A FIO PARTNERS PERSPECTIVE:

Consolidation of the Nonprofit Sector: A Progress Report

Jane Arsenault, MBA

Over the last two years there has been considerable interest and attention paid to the consolidation of the sector. The debate that has been strongly fueled by a set of circumstances that can only be called: “a perfect storm.” This confluence of bad news is made up of the following streams of circumstance:

1. The recession itself;
2. The loss of equity and interest revenue as agency endowments dwindled;
3. The loss of foundation funding as foundation endowments dwindled…a loss that will play itself out over the next three years due to the “rolling” nature of foundation payouts;
4. Massive cutbacks in state contracting, with significant closures and shutdowns of entire streams of contracting;
5. Significant cutbacks in corporate philanthropy;
6. Declines in individual giving as families have watched their savings disappear, loss of equity in their homes, and current revenue reduced by layoffs, reductions in hours, etc.

This contraction of revenue has impacted almost every nonprofit entity in the nation and, if the nonprofit sector is similar to the for profit sector in times of economic contraction, should cause a dramatically increased interest in the use of consolidation models. As the recession began to unfold, and pundits began to understand the magnitude of what was happening, there were predictions that the sector would lose 100,000 organizations by 2013, either through bankruptcy or consolidation.

FIO Partners is the exclusive provider of customized consulting services, unique assessment tools, and curriculum to ensure the healthy development and growth of nonprofit organizations, foundations, government entities and those who serve them.

FIO Partners, LLC
6 Wilbur Road
Lincoln, RI
(401) 651 -1994
www.fiopartners.com

This expected contraction would be unprecedented in the 250 year history of the sector in the US. From its inception, the sector has known only growth, with no periods of contraction. There was a furry of interest in consolidation in the mid-80's as managed care forced consolidation of hospital systems and health care organizations across the US but this did not last, nor did it spread to other industries of the sector. The last 30 years, when the sector is viewed as a whole, has been a period of unprecedented growth, both in total revenue to the sector and in the number of new nonprofits founded and operating. Revenues from the nonprofit sector increased 144 percent from 1977 to 1997 after adjusting for inflation, nearly twice the 81% growth of the nation's economy in the same period. (Saloman, Lester, The State of Nonprofit America, pg 30)[1] The number of nonprofits (501(c)3 and (c)4 increased by 115 percent compared to 76 percent for for profit entities in the same period. The rate of expansion in terms of the number of nonprofits continued to accelerate, with 27,000 founded from 1987-1997 compared to 15,000 from 1977-1987. The sector continued to outpace overall economic growth through the 90's. While the nation's gross domestic product grew by an inflation-adjusted 36.6 percent from 1994 to 2004, the nonprofit sector's revenues increased 61.5 percent, according to a new compendium of nonprofit facts from the Urban Institute's National Center for Charitable Statistics. The sector's expenses and assets grew at even faster pace: 62.6 and 90.7 percent, respectively.

There are very different points of view on the value of this growth. The perspective most often heard from the corporate sector, and from some government funders as well, is that there are too many overlapping non-profits, all competing for the same philanthropic dollars, many never reaching a cost-effective scale, which hurts their ability to achieve their goals. Their view is that the lack of scale undermines the quality of services, reduces impact, and wastes resources. Their prescription is to merge as many as possible.

Others see the growth as having multiple causes: (1) the ready availability of foundation funds that grew exponentially in the 20 years pre the current recession; (2) the use of the non-profit structure as an alternative form of economic development, empowering disenfranchised communities (who would otherwise struggle to access capital from banks) to start their own community organizations, day care centers, schools, etc. with foundation grants; (3) a reflection of the increasing pluralism of American society as our more fractured society uses npo's to organize and gain influence.

As noted by a colleague recently, we should "recognize the vitality of a diverse nonprofit landscape and appreciate the many contributions that small nonprofits make both with and beyond their stated missions. Those micro-nonprofits create critical social capital in our communities. Often serving neighborhoods or particular populations, these micro-enterprises are often the only tireless advocates for preserving place, quality of life or vital services to underserved populations. Consider neighborhood associations throughout American cities who tirelessly defend against institutional encroachment or inappropriate zoning variances, or the grassroots environmental organizations that protect a small but critical stream or watershed from development that the largest groups just don't have the time to pay attention to. Or an organization like the Gray Panthers that is among the few organizations that pay attention to the minutiae of service cuts (free public bus passes, particular bus routes, utility rate hikes, lifeline services) that may seem small, but would have a dramatically negative economic impact on our most vulnerable populations like the disabled or elderly.

The social safety net and quality of life of our communities depend on a network of organizations from the smallest to the largest. These small organizations, whether conservation organizations, neighborhood associations, people advocacy, sports leagues or others also provide opportunities for developing new leadership in our communities, and they offer especially vibrant pathways in communities of color, immigrant communities and among various age cohorts. Many of the innovations and issues that we now take for granted were pioneered by these small grassroots groups, including urban farming, awareness of the danger of lead paint, community-based affordable housing initiatives or natural resource protection." (Gifford, Gayle, unpublished commentary, October, 2010).

But what has actually happened as a result of the "perfect storm?" There is, as yet, no research that records what has occurred in the last two years. We have anecdotal evidence based on interactions with consultants around the country who do this work and our firm has a strong body of work in this area. The following summarizes observations based on the work of those who are helping the sector consolidate.

Mergers are occurring. Two types appear to be the most common. First are mergers that are essentially forced by funders. Whether foundations or state government, the threat and actuality of dramatic cutbacks are causing organizations to merge, almost always with like entities. Second, are strategic mergers in which an organization recognizes that they will be better off as a part of a larger service system. This may occur due to increased demands for accountability and evidence of outcomes or it may be caused by a recognition that an organization needs to capture a referral stream to survive. In terms of volume, it appears that the number so far is in the hundreds, not the thousands. Our work is summarized below:

Mergers: our firm supported three mergers in 2009, 1 in 2010, and is currently supporting a merger of 5 organizations into 1 as well as a small organization into a larger one.

.

Parent Corporations: a well used model in health care, there is some recent interest in looking at this model for health and human services. We helped one parent corporation into existence in the last year and added a subsidiary to an already existing system. We are about to start another in RI. Other consultants we know report there is little call for the model and few know how to structure one.

Networks: these models are being initiated by state governments who want to reduce the number of contractors providing state services. By forcing providers into networks, states push down the responsibility for quality assurance and regulatory compliance to network administrators, reducing state costs. Providers, however, are faced with being a part of a network or not having a state contract. Network administration requires additional overhead, even when networks are built around a lead agency. This reduces the amount of money for programming. No organization willingly joins a network unless there is no other choice. In the last two years, we have built three networks, all in Rhode Island, and have started another in Calgary. We have recently begun working on another network in Rhode Island.

Management service organizations: there is more interest in these models that combine back office functions, producing efficiency and, in some cases, reducing cost. We have conducted back office analyses for several groups of like agencies around the country in the last two years. We have consistently found potential savings, but other obstacles seem to get in the way of groups of organizations pursuing this savings. Inertia, territoriality, fear of loss of control, and savings amounts that are not sufficient to merit the hassle of partnering, are all problems that routinely occur.

In considering consolidation in the sector, it must be recognized that the dynamics of combining organizations is radically different than the for profit sector. There are no shareholders and the traditional bottom line is not a motivator for organizational combination. For the most part, faced even with draconian cuts in funding, nonprofits are shrinking rather than combining. Forming alliances, particularly in the case of merger, is a matter of creating relationships. Combinations occur for strategic reasons but the choice of partner is most often based upon relationships of trust at either the board or staff level. Organizations seeking such alliances face several challenges:

1. The organizations they know best are likely to have been competitors in the immediate past, straining relationships and creating distrust;
2. The large vs small dynamic: larger organizations are often viewed as predatory by smaller organizations, even when they are sincerely motivated to sustain fragile programming.
3. There are very few leverage points: if a non-profit doesn't want to partner, it doesn't have to. They can't be bought out or acquired in the traditional sense. At best, an organization can be strongly encouraged to consider merger by a major funder, but even then, the choice is theirs.

Given the state of the sector, there are larger entities who are actively seeking to develop an acquisition strategy. This was an element of strategic planning that was unheard of just two years ago. Nonprofits seeking to develop such a strategy are on new ground and must tread carefully. We know that forming alliances among nonprofit is about creating spheres of influence and trusting relationships. An acquisition strategy must be patient and artful. Negotiations are careful and respectful. Alerting funders that an entity is open to sustaining fragile services through acquisition can be helpful. A careful analysis of the health of existing relationships is a critical component. Clear goals for the acquisition strategy are also a must have element.

Projections remain that the revenue in the sector will continue to decline for at least another year or two so it yet may be that the pace of consolidation will increase. Organizations seeking to grow through acquisition must pay careful attention to the actions of funders and regulators, as entities hit by significant cutbacks or by dramatically rising expectations will be the most likely to seek partners as a means of survival.