Nonprofit M&A is No Oxymoron

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I manage two nonprofit merger funds: the SeaChange-Lodestar Fund for Nonprofit Collaboration and the New York Merger, Acquisition and Collaboration Fund (see www.seachangecap.org). These are not profit-seeking funds that, like many investment funds these days, just don’t have any profits, but rather funds that make grants to encourage and support mergers, acquisitions, joint-ventures and other types of formal long-term collaboration (such as back office integration and programmatic alliances) between nonprofit organizations.

The funds have been involved in about 110 collaborations and have looked at another 500+. While the funds are small – we are making grants totaling roughly $1.0 million per year – we’re the only game in town at the national level and in New York City.

Some friends and former colleagues seem to think that since nonprofit M&A is obviously an oxymoron, I must be tilting at windmills or chasing UFOs. But I’m not insane. In fact, I have a fair amount of for-profit M&A experience from an earlier career in private equity. I’ve also had the great good fortune of learning from the Lodestar Foundation, whose principals, Jerry Hirsch and Lois Savage, have been virtually alone in their focus on making grants to support collaboration over the past decade.

Yet despite some relevant experience and two great mentors, I’ve learned the hard way how different nonprofit collaboration is from its for-profit counterpart and from normal-course grantmaking. Organizations often ask me to share with their leadership what I’ve learned on the job. Most of this can be boiled down to eight maxims to be kept in mind by anyone involved with a nonprofit that is, might be, or should be considering a merger or some other type of collaboration.

Be proactive
Mission first
Watch your language
Delay the lawyers
Don’t forget the money
Get help
Don’t dawdle
Celebrate!

I. Be proactive

The best nonprofit collaborations are well thought-through, carefully implemented, and offer potential benefits including (or not) lower costs, strengthened leadership, improved governance, reduced duplication of efforts, more (or more diversified) funding, and programmatic improvements from some combination of breadth, depth and quality.
Given this range of potential benefits, collaboration is an option that should be considered a proactive strategy even by strong and growing organizations. The best collaborations we have seen often fit this description. However, all too often collaboration is considered only in reaction to a looming or potential crisis. In fact, I continue to be astounded by how many nonprofits, even those with seemingly well-functioning boards of apparently clear-thinking people, find themselves under great financial pressure with few degrees of freedom and very little time. A number of factors may explain how this happens:

- Most nonprofits – other than elite universities, hospitals or major cultural institutions – have far less margin for error than many board members realize. Most have, at best, three months of liquidity (six months is a luxury), enter each fiscal year with a sizeable funding gap, and have very little visibility into the decision making of their funders.

- The financial resources available to handle a bump in the road are generally less than meets the eye given the restricted nature of many grants (and fees from government contracts). So cash cannot always be used to plug a hole. And using restricted cash for other purposes often creates a bigger problem in the future.

- If financial problems do arise, restructuring alone can seldom solve them. While a distressed business is often a fine operating business burdened (for whatever reason) with a balance sheet in need of restructuring, this is seldom the case for a nonprofit.

- At the first sign of trouble, funders often run—creating a nonprofit version of a classic “run on the bank.” Or even if they don’t run outright, they often delay their funding decision “until the next grant cycle”. Either way, this can quickly cause problems if there is little surplus to tide the organization over.

- Few carrots exist to encourage funders to take organizational risk. Unlike a for-profit company, a nonprofit cannot offer funders a reduced price, seniority, or other advantageous terms. No specialist funders are organized to evaluate and assume organizational and/or financial risks. So the best hope, if trouble comes, is to limp along, hollowing out the program, freezing salaries, reducing headcount, and begging existing supporters for support, all the while continuing to show a brave face to the external world.

- There are no outside parties or forces encouraging an organization to step back and take an objective view of its situation. There are no nonprofit equivalents to rating agencies, stock market analysts, or even short-sellers. There are no imperfect but impossible to ignore proxy indicators of organizational health such as stock prices or credit spreads.

- Exploring and implementing collaboration often takes much longer than expected, can require great patience, and costs money. Compelling collaborations sometimes gestate for years in some form or other. Working through the due diligence process
to evaluate a collaboration and the legal process to then implement it can also take time (setting up a 501(c)(3) is easy; modifying one is not).

- Organizations are often surprised to discover that collaboration will inevitably involve some one-time costs (e.g. consulting, legal, accounting, real estate, insurance, severance, public relations, and IT) that they may not have the unrestricted funds available to cover, and that many funders are reluctant to cover these costs with new grants.

This long and discouraging list is only meant to suggest that since the clock often runs down faster than expected, it’s best to get on the field early. There are a number of ways to meet potential collaboration partners or to get to know better an already-identified candidate. These include participating in Executive Director/CEO convenings organized by focus area or geography, joining an affinity group, or raising the subject with funders that are particularly active or plugged-in.

II. **Mission first**

Nothing should be discussed in any detail unless and until there is confidence that the potential collaboration would further the mission of your organization. In the simple case where organizations A and B combine, this could happen in three ways. The missions of A and B might be so similar that the combined mission just is the mission of each organization (e.g. Big Brothers Big Sisters in Chicago or Gilda’s Club/Wellness Community). Alternatively, the combined mission could be more compelling to both A and B than their individual narrower missions. Finally, the combination could result in a new and changed mission that both organizations find compelling. (Less than complete collaborations – for example a back-office collaboration – should still be looked at from a mission-first standpoint though the connection will be indirect and the issues more straightforward.)

At least in the United States, we can usually take for granted that the fundamental mission of almost all for-profit businesses, other than those that are family-owned, is the same: make money for shareholders. But in the nonprofit world, mission alignment cannot be taken for granted even for organizations working in similar sectors or with mission statements that look similar from the outside.

There are important reasons to focus on mission before getting into details about governance, leadership, strategy, legal structure, IT systems, and the like. It is the duty of the board to oversee the organization in virtue of the mission and to use the assets for the benefit of public (i.e. the mission). It is the mission which keeps staff motivated and funders engaged. It is a joint focus on mission that will provide the ability to get through all the other tough issues. And there are so many impediments to any nonprofit collaboration that unless the potential mission-related benefits are significant, mutually acknowledged, and constantly communicated from the beginning then some nay-sayer will almost inevitably hijack the discussion and kill the opportunity before it gets off the ground (though often after considerable time and resources have been wasted.)
Of course, “mission” is a notoriously slippery word that gets used in lots of different highly abstract ways while also overlapping with other things like “vision”, “theory of change” and the like. But regardless of the terms used, there are four mission-related questions: What do we do? Why do we do it? What assumptions do we make about the “way the world works” and the ecosystem/environment in which we operate? How do we measure success? Mission alignment comes if there is significant overlap in the last three. (What the organizations do can be different as many collaborations are about expanding programmatic breadth.)

A focus on mission also provides an opportunity for the organization to step back and see itself as part of an ecosystem that is trying to have an impact in a given area. Taking this high-level, mission-first perspective can allow an organization to see the benefits of working with partners while tending to make other issues – e.g., their accounting system or ours? – seem parochial and relatively unimportant.

Unsurprisingly, serious consideration of a potential collaboration sometimes reveals unstated but important differences of view around the board table about the real mission of the organization. Important questions of mission can go unexamined for years in an environment where many organizations simply struggle to stay afloat and where “doing what we’ve always done” is the strategy of least-resistance. Individual board members need to recognize that the consensus-at-all-costs culture of many nonprofits can hinder the clear, decisive and timely decision making that collaboration often requires. Reaching unanimous agreement on the mission simply may not be possible. In this case, the collaboration (or its consideration) may provide a healthy opportunity for the organization to clarify and reaffirm its mission with the believers staying involved while the dissenters respectfully move on.

III. Watch your language

The nonprofit world has a language of its own: capacity building, theories of change, logic models. So too does the business world: marginal costs, synergies, risk-adjusted returns. And a nonprofit collaboration often brings together people from different nonprofits and from both the nonprofit and business worlds. Since many of these terms are ill-defined to begin with (combination versus collaboration, mission versus vision), language can become a source of confusion and needless friction unless particular care is taken to agree upfront on the right words and then stick with them.

Acquisition, takeover, transaction, deal, and even merger are loaded terms that should usually be avoided if union, integration, combination, or collaboration can take their place. Board members with transactional experience should be careful not to leave nonprofit professionals dazed and confused by using specialist business jargon (i.e. MOU, Term Sheet, and Heads of Terms). Even something as simple as using we in place of you and us can be helpful in building trust.

IV. Delay the lawyers

Legal help can be vital to getting sensible collaborations done. Lawyers with the right experience can sometimes make the difference between success and failure. However, a premature focus on the legal aspects – both transactional and due diligence related – of a
potential collaboration runs the risk of distracting organizations and their boards from the mission-related (and other) issues likely to determine whether a given collaboration makes sense to begin exploring in earnest (it also creates a needless risk of wasting time and money). I have yet to see a collaboration that the organizations wanted to pursue but which ultimately proved impossible for legal reasons.

V. Don't forget the money

Board members, particularly those with a business background, seem to think that nonprofit collaboration is always about cost savings. On the other hand, consultants seem to suggest that it is never about cost savings. The truth is somewhere in between. While potential cost savings are not a sufficient reason to pursue collaboration in the absence of mission alignment, they can still be very meaningful relative to the cost of making the collaboration happen. For example, if a merger that will cost $200,000 to consummate is expected to save $600,000 over four years (because of reduced costs of $150,000 per year), then, even in purely financial terms, it represents a highly leveraged 3:1 return. In effect, funding the collaboration is a highly-leveraged capacity building grant. Moreover, even if the savings are modest relative to the total scale of the combined organization, they may be very important at the margin and will often come from a reduction in the type of expenses that are the most difficult to fund – overhead. And the reality of this 3:1 leverage would be no less true if, like many nonprofits, the organization chose to reallocate the $600,000 to provide additional services rather than shrinking in absolute terms.

The good news is that potential cost savings are not difficult to estimate. The expenses of running most nonprofits are overwhelmingly personnel-related; people in nonprofits work hard and few are highly compensated. So unless the combined organization will be doing much less than the organizations were before the collaboration, there will not be much opportunity to reduce costs in programmatic areas. However, there can often be easily identifiable redundancies in overhead functions (like HR, accounting, and development) as well as in areas like real estate, insurance, or technology.

But while money should not be forgotten in conjunction with cost savings, it should be forgotten with respect to price. In the nonprofit world, there is no real analogy to purchase price as money very rarely changes hands when transactions happen. Even in the extreme situation where an observer might rightly conclude that a strong “buyer” is acquiring a terrific program from a “selling” organization that needs the cash, it’s a mistake to assume that they are going to pay upfront for the privilege. From a purely financial standpoint, even the best nonprofit program is a liability. Leaving aside what it would do with the money, could even one of the best organizations (for example, Teach For America) actually sell its program to another nonprofit for cash? I doubt it.

VI. Get help

Very few nonprofits have been through multiple collaborations; most have been through exactly none. However, experienced practitioners can help provide legal, consulting, and facilitation services to help navigate the process of exploring and implementing a collaboration. These include larger organizations like LaPiana Consulting, the Bridgespan Group, or Fiscal Management Associates, as well as local and regional firms like
KransePlows and Lamb Advisors. A number of law firms have dedicated nonprofit practices while others may make their services on a pro-bono basis. These law firms can be approached directly or through groups like the Lawyers Alliance for New York. Community foundations can also be good sources of referrals to these types of practitioners. Some community foundations, such as the Boston Foundation, for example, have recently set up particular programs to fund this type of assistance to qualifying nonprofits in their areas. In other cases, a critical mass of local funders have come together to enable collaboration in a particular sector.

VII. Don’t dawdle

Exploring a potential collaboration takes time. Yet protracted discussions can be exhausting for all parties and potentially unsettling to the organizations as word gets around to staff and funders that something might happen. Boards must push themselves to go “as fast as we can but as slow as we must.”

VIII. Celebrate!

Collaboration is like marriage: if you can’t celebrate, don’t consummate. While the nattering nabobs of non-profit negativity may always remain lukewarm to nonprofit M&A, probably from some visceral feeling that these transactions and the associated language are part of the objectionable corporatization of the nonprofit sector, who cares?

And don’t let anyone bamboozle you into conceding that if research suggests that the majority of for-profit M&A transactions destroy value then the situation in the nonprofit sector must be worse – this is exactly backwards. The results of for-profit M&A are likely to be worse since it is easier (there are many intermediaries and helpers to get it done) and there are many bad reasons – ego, market share, the thrill of the auction, personal enrichment – to pursue it. Furthermore, all the research really says is that for-profit acquirers often pay too much. But in financial terms, nonprofits pay nothing to collaborate other than incurring modest transaction costs which are a generally small fraction of the potential benefits despite the abhorrence of most funders to cover them.

So regardless of the truth about collaboration in general, the brute fact remains that there are 1.0+ million nonprofit organizations in the United States pursuing diverse missions and operating in an environment of social, demographic, technological, political and financial change. In an environment of this scale and complexity, some nonprofit collaborations will be sensible, well thought-through, and mission enhancing, while others won’t.

One litmus test for any given collaboration is to imagine that you’re reading the press release announcing the collaboration or attending the first gala after it. Would it be a celebration? Could it be if you were able to put aside your purely personal considerations? If not, then perhaps one or both parties should seriously consider (or reconsider) other options such as continuing the status-quo, pursuing a different type of collaboration, pursuing the same type of collaboration with a different partner, undertaking a restructuring, or simply dissolving in an orderly way.
The ability to celebrate is not only a proxy for the mission-fit of a potential collaboration. It is also a crucial step to closing one chapter of an organization’s life while getting the next one off to a solid start with staff, board members, funders, and other stakeholders.