Strategic Planning: Best Practices for Nonprofit Enterprise Management

Many nonprofits are reconsidering and repositioning their strategic planning to help sustain the continued success of their missions. Several of our clients and the industry at large are taking actions to accomplish this, including:

- Changing fundraising campaigns;
- Assessing the impact of mergers and acquisitions;
- Dialing in on liquidity; and
- Focusing on staff and board succession planning.

Here we offer more detail about these strategies along with best practices and general considerations to help nonprofit organizations achieve success in their missions.

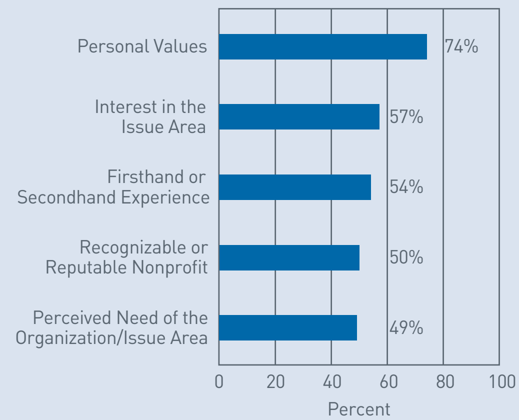
Fundraising

Fundraising is the lifeblood of many nonprofit operations and can directly affect their ability to fulfill their missions. Some nonprofits look to their donor base to develop fundraising campaigns. Organizations may explore donor psychology to understand why donors give and what they expect in return. Other nonprofits tailor their donor relation strategies to appeal to different donor groups. Some nonprofits see how willing donors are to contribute in light of economic, political and other external factors.

Individual Giving

While donors don't fall into precise psychological buckets, there are noticeable trends for why donors give, according to the 2018 U.S. Trust® Study of High Net Worth Philanthropy.[1] The most highly cited reasons donors donate to a cause are values, interest in the issue area, firsthand experience, recognizable or reputable nonprofit, and perceived need (Figure 1). Low-ranking reasons included: report rankings, social circle endorsement, pitches and collateral.

Figure 1
How High Net Worth Donors Choose a Cause or Organization to Support



Source: 2018 U.S. Trust Study of High Net Worth Philanthropy[1]
Chart reflects only top five categories.

Corporate Giving

We've identified several underlying factors that drive corporate charitable giving. The first is the company's desire to be a good corporate citizen and to improve the communities in which it operates. All else being equal, individuals and other businesses are more likely to want to consume more goods or services from a business that has a strong charitable and community profile relative to a business that does not.

The second reason stems from employees. Several well-known surveys and studies have found employees are more likely to want to work for an organization that operates with values like their own. Organizations with a strong charitable and community profile are likely to be more attractive than organizations without such a profile.

[1] The 2018 U.S. Trust® Study of High Net Worth Philanthropy, *Charitable Practices and Preferences of Wealthy Households*, https://ustrustaem.fs.ml.com/content/dam/ust/articles/pdf/ADA-2018-HNW-Philanthropy-Full-Report.pdf.

The final reason is the responsible investment movement and its effect on corporate sustainability and reporting. As the responsible investing trend grows, publicly traded corporations face pressure to be good corporate citizens. Good corporate citizens give back to their communities through monetary donations and volunteering. We expect this reason to become even more important in the coming years as responsible investing assets continue to increase and more investors and stakeholders begin to request this information from the companies in which they invest.

Motivation

Research suggests individuals and corporate donors want to have a positive impact. They support the organizations they believe are best suited to provide solutions. Given the low score of pitches and collateral on individual decision-making in the 2018 U.S. Trust survey, nonprofit organizations should be intentional about donor relations. We suggest appealing to donors by emphasizing value alignment, impact on a particular cause, and what it means for the community, affected area, or other boundaries of the nonprofit's mission.

By working with nonprofits, we found that turning investments, administrative and reporting responsibilities over to an investment manager or outsourced chief investment officer can help a nonprofit organization redeploy its human resources and time to donor outreach and relations, generally resulting in greater fundraising flows over time.

Fundraising will always be the lifeblood of nonprofit organizations. Understanding donor psychology, composition and future willingness for charitable giving can help the lifeblood continue to flow.

Mergers and Acquisitions

Today, many organizations are considering strategic moves to confirm the continued success of their mission. One trend we observed is the frequency of mergers and acquisitions (M&A), particularly in higher education, religious institutions, associations and healthcare segments. There are a few considerations for organizations looking to engage in these transactions. Let's define the two terms.

- **Merger:** A statutory term referring to the combination of two organizations into a single legal entity. The organization that is merged into the other goes out of existence, and the entity that remains is often referred to as the "surviving" organization.
- **Acquisition:** A transaction in which one organization purchases the assets or stock of another organization. The purchaser incorporates the acquired assets into its operational structure, and the seller remains a separate entity, receiving the proceeds from the assets or stock it sold.

For example, if a chapter of a trade association in the southern part of the state combines forces with the northern chapter to better serve its members, resulting in a single legal entity, that's a merger. If a regional nonprofit hospital system purchases a hospital in a new market to expand its geographic reach and the organization formerly operating the hospital remains in existence as a separate legal entity following the sale transaction, that's an acquisition. The two examples are simplistic and could in practice be accomplished by a merger or an acquisition transaction.

Strategic Intention

It's important to explore the "why" of this trend toward mergers and acquisitions — strategic intention and failure avoidance. Strategic intention drives organizational growth through increasing revenue sources, reducing overhead/expenses, or some combination of the two. For example, consider neighboring hospice providers that completed a merger to "expand their collective customer impact and to gain a competitive advantage in an industry where for-profit providers had become significant players."[2] These organizations understood that as standalone entities, they would struggle to obtain the resources necessary to compete with some of the for-profit competitors. By combining resources into a single entity, they remained competitive and achieved their strategic growth goals.

[2] D. Haider, "Nonprofit Mergers that Work," *Stanford Social Innovation Review*, March 2017, https://ssir.org/articles/entry/nonprofit_mergers_that_work.

Failure Avoidance

Failure avoidance is no less important. There are more needs, causes and missions than there are nonprofits or government dollars to support them. For example, merging three youth mentoring organizations across northern Illinois and Indiana, including the Big Brothers Big Sisters of Metro Chicago, turned "a largely insolvent operation serving 100 or so at-risk children in 2005, into a $4 million sustainable enterprise promoting high quality services for 1,800 at-risk children in 2015."[3] On its own, the Big Brothers Big Sisters of Metro Chicago ran the risk of depleted funding for the worthy cause of helping at-risk youth in Chicago. Instead, the organization combined its resources with other like-minded organizations, thereby allowing it to continue supporting its mission. When resources are strained, donor support may dry, or other operational concerns cause financial hardship, a merger or acquisition could secure an organization's longevity.

Focus on Due Diligence

In any potential merger or acquisition, the strategy must focus on due diligence. In our opinion, there are a few key questions to consider:

- Will a merger or acquisition, traditionally a scaling up of operations, help the organization succeed in its mission?
- What types of organizations would create synergies with existing operations that would have the greatest impact on the target mission, demographic or region for the organization?
- Does the organization have the requisite resources, experience and capacity to engage in the complex process of a merger or acquisition?
- Is there a cultural, mission and operational fit with the target organization?

Best Practices

With these questions in mind, we suggest a few best practices when considering a merger or acquisition.

Retirement Plan Health

Financial health, typically including both the balance sheet and income statement, is central to any merger or acquisition due diligence process. We recommend paying extra attention to the retirement plan status of the target organization. For example, a religious-based healthcare system that looks sound on the balance sheet and shows a strong operating surplus on the income statement could nevertheless have a severely underfunded pension plan. If a nonprofit hospital system without a religious orientation acquired the religious-based healthcare system, the pension plan could potentially lose its exemption to the Employee Retirement Income Security Act of 1974, as amended (ERISA), creating the need for financially intensive funding status remediation. Remediation could significantly impact the acquiring organization's financial status, cash on hand and credit rating. Understanding the target organization's retirement plan health can help avoid pitfalls. Asset-liability studies, actuarial reports and other risk analysis activities are part of the due diligence phase and can provide insight into the target entity's financial health.

Designation Status of New Organization

The Internal Revenue Service (IRS) lists explicit rules for tax-exempt organizations that "end their operations, either through shutting down, transferring their assets or merging with another tax-exempt organization." The IRS must be informed of the action. It may also be appropriate to ask for a private letter confirming the resulting entity will retain its valuable tax-exempt status.

In addition, consider whether the resulting entity will retain its religious affiliation. This can impact certain aspects of the operation, especially retirement plan status. Certain forms of retirement plans available to religious organizations are typically not available to other types of nonprofit organizations. Religious organization retirement plans that quality as "church plans" are exempt from ERISA. Losing church plan status could cause significant hardship for the plan sponsors.

[3] Ibid.

Synergy and Cultural Integration

Synergy is the operational benefit resulting from a successful merger or acquisition. For example, two soup kitchens serve the same area. On their own, each kitchen spends money on supplies, kitchen space and human resources. If the soup kitchens combined forces, they could take advantage of economies of scale by purchasing supplies in bulk, cooking in a single location and potentially needing fewer people to cook and serve meals. By reducing overhead costs and taking advantage of the synergy of combining operations, the combined entity would have more capacity to provide meals to those in need.

Cultural integration is important to any merger or acquisition. Many established organizations have a set way of doing business and may be hesitant to accept change. This could impede a successful merger or acquisition and prevent the resulting entity from capitalizing on synergy and overhead reduction considerations. Not every organization and its employees will work seamlessly with one another. Determine the cultural fit of the two organizations in advance and have a plan in place to ease the transition.

Donor Restrictions

Sometimes donor restrictions prevent smooth mergers and acquisitions. A common example of this is in higher education, where legacy donor gifts can prevent colleges and universities from easily acquiring, or being acquired by, other institutions. This happened at Newcomb College, where the will of a donor established the college's name. Following Hurricane Katrina, the college was in financial straits. As a result, the board of directors voted to create a new co-educational entity, Newcomb-Tulane College. The original donor's family argued the change violated the donor's intent. The issue went to the Louisiana Supreme Court, which sided with the university after a drawn-out legal battle. While the outcome worked in the college's favor, it nevertheless caused legal, reputational and time costs. Before considering a merger or acquisition, assess the impact the merger or acquisition may have on restricted gifts. Consult legal counsel to determine what court, regulatory, or donor approvals may be necessary, as rules differ from state to state.

Donor restrictions can also impact combining endowments and/or planned giving programs. For example, certain charitable giving vehicles can create liabilities that might not legally translate or transfer well into a new entity without donor permission. Similarly, combining endowments may create charter, investment policy and/or other conflicts under the new structure. Proactively plan and communicate how donor outreach will be managed under the new entity. Mergers and acquisitions are complicated transactions. We suggest engaging the appropriate legal counsel, M&A consultants and other related services early and often in the process.

Dialing in on Liquidity

Broadly speaking, the founding purpose of most endowed or foundation assets is to support a spending or distribution policy. An organization's investment program is successful if it can support its spending or distribution policy while preserving purchasing power and allowing the modest growth of wealth. The way the spending or distribution policy is developed and defined may significantly impact the investment program's ability to generate necessary returns to support this goal.

An organization's liquidity needs, as defined by the spending or distribution policy, greatly influence the overall asset allocation structure of its investment portfolio. Too much cash could create performance drag on a portfolio, while too little could create "emergency" liquidity needs that can potentially force security sales at a loss in the event of a market downturn. In an extreme example of liquidity risk, the Harvard Management Company experienced costly liquidity issues in 2008–2009 when a heavy allocation of illiquid investments combined with margin calls on derivative financial instruments forced the school to sell part of its equity portfolio at a loss. The school then borrowed additional money in the public debt markets to meet the liquidity needs of its spending/distribution policy.

Spending and distribution policy discussions should include operating reserves, even if they are held separately from the longer-term investment portfolio. In accounting firm BDO's 2020 *Nonprofit Standards, A Benchmarking Survey*, nonprofit organizations indicated how much is typically kept in operating reserves. As Illustrated in Figure 2, 1–6 months of operating reserves is most common, at 52%, while 19% maintain 6–12 months, 27% maintain 12 months or more, and 2% carry zero operating reserves.[4] Generally, for organizations with six months or more of operating reserves, the investment portfolio tends to need less liquidity, while organizations with six months or less of operating reserves tend to need more investment portfolio liquidity.

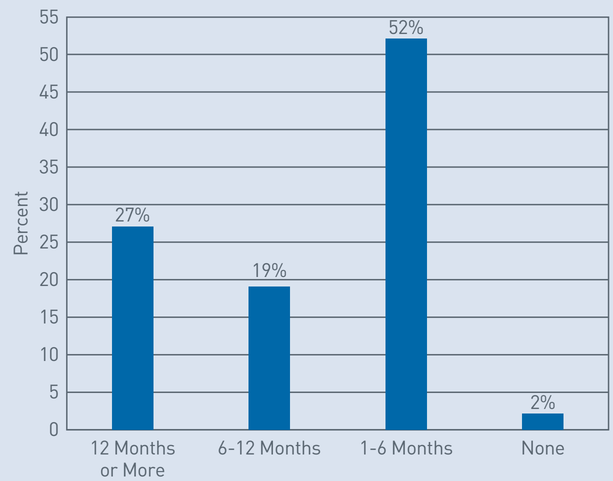
Regardless of whether an organization follows the Uniform Management of Institutional Funds Act of 1972 (UPMIFA) guidelines, our experience working with nonprofit organizations has shown that clearly defined spending and distribution policies can instill discipline into the budgeting and financial management process.

Consider the difference between going to the grocery store with a budget and shopping list and going without either in mind. If you go in prepared, the outcome is predetermined and based on a disciplined process that typically results in spending what you intended and getting what you came for. Conversely, if you go without a budget or a list, chances are you will spend more than you intended, purchase items you don't need and forget items you do need.

In a nonprofit organization, a spending rule can help determine the budget (or at least the asset's contribution to a budget). The organization can then determine what operations, purchases or other considerations can be added to the "shopping list." This may prevent an organization from overspending each year, something that could impair purchasing power of the investment assets if they are used to cover the extra spending.

From an investment perspective, a spending rule can assist an organization in determining the investment program's required rate of return and risk tolerance objectives. For example, if the spending policy is set at 4%, plus 2% for long-term inflation and 0.50% for management/overhead fees, simple math indicates a

Figure 2
Typical Operating Reserves Held by Nonprofits



Source: BDO's 2020 Nonprofit Standards Benchmarking Survey

required rate of return at 6.5% to meet the spending obligation. An investment manager could then use risk optimization to minimize risk against the return objective of 6.5%, potentially allowing the portfolio to meet its investment goal efficiently and effectively. Without a required rate of return, the portfolio (specifically, the asset allocation) could be geared to return too much or too little. A portfolio with a too-high return target would take more risk than required to meet the goal of 6.5%. Alternatively, a portfolio with too low of a return target would take less risk than required to meet the same goal, and consequently would likely fail to meet the return requirement. Setting a spending policy can help an organization set an absolute benchmark to serve as a measurement of investment program success.

Given its importance to budgeting, financial management and portfolio management, we recommend clearly defining a spending or distribution policy as part of a nonprofit organization's investment policy statement (IPS). In our white paper on crafting a robust IPS, *The Discipline to Succeed*, we discuss how to document a spending policy as part of a nonprofit investment program.

[4] BDO USA, LLP's Nonprofit Benchmarking Survey. Data as of June 2020.
https://www.bdo.com/insights/industries/nonprofit/nonprofit-standards,-a-benchmarking-survey-(1)/strategic-planning.

Staffing and Board Succession Planning

Board composition is a crucial component of a successful nonprofit organization. Board members can enhance the charitable mission through their own efforts and contributions. In the early stages of a nonprofit, much care and study go into the selection of the initial members. This governing board is legally accountable for the actions of the nonprofit organization, so individuals who serve must be aware of and willing to shoulder the responsibility. Their focus is to oversee compliance with regulations (for example, public support testing for 501(c)(3) tax-exempt status), maintain and refine policies and procedures, and confirm the plans and programs of the organization's mission are implemented and enhanced. At the same time, they are also responsible for conducting the three legal duties: duty of care, duty of loyalty and duty of obedience. Great care should be taken in selecting the inaugural members of the board and this same level of due diligence should be applied when determining subsequent generations of the board.

Realistically, selecting board and leadership positions can be one of the most substantial decisions facing any nonprofit organization. The gravity of this responsibility becomes increasingly vital as the nonprofit advances so staff, volunteers and even donors have a sense of stability and continuity about the organization and its mission. Consequently, volunteers may desire a place on a firm's board of directors, yet not every applicant may be ready or qualified to serve. Referring again to BDO's *2020 Nonprofit Standards, A Benchmarking Survey*, board succession planning is listed as a major governance concern by 54% of respondents (tied for second out of all response options). Further, 66% of all respondents listed staff retention/recruitment as a strategic planning concern, with the health & human services subsector showing the greatest concern.[5] Together, these data points suggest board succession and staffing are major strategic and operational concerns for nonprofit organizations across the country.

To mitigate these challenges, best practices for board succession planning might include:

- *Seeking recommendations from current or retiring board members.* Enlist board or committee members to seek qualified, dedicated individuals for consideration. Individuals who served the board faithfully would likely view this as an obligation to find a qualified successor, someone who could carry on their legacy of service.
- *Considering committee and project volunteers.* This service demonstrates commitment and leadership skills. Some organizations may require this as the first stage of candidacy, and it can provide a more candid assessment of an individual seeking a board position.
- *Considering a profiling questionnaire.* Ask candidates to complete an application with data on their talent, experience and references. Ask about the candidate's goals and expectations for sitting on the board to glimpse into the candidate's personality. Candidates who pass this initial phase of the process could then interview with a selection committee. The interview is an opportunity to determine if the candidate would assimilate into the existing board. Additionally, this facilitates selecting a "mentor," if the organization employs this concept, to help enhance the transition to functioning board member.
- *Considering diversity in the dynamics.* Succession planning can bring positive change and new influences to help further the nonprofit's mission. When profiling candidates for board vacancies, consider, along with experience and personality, other aspects such as gender, age, culture and location. These aspects can broaden the collective attitude of the board and its interpretation of leadership. In a time when relevancy is a concern for most organizations, this broadening dynamic can establish a bridge between generations.

---

[5] BDO USA, LLP's Nonprofit Benchmarking Survey. Data as of June 2020. https://www.bdo.com/insights/industries/nonprofit/nonprofit-standards,-a-benchmarking-survey-(1)/governance.

BDO USA, LLP's Nonprofit Benchmarking Survey. Data as of June 2020. https://www.bdo.com/insights/industries/nonprofit/nonprofit-standards,-a-benchmarking-survey-(1)/strategic-planning.

Succession planning can be a critical component of strategic planning and requires the same respect and diligence given to other areas of the enterprise management process. Whether planning for leadership or staff and volunteers, together these individuals can play important role in the success of the organization's mission. For more information on board succession planning, please see our white paper, *Succession Planning for Nonprofit Boards and Leadership*.

Conclusion

Looking at how nonprofit organizations fit into the community, country and world, it is hard to point to a time with more changes, concern for capital market returns, and need for nonprofits to succeed in their missions. Strong enterprise management through strategic planning can help nonprofit organizations position themselves well in this environment. Our research indicates that these steps and best practices generally improve success in nonprofit management.

For more information, please contact your PNC Institutional Asset Management® representative.

About Us

The Endowment & Foundation National Practice Group

The Endowment & Foundation National Practice Group builds on PNC Bank's longstanding commitment to philanthropy and is focused on endowments, private and public foundations, and nonprofit organizations. We seek to help these organizations address their distinct investment, distribution and capital preservation challenges.

For more information, please contact Henri Cancio-Fitzgerald at 704-551-2843 or henri.fitzgerald@pnc.com.

For more information, please contact your PNC Institutional Asset Management representative.