 million children each school day. But as the organization grew, its leaders saw operational and financial fault lines opening that threatened its ability to reach a declared goal of feeding five million children by 2020. "We needed to slow down to fill cracks in our foundation," recalls CEO Shridhar Venkat. "There's no point in growing if the foundation is not strong."

Akshaya Patra spent the next five years adding to its leadership team, honing the technology that powers its high-tech kitchens, devising more-efficient meal distribution, and sharpening its marketing and fundraising skills. Venkat, for example, hired a Six Sigma Black Belt quality-control chief and a chief information officer. Meanwhile, the organization racked up dozens of awards, including its fifth consecutive Gold Shield for excellence in financial reporting from the Institute of Chartered Accountants of India, earning it a rare place in the institute's Hall of Fame.

All that shoring up of behind-the-scenes capabilities paid dividends for the organization's balance sheet. "For Akshaya Patra's first 12 years, we ran programs with no financial reserves," recalls Venkat. "After our fifth Gold Shield award, Indian philanthropist Ratan Tata stepped in and gave us six months of working capital reserves." And a sharper fundraising message helped the organization raise $5 million in unrestricted capital.

Now that it's stronger operationally and financially, Akshaya Patra is ready for a growth spurt, declares Venkat. "Over the next two to three years, we have the possibility to add one million children from the state of Uttar Pradesh." And the Infosys Foundation is funding Akshaya Patra's construction of a new high-tech mega-kitchen in the state of Telangana to feed an additional 100,000 children there. Says Venkat: "We had to strengthen our foundation to grow later."

Using the Grantmaking Pyramid to change the conversation

Akshaya Patra and CIS may operate on different continents in very different contexts, but they illustrate the broad applicability of the Grantmaking Pyramid. Both organizations hit pause on growth to address organizational and financial weaknesses. The Grantmaking Pyramid reflects their learning journey and, more importantly, provides a simple framework for others to follow. By focusing attention on an organization's foundational and financial needs, it aims to prompt a discussion that leads to making the right mix of investments at the right time, ensuring that important capabilities and the balance sheet get the support needed to underpin the delivery of effective programs.

The Grantmaking Pyramid is in action today in the Ford Foundation's new BUILD initiative a $1 billion investment over five years in some 300 grantees. BUILD seeks to foster measurably stronger, more powerful civil society organizations and networks working to address inequality around the world. Ford believes its grantees must be equipped to play the long game, which means doing more to strengthen their core capabilities and financial health, not just fund programs.

The foundation launched the initiative in 2016 after conducting a self-assessment that yielded surprising results. Its support for grantees didn't match its lofty intent. In general, Ford paid too little toward indirect costs, and doled out mostly one- and two-year grants that made it difficult for grantees to plan multiyear strategies aligned with the long arc of social justice work. The self-assessment also prompted Ford to raise its indirect cost reimbursement rate to 20 percent on all project grants and accelerate a move to general support grants as the default whenever possible.

Over the first year, Ford invited 146 of its grantees to join the first BUILD cohort. The Grantmaking Pyramid took center stage as program officers initiated conversations with grantees about unmet organizational and financial needs. The early going revealed unexpected tensions on both sides of the conversation. Program officers had difficulty accepting that fewer robust organizations with larger grants can advance impact more effectively than a larger number of under-funded organizations. Similarly, grantees felt compelled by the current political climate to put all of their resources into "fighting the fight" through programs, rather than investing in capabilities or growing the balance sheet.

The early tension over how to implement BUILD grants subsided as program officers came to grips with ambivalence about increased spending on capacity building over seemingly urgent support for activities. For their part, when grantees realized Ford was serious about investing in their capacity needs, they also began to open up to a different kind of conversation. One grantee spoke for many when she said: "No one has ever encouraged me to have a conversation like this before."

Embracing a new approach to grantmaking is one thing. Figuring out a way forward is another. Many program officers faced a steep learning curve when it came to assessing and discussing issues of organizational health and development. Many grantees struggled to define their capacity needs. It can be surprisingly difficult. By the end of 2016, Ford had approved 86 BUILD grants, and by May 2017, the number surpassed 120. The rest continued to work on refining their grant applications to target critical unmet needs.

Less than a year into the BUILD program, the Grantmaking Pyramid shows signs of having the desired effect. Most grantees have invested in *foundational capabilities*—such as human resources, staff development, information technology, fundraising, communications, and evaluation—and *differentiating capabilities*—such as research, advocacy, network building, and data analytics. (See "Zero in on Funding Gaps" below for more on these capabilities.) A number invested in improved salaries, especially NGOs in developing countries where their efforts already are having a ripple effect among other funders. One in five used BUILD money to strengthen financial reserves. Only a quarter of the grantees focused on growth.

Zero in on Funding Gaps

Patterns of underinvestment in nonprofit and NGO foundational capabilities and financial health are endemic to the social sector.[10] Asking the following questions can help identify where some of an organization's gaps may exist:

Common cracks in the foundation	Questions to ask your organization
Leadership	• Does the organization have the right programmatic and non-programmatic leadership? • What type of talent development opportunities exist for current and emerging leadership?
Diversity, Equity & Inclusion	• Does the organization actively manage diversity, equity, and inclusion? • What investments are necessary to support critical organizational and cultural changes?
Governance	• Has the organization recruited, trained, and retained the right board leadership? • Are the board's skills and connections fully used? Why or why not?
IT systems & Infrastructure	• Are systems up to date and is data and information secure? • Do employees often fill gaps where IT systems or software fall short?
Fundraising	• Do non-development staff spend too much time focusing on fundraising efforts? • Would additional support unlock new revenue streams?
Communications & Marketing	• Who is your audience, and how do you reach them? • Do you have a strategy for influence? How do you measure success of communications?
Learning & Evaluation	• How do you assess the impact of your work? • How do you use this information to inform continuous learning and development?

Ford's experience suggests the potential power of the Grantmaking Pyramid to refocus conversations between funders and grantees. "The best use of the pyramid is as a conversation and alignment tool that leads funders to give nonprofits big, long-term, unrestricted money to do what they need to," observed Kathleen Enright, president and CEO of Grantmakers for Effective Organizations. "But our field has a habit of poorly applying good ideas. I worry that some foundations might apply this thinking by giving tightly restricted grants for foundational capabilities."

To avoid that outcome, grantees can start by bringing the Grantmaking Pyramid to funding conversations and feeling empowered to ask for support for foundational capabilities. Funders can start by communicating that building strong organizations isn't, as one Ford Foundation program officer told us, "a hurdle to jump over in order to receive program funding, but rather a focus of an effective grantmaking strategy."

Grantees can best prepare for these conversations by doing three things:

- Identifying and understanding their needs. Nonprofit leaders should be candid with funders about where they need operational and financial support.
- Knowing their costs and advocating for them. Funders cannot pay their fair share if grantees don't tell them what it is.
- Prioritizing how to spend unrestricted funds. This exercise helps to identify where funding gaps exist, and ensures that capability building and program expansion are sequenced appropriately.

Similarly, foundations must take equal ownership of this journey by:[11]

- Customizing the Grantmaking Pyramid to the context of their grantees—identifying specific foundational capabilities they are willing to support.
- Asking grantees their true costs of programs, and being prepared to pay their fair share of the operational and financial support it takes to deliver those programs from a position of strength.
- Supporting grantees' ability to accumulate operating surpluses to build reserves. When appropriate, investing directly in strengthening a grantee's unrestricted operating reserves.
- Creating a safe space for grantees to be open about their weaknesses.[12]

We know from our research that the outcome of conversations initiated by the Grantmaking Pyramid will vary by the "business model" of the nonprofits involved.[13] The costs associated with a homeless shelter, for example, will differ from those of an immigrant advocacy organization, just as costs for an international NGO will differ from those of a single country NGO.

Our limited analysis to date has shown that grouping nonprofits by business model—market segmentation—will permit comparisons within and across models and greatly aid our understanding of what it means to build capacity for similar types of organizations. "The notion of capacity building is most valuable when applied to specific business models," says Brian Trelstad, a partner at Bridges Fund Management in the United States. "There is less value in discussing organizational health writ large instead of focusing on what capabilities an organization needs to succeed given its strategy and cost structure."

We plan to push ahead this year to refine and deepen our understanding of business model segmentation, and how it applies to nonprofit cost structures and capital needs. Having this information will benefit funders and grantees alike when it comes to funding discussions.

The power of the Grantmaking Pyramid lies in its potential to reshape those discussions and set funders and grantees on a path that leads to new ways of thinking and working together. As the Ford Foundation's early experience with the pyramid shows, charting that path takes time and effort. But the effort will pay dividends in terms of deeper, more lasting impact for the nonprofits involved. Now, more than ever, we need to do all we can to ensure that nonprofits have the resources they need to deliver on their missions.

Notes

[1] CIS's 990 Forms show it that it had negative liquid unrestricted net assets from 1999 through 2005.

[2] The analysis excluded hospitals, universities, large cultural institutions, organizations based outside of the United States, and those without available data. We included nonprofits and NGOs that received grants from two or more of the major funders. To understand financial health, Bridgespan analyzed two indicators for each organization: number of deficit budgets in last five years, and months in which ongoing expenses could be covered by liquid unrestricted net assets. The Nonprofit Finance Fund, SeaChange Capital Partners, Financial Management Associates, and other leading experts recognize and use these measures as indicators of financial health.

[3] "Reserves" are often governed by an organizations' internal policies and practices. By using the liquid unrestricted net asset measure, this analysis identifies those resources readily available for deployment at the discretion of the board and leadership of an organization.

[4] These findings are consistent with other findings from across the sector. A 2016 report revealed similar results, showing that 40 percent of nonprofits in New York City are at significant financial risk and as many as 10 percent were actually insolvent. (See Dylan Roberts, George Morris, John MacIntosh, and Daniel Millenson, "Risk Management for Nonprofits," Oliver Wyman and SeaChange Capital Partners, March 2016.)
Darren Walker raises an important question in "How Can We Help You" ("State of Civil Society Report 2015," CIVICUS: World Alliance for Civic Participation)—when can "fewer, stronger institutions make a more powerful impact?" This analysis does not preclude the conclusion that some institutions should go out of business, but finding endemic weakness among organizations at the center of many large foundations' strategies should give us pause.

[5] The separation of program, organization, and capital structure is one such important contribution—advancing the reality that "a nonprofit's underlying business...is distinct from, though clearly related to, its program." Clara Miller, "Hidden in Plain Sight, Understanding Nonprofit Capital Structure," *The Nonprofit Quarterly*, Spring 2003.

[6] The Nonprofit Finance Fund offers resources for understanding balance sheet needs, identifying the hierarchy of liquidity, adaptability, and durability.
Rodney Christopher, "Why Do Balance Sheets Matter?" *Grantmakers in the Arts Reader* 22, no. 1 (Spring 2011); and Claire Knowlton, "Financial Diagnostics: Prescriptions for Long-term Health," Nonprofit Finance Fund, August 2016: https://www.acso.org/NFF%20Finance%20Presentation%20ACSO%20Conference%202016.pdf.

7 Jeri Eckhart-Queenan, Michael Etzel, & Sridhar Prasad, "Pay-What-It-Takes Philanthropy," *Stanford Social Innovation Review*, Summer 2016.

8 Ann Goggins Gregory & Don Howard, "The Nonprofit Starvation Cycle," *Stanford Social Innovation Review*, Fall 2009.

9 Communities in Schools is a Bridgespan client.

10 "State of the Nonprofit Sector 2015," Nonprofit Finance Fund, 2015.

11 Additional tools, like the Leap of Reason "Performance Imperative," Wellspring's "Organizational Mapping Tool," McKinsey's "Organizational Capacity Assessment Tool," Algorhythm's "iCAT," and TCC's "CCAT" provide detailed guides to identifying and critical organizational needs.

12 The issue of effective donor/grantee relationships is one that has long been explored and researched by organizations like Grantmakers for Effective Organizations and the Center for Effective Philanthropy. See CEP's "Working Well With Grantees," and Bridgespan's "The Donor/Grantee Trap.

13 Eckhart-Queenan et al., "Pay-What-It-Takes Philanthropy.

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