NONPROFIT STRATEGIC ALTERNATIVES AND COVID-19

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Weeks into the COVID-19 pandemic, there remains considerable uncertainty surrounding the extent and duration of its impact on the nation's citizenry, healthcare system, and economy. For directors and officers of the nation's nonprofit human services providers, these uncertainties present complex business challenges related to clients, staff, operations, financing, and government policy. Given the expansive range of potential outcomes impacting each of these, now is the proper time for decisionmakers to review corporate strategy in anticipation of potentially dramatic changes in market conditions. This process necessarily incorporates consideration of multiple scenarios given the level of uncertainty associated with the pandemic, and its conclusions will be tentative and subject to shifting data regarding the specific variables of interest to individual firms.

Introduction This century's second global economic crisis challenges American policymakers already confronted by headwinds that include an aging population, modest economic growth, income inequality, and the near-term prospect of disruptions stemming from the massive technological changes driven by 5G and its related technologies.

Reconstruction in the United States is again expected to lead the global recovery because of the nation's vast resources and its relative (albeit diminished) willingness to endure the collateral damage inflicted by Schumpeter's "gale of creative destruction." Corporations, including nonprofit corporations, are the vehicles through which economic vitality will be restored. The restoration process will inevitably leave many existing corporations confronting their endgames, while others make the necessary adaptations to survive and thrive in new industry environments.

This essay considers the challenges and opportunities faced by nonprofit human services organizations recovering from the massive dislocations associated with the COVID-19 pandemic. Nonprofit organizations differ from their for-profit counterparts in that they have no owners, are not governed nor capitalized like their commercial counterparts, and pursue very different missions. Crafting effective strategies to advance their charitable mission demands that directors and officers consider alternatives that extend beyond the boundaries of pre-crisis thinking. This is especially critical for those nonprofits experiencing stagnation, decline, or distress. A base case scenario that nonprofit directors and officers might face is suggested below, along with

observations concerning strategic alternatives the base case scenario invites. This base case supposes that the virus is contained in the next two to three months and followed by a deep and prolonged economic downturn. A contrarian perspective is also summarized in support of a competing outlook.

Macroeconomic Considerations The current economic downturn was not caused by market failure and can only be moderated by fiscal and monetary policies. Still, the most significant planning variables may relate to highly uncertain macroeconomic assumptions rather than others related specifically to the human services industry or to the firms engaged in it.

Federal and state governments directly or indirectly provide a large portion of the revenues of nonprofit human services providers. Consequently, public policies and their impact on funding are critical factors in assessing the post-crisis outlook for the human services industry.

There is consensus that the U.S. economy entered a deep recession in Q1 of 2020 as a result of COVID-19, while great uncertainty remains concerning the recession's duration and long-term impact. Fiscal and monetary policies to date have targeted income maintenance, financial market liquidity, and sustained low interest rates, with the goal of deterring (or at least, delaying) bankruptcies, sustaining consumer spending during the crisis, and stimulating economic growth thereafter. The presumed impacts on the human services industry may include the following:

- *Low treasury rates, but sustained challenges for high-yield* Counterintuitively, the ballooning federal deficit, along with declines in target growth rates associated with an aging population, make an extended period of low-interest rates likely, as higher rates would have a catastrophic impact on the federal government's ability to fund its defense, transfer payments, and other obligations. More important for human services providers are the rates available to high-yield borrowers, which includes all but a few human services nonprofits. Historically, high-yield bonds trade more like equities than treasuries, and so perform best when growth trends are favorable, investors are confident, and default rates are low or falling – none of which are likely in the near or medium-terms. Indeed, the only hint of encouragement for high-yield borrowers is found in the huge spreads between treasuries, which create the possibility for gains as spreads narrow as risks diminish. The recent performance of the tax-exempt markets has been unprecedented, with declines in prices evidence of the market's concerns regarding the impact of the pandemic-induced slowdown on states, cities, and other tax-exempt borrowers. The base case is that the cost and availability of capital to high-yield borrowers will be impaired for an extended period, and adversely impact virtually all nonprofit providers of human services – possibly to the benefit of the growing number of private equity platforms competing in the industry.
- *A Sharp increase in Defaults and Bankruptcies* Regulatory authorities were becoming increasingly concerned about the buildup of BBB-rated and high yield corporate bonds even prior to the pandemic. The ferocity of the current downturn will inevitably lead to a torrent of downgrades and bankruptcies that will further depress markets. While rating agencies will be pressured to modify their practices, the culling of zombie companies

(both for-profit and nonprofit) sustained by the CARES ACT and its successor(s) is inevitable if the U.S. is to escape the fates of Japan, Greece, and Italy. The base case scenario is that the number of nonprofit human services providers shrinks significantly as a result of exits by many and affiliations between others.

- *Stressed State Budgets in the Short and Medium Term* The CARES ACT included $150 billion in direct federal aid to states and municipalities to address their immediate needs. Federal budget deficits will sharply limit the central government's ability to increase support for states post-crisis, when sharp declines in state and local tax revenues fall far short of budget expectations due to the depth of the pandemic-induced recession. Further, the Treasury's decision to delay the federal tax deadline until July 15 will result in many state and local governments waiting an additional three months to collect tax revenues. These developments will cause states and local governments to attempt to issue substantial new long-term debt during a period of great stress in the municipal finance markets. The base case scenario for nonprofit human services providers is that traditional sources of funding for human services will be sharply limited and even reduced in the short and medium terms, potentially resulting in negative earnings for the industry as a whole.
- C*haos in Public Finance* The $3.85 trillion-muni market is comprised of state and local issues (approximately two-thirds or $2.6 trillion), with the remainder being primarily revenue bonds issued by everything from hospitals to transportation providers to colleges and universities. Unprecedented disruptions to liquidity in this normally staid segment of the markets resulted in actions by the Fed intended to shield governments from drastically higher rates at the very moment they were experiencing both expense and revenue shocks. While this intervention calmed the markets in the short-term, systemic downgrades of states, cities, hospitals, transportation, and service utilities can be expected in the near term, which follows an interval during which investor's exposure to non-rated municipal issues increased markedly. Collectively, the markets longstanding "extend and pretend" attitude regarding public pension liabilities, the dearth, inadequacy, or unavailability of timely financial reporting by issuers and obligors, and the absence of reliable valuations of debt issues that trade infrequently, lead to a near collapse of municipal finance markets - and more pain for states, municipalities, and nonprofits that once accessed it. The base case scenario for nonprofit human services providers is that access to capital – whether for sustenance, growth or consolidation - is simply unavailable.
- *A reset on globalization* The pandemic highlights that supply chain economies resulting from globalization entail heightened political and public health risks, leading to a reassessment of the risks relative to the rewards. This realization is manifested in the political sphere through a yet greater focus on immigration policy and border control in both Europe and the U.S. These developments portend a shift in the size of the labor force, which has been one of the critical factors (along with technology) that has restrained inflation over the past decade. The base case scenario for nonprofit human services providers varies, depending on the number of non-citizens living in the local

community, and the relative impact of a decline on both labor costs and service demand. States and municipalities where the impact will be greatest include California, Texas, New York, Nevada, and New Jersey.

- *COVID will impact the economies of states, regions, and industries differently* While COVID's impact on consumer spending is national, the consequences of the recession caused by it will impact economic sectors and geographic regions differently. Moody's has identified five industries, mining/oil and gas, transportation (including mass transit, which is experiencing plunging ridership that will likely be sustained), employment services, travel, and leisure and hospitality as likely to suffer the worst declines. Together, these industry sectors employ almost 25% of the nation's workforce. If Moody's forecast proves correct, the economic impact on cities including Midland, TX, Las Vegas, NV, Atlantic City, NJ and Orlando, FL will be disproportionate. Less challenged may be tech-oriented university towns such as Provo, Ut, Durham-Chapel Hill, N.C., Hartford, Conn., Albany, N.Y., and San Jose, Calif. The base case scenario for nonprofit human services providers is that where greater the pain experienced by states and municipalities there is higher likelihood that long-established policies – such as real estate tax exemptions for nonprofits – will be reconsidered.

A Contrarian Perspective: At a basic level, inflation is a general increase in prices across the economy, but it is a phenomenon not fully understood by economists. It is worth considering that some economists forecast rapid growth in inflation resulting from massive increases in the money supply, while other economists forecast an extended period of deflation (i.e., a general decline in price levels) resulting from a collapse in global demand. Either of these developments would lead to a very different macroeconomic and industry environment, and different strategic alternatives for nonprofits.

Industry Considerations Nonprofit human services providers deliver services such as behavioral health, addictions, intellectual and developmental disabilities, child welfare, foster care, special and alternative education, community housing development, or juvenile justice services. The industry exhibits many but not all the characteristics of monopolistic competition, a term used to describe industries with low barriers to entry in which many firms offer products or services that are similar, but not perfect substitutes.

Human services enjoyed two generations of sustained growth between 1970 and 2010 while avoiding the market forces that transformed many other industries (e.g., banking). Throughout this period, nonprofit providers experienced exceptionally low levels of bankruptcy and minimal technological disruption. While certain human services segments, including autism services and addictions, experienced significant incursions by well-capitalized for-profit competitors, the provision of human services remains a highly fragmented industry dominated by nonprofits and yielding modest returns on invested capital.

COVID-19 has impacted both the expenses and revenues of nonprofit human services providers. Many providers have furloughed a substantial portion of their workforce, resulting in reduced wage costs but increased termination, unemployment, and overtime costs and sometimes, hazard

pay. In the near term, worker's compensation costs will likely be impacted by the disproportionate number of COVID-19 infected people employed in helping professions. Premium costs associated with liability insurance, especially abuse and molestation coverages, were rising even before the COVID-19 outbreak, and may soon be unavailable at any affordable price. Concurrently, revenues have declined as outpatient, day programs, special education, and alternative schools, and other services were closed or curtailed to comply with social distancing practices. For some providers, these shuttered services constitute a majority of their income. For those few human services nonprofit providers that derive a meaningful portion of their revenues from investments, the roughly 30% drop in the value of publicly traded equities has only added to their fiscal challenges.

In most instances, the onset of a recession increases the ranks of the unemployed and helps mitigate the perennial staffing shortages experienced by human services providers. The post-COVID-19 experience, however, may differ in that it is reasonable to suppose that individuals considering (new or continuing) employment with human services organizations will be mindful that direct care positions placed workers at heightened risk of infection during the pandemic. As labor costs comprise a substantial majority of the total expenses of many nonprofit human services providers, factors that impede staff recruitment and retention result in higher wage and overtime costs that reduce profitability in an already low-margin industry. Collectively, industry fragmentation, cost pressures, and state funding constraints portend an extended interval during which aggregate industry growth and profitability will be pressured, and potentially negative.

A Contrarian Perspective: Historically, the United States has spent a significantly larger portion of GDP on medical services than other developed nations without commensurately better outcomes. Pandemics highlight realities that the poor are more likely to contract the virus, more likely to die from it, and more likely to experience economic devastation. Difficulties in slowing the spread of COVID-19 may prompt a rebalancing of the nation's investment in social services relative to medical care, leaving the U.S. model more like that of other industrialized nations. This development would lead to a very different industry outcome, fortifying the claim of the human services industry on available public funding, with vastly different strategic consequences for nonprofit providers.

Firm-Level Considerations Individual nonprofit providers will be impacted by macroeconomic and industry factors differently based upon the specifics of their service lines, payor mix, capital structure, and the quality of their governance and management. Still, the following generalizations are warranted in assessing future, post-crisis strategic alternatives of nonprofits:

- *Risk Matters.* Nonprofits that generate cash from multiple payors by offering different services across multiple states have less risk than providers dependent on a few payors for a single service in one state.
- *Scale and Scope Matter.* Delivering diversified services in multiple states enables the development of a corporate infrastructure capable of successfully competing based on price in a marketplace where price increasingly dictates payor decisions.
- *Capital Matters*. As a provider's revenues grow, its need for capital increases in order to acquire and maintain the requisite working capital and other assets necessary for operations

and investment. Capital consists of debt and equity (net assets in nonprofit parlance), and the former isn't available without the latter, creating an underappreciated but formidable challenge for nonprofits, who cannot issue stock and are engaged in a low-margin industry.

- *Governance Matters.* As a nonprofit expands, its growing complexity results in information asymmetries between the board and management. While nonprofit trustees are typically well-intentioned professionals, their lack of relevant industry experience often means they are better equipped to advise management on matters such as financing, compliance, and risk management than engage in strategic planning, capital allocation, and performance monitoring. During the post-crisis interval of industry transformation, the ability to judge strategic issues will be a precondition for board effectiveness, and potentially a source of significant strategic advantage.
- *Management Matters* Scholars posit two theories on the impact of crises and organizational decline on management. One theory posits that management's response is characterized by a predilection for reduced information processing, greater centralization of control, and conservation of resources. These reactions reduce organizations' capacity to notice shifts in the operating environment and, consequently, their ability to adapt and implement changes in standard practices and the innovations that distinguish winners from losers. The competing theory suggests management's loss aversion drives risk-seeking behaviors to reverse the losses the organization has suffered. (The interesting corollary of this latter theory is that, in those few instances where management perceives its organization as having emerged from a crisis in a strong position, they will become risk-averse, since they will seek to avoid depleting their perceived gains). Generally, only when decisionmakers conclude there is a high probability that an urgent problem can be subdued, and they have the power to execute the relevant strategy, will they be willing to bear the risk associated with pursuing innovation in times of crisis. Under other conditions, rigidity will be more likely to emerge, especially if leaders are faced with resistance to change by interest groups that stand to lose from the innovative alternative. For many nonprofits, COVID-19 will prove an existential threat, and their prospects for surviving it depend on management's ability to choose the proper strategy considering their organization's strengths and weaknesses, opportunities and threats.

A Contrarian Perspective: The COVID-19 pandemic results in a sharp decline in organizational performance but of limited duration, and so is best accommodated by a risk reduction strategy focused on expense reductions to conserve cash, rather than radical adaptations of strategy, services, or processes. The human services industry has enjoyed a history of relative stability, and the post-crisis environment will most likely closely resemble that which preceded it. The pandemic alleviates provider staffing shortages as unemployment becomes a structural economic issue for reasons unrelated to COVID-19 with unemployment rates above 10% through the medium term. For human service providers, high rates of unemployment for an extended period stabilize labor costs over time, enabling a hobbled industry to endure in a depression-like economic environment.

<u>Strategic Alternatives</u> Few nonprofit human services providers assert their strategy delivers the low cost or differentiation necessary for the creation and maintenance of sustainable competitive advantage. Consequently, they instead have relied upon the provider isomorphism and inertia to thwart erosion of their position in the service system. This absence of any clear competitive advantage will become a source of increasing concern as the adoption of evidence-based practices, and value-based payment mechanisms shift the market dynamics such that there emerge generally accepted standards by which payors compare the relative value of services rendered. In this environment nonprofits will no longer be able to assert their uniqueness or effectiveness without compelling evidence, and so providers' operating risk will increase materially. The effect of these market shifts for many nonprofits - notably those experiencing distress, decline or stagnation - is that they must incorporate the notion of the "end game" into their strategic planning. Ironically, the "end game" is the starting point for the strategic planning process of private equity platforms.

Strategic options available to nonprofit service providers differ depending upon their goals and whether the organization was thriving before the COVID-19 outbreak or alternately facing stagnation, decline, or actual distress. The remainder of this essay offers strategic recommendations for these two broad categories of providers.

<u>Provider Category I: Providers Experiencing Distress, Decline, or Stagnation</u> For purposes of this discussion, stagnation is evidenced by a condition of constant but stable suboptimal performance over time, while decline refers to a steady downward trend in an organization's revenues or resources. Distress refers to the near-term risk of cash-flow insolvency (a circumstance in which the organization has sufficient assets to satisfy obligations in a timely manner but insufficient cash) or balance sheet insolvency (a situation in which the organization lacks sufficient assets to pay its debts). Generally, distress, decline or stagnation indicate an inability to compete successfully based on cost or quality (i.e., differentiation) for reasons that may include ineffective governance or management, or inadequate capital access. Unfortunately for these firms, capital will be critical to competing on cost in the coming years because this strategy in an increasingly price-sensitive environment will require scale. Capital will be equally essential to competing on quality, which will require significant investments in emerging 5G technologies in the medium term.

Directors and officers of nonprofit organizations who have contended with distress, decline, or stagnation pre-crisis have experience adapting to resource constraints in a stable industry operating environment. Crises like COVID-19 differ, however, being distinguished by rapid and discontinuous fluctuations in an organization's revenues or resources that threaten an organization's continued viability while compressing management's response times. The piecemeal, incremental adaptations sufficient to sustain organizations under normal operating conditions frequently prove inadequate in times of crisis when organizations must act with urgency to survive. Most nonprofits already facing distress, decline, or stagnation will find the need to act with urgency in times of crisis beyond their capabilities.

For nonprofits in these circumstances – typically small organizations or large, undiversified ones – strategic responses are limited to turnaround (and possibly reorganization in the context of

Chapter 11 bankruptcy), affiliation, or exit (perhaps in connection with a Chapter 7 bankruptcy). The prospects for avoiding downward spirals while assessing alternatives depend upon the level of urgency perceived by decisionmakers, their ability to respond based upon their perception, and the level of instability in the human services industry environment in the short and medium-term.

Turnarounds entail an overhaul of strategy, structure, and control and involve high levels of risk and difficulty even for commercial enterprises in a stable industry economic environment. For nonprofits in the post-COVID-19 financing and funding environment, pursuing a turnaround will be ill-advised in almost all instances.

The utility of Chapter 11 filings by nonprofits executing corporate reorganizations is surprisingly underappreciated and underutilized given that directors and officers have control interests, but not ownership interests, to protect. Chapter 11 may prove especially useful for larger nonprofits experiencing covenant defaults on outstanding bonds or cash-flow insolvency as a result of COVID-19. In such instances, affiliation with another nonprofit may offer a viable path to sustainability, but only if the struggling nonprofit can both shed a portion of its liabilities and extend operations for the interval (roughly six months) typically needed to conclude nonprofit business combinations. In such circumstances, the automatic stay afforded the debtor by bankruptcy can ultimately work to the benefit of all parties, including bondholders.

The range of potential outcomes identified for nonprofits experiencing balance sheet insolvency may be surprising. While commercial firms in similar circumstances are highly likely to liquidate, crisis-laden nonprofits retain the potential to enter affiliations that result in new capital investments and the refinancing of existing indebtedness, often without ever filing for bankruptcy. The reason for the broader array of outcomes is that the missions and valuation processes of nonprofit and commercial firms differ. Commercial firm valuation is based upon the expected present value of future cash flows relative to the capital invested, and strategic assessments seek to identify the option that optimizes shareholder value. Valuations of nonprofit organizations by other nonprofits incorporate additional considerations such as service, payor, and geographic diversification and may be driven by a variety of motivations, charitable and otherwise.

For nonprofits experiencing distress, decline, or stagnation, the process for exploring affiliations is simplified because the highly fragmented human services industry is populated with only a very small number of "buy-side" participants. These participants primarily include nonprofit organizations whose growth aspirations are limited to synergistic transactions within local markets, and a few aspiring industry consolidators. The reasons for the dearth of nonprofit consolidators in a fragmented industry are complex and surprising given the uniquely attractive economics of nonprofit deals. Nonprofit deals are unique because they entail the combination of the transaction participant's balance sheets, and even in instances in which cash is transferred from "buyer" to "seller" at closing, the payment is accounted for as an intercompany transfer rather than a purchase price.

Procedurally, preparing a nonprofit experiencing distress, decline, or stagnation to explore affiliation options in a crisis entails the following steps, pursued with the requisite urgency and secrecy:

- assemble a project team including legal counsel and an M&A advisor, each experienced specifically with nonprofit transactions;
- gather the information customarily required by buyers assessing a deal, and from it draft an offering document presenting the critical investment considerations and the proposed deal structure and timing;
- identify potential buyers, weighing their demonstrated deal execution capability in addition to their capital capacity, operational capabilities, and openness to negotiating critical non-economic factors, and
- delay announcement of the conclusion of the process until as near the closing date as practical.

Provider Category II: Stable Providers with Sustainable Business Models Great companies use downturns to position themselves to thrive during the subsequent economic recovery. The magnitude of the COVID-19 economic dislocation and the limited number of competitors presents nonprofit consolidators with the prospect of building sustainable competitive advantage for a generation. This assertion is supported by studies indicating that deals concluded during downturns generated significantly higher returns than those concluded during economic expansions.

Of course, to comfortably pursue opportunistic and transformative transactions, consolidators must first assess their ability to weather the crisis by quantifying their liquidity under different scenarios. This process should include an assessment of the specific risks and opportunities associated with each business line and each affiliate, prioritizing those with the greatest potential impact on performance, and concluding with an action plan to address substantive threats.

Once comfortable with its plans for the core business, management can proceed to define the acquisition criteria by which it will rank the array of opportunities that the economic downturn will present. Typically, these criteria will incorporate considerations like those summarized below:

- *Wealth Capture* The single most significant challenge facing nonprofit consolidators is creating a balance sheet adequate to support revenues at scale, without excessive risk, in the absence of the ability to issue equity, while competing in low-margin businesses. For this reason, a key acquisition parameter for nonprofit consolidators will be the incremental fair value of the net assets to be consolidated as a result of an affiliation, relative to the alternatives. Contributions of net assets from new affiliates have been the greater portion of consolidator's incremental net assets in years past[1], and ***in the short and medium-term, this source may constitute well over 100% of consolidator's incremental net assets because for many affiliates operating net income will be negative***.
- *Wealth Creation* Nonprofits pursuing scale do so for multiple reasons, one of which is to benefit from fixed cost economies and thereby generate incremental earnings and cash flow relative to invested capital – or at least smaller operating losses.

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[1] Over separate four-year intervals (2011-2015 and 2015-2019) two Angler West clients earned respectively 76% and 82% on their incremental consolidated net assets as a result of contributions of net assets recognized on the Closing Date from new affiliates.

- *Diversification* Economies of scope deliver not only economic benefits but also offer critical risk-reduction attributes to providers serving markets where there are dominant public payors that regulate pricing. Expansion via affiliation into new service areas or geographies is frequently the progenitor of subsequent de novo business development, and so sets in motion a virtuous cycle of revenue diversification.
- *Talent* Many human services industry leaders entered the field in the two decades following the enactment of the Great Society legislation and the deinstitutionalization movement that followed and are now of retirement age. Affiliations can present an unrivaled vehicle for acquiring the next generation of nonprofit leaders.
- *Debt Capacity* Nonprofit affiliations present consolidators with the opportunity to enhance consolidated debt capacity through the issuance of obligated group financings.

As of this writing (April 8, 2020) no state has yet arrived at the predicted peak outbreak of COVID-19, and so the level of uncertainty regarding its economic impact on the economy and the human services industry is highly speculative. Nonetheless, the goal of scenario planning is not to forecast the future so much as to prepare, to the extent possible, for an acknowledged inability to do so.

END

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