LANCASTER POLLARD

The Nonprofit Minute

SUMMER 2003

About the Firm

Lancaster Pollard Investment Advisory Group, an SEC-registered investment advisor, helps nonprofit organizations create the financial means to last the life of their missions by managing *total* financial risk rather than just investment-associated risk. Lancaster Pollard Investment Advisory Group shares common ownership with Lancaster Pollard, a leading provider of investment banking and mortgage banking services for the senior living, health care, affordable housing and private education sectors.

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What Is The Optimal Capital Structure Of A Nonprofit Corporation?

Organizations with a preponderance of assets in the fixed asset category typically use a mix of equity and debt to maintain and grow themselves. These organizations are capital intensive because of significant investment in physical plant and include hospitals, churches, museums, schools, colleges, and a number of social service concerns. Determining the optimal capital structure can have a significant impact on the ability of the organization to survive for perpetuity.

Capital structure is defined as the permanent long-term financing of a company, including long-term debt, equity, and retained earnings.

While an optimal capital structure for a ***for-profit*** concern may minimize the total cost of capital *or* maximize the market value of equity, the optimal capital structure for a ***nonprofit*** optimizes a mix of debt *and* equity to minimize the risk of financial failure. We use implied credit ratings as a diagnostic tool to determine risk.

Credit ratings can be viewed as a mechanism to predict future default. The figure below shows the relationship between credit rating and the probability of default. Credit ratings from AAA to Baa are collectively known as "investment grade" debt, as opposed to Ba to C, which are known as "speculative grade" or

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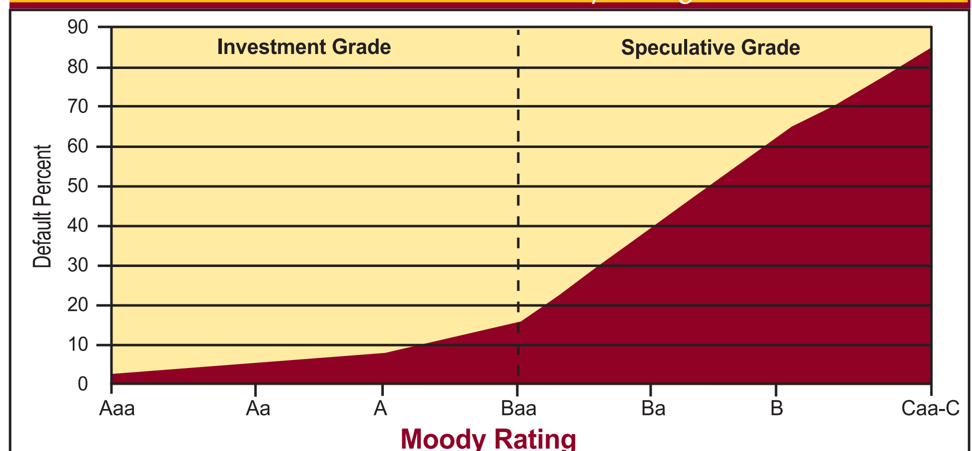


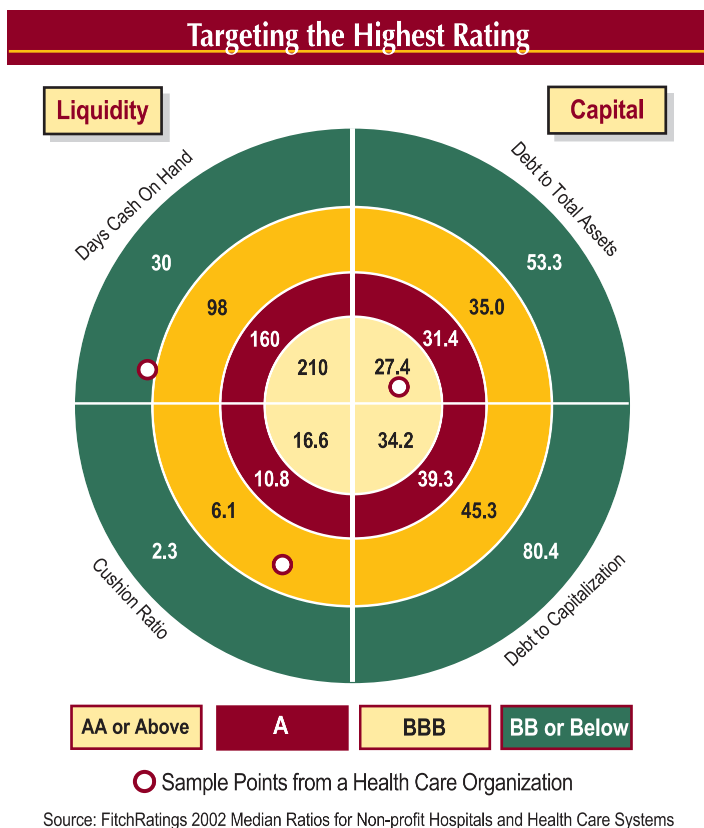
"high yield" debt. Look at the dramatic increase in risk to the organization that occurs as credit quality changes from investment grade to speculative grade. Improving credit quality can significantly lower the default risk of the organization.

Organizations typically have several decision points for changing capital structure. One decision point is when an organization chooses to issue debt. This article focuses on another, when an organization receives equity.

An organization can receive equity by either increasing the fund balance (retained earnings) from an operating profit or by receiving a capital gift. Implied credit ratings can be used to help indicate how to use the marginal equity dollar to improve the credit profile.

Many nonprofit organizations have a strong bias to use the marginal equity dollar to repay debt as quickly as possible. This strategy may not be optimal. As these equity dollars are collected, the organization faces a trade-off.

Targeting the Highest Rating



Source: FitchRatings 2002 Median Ratios for Non-profit Hospitals and Health Care Systems

Should it reduce debt outstanding or should it increase liquidity?

The best course of action is to calculate the implied credit ratings of key liquidity and capital ratios, and work to improve whichever is lower. The credit rating agencies publish rating medians that indicate how the "average" value of a financial statistic relates to credit ratings.

The chart in the left column, **Targeting the Highest Rating,** shows two liquidity ratios and two capital structure ratios. This is a sample chart for a hospital or health care organization based on Fitch 2002 median ratios. In the example, the hospital has data for two liquidity ratios and one capital ratio. The days cash on hand ratio is below investment grade. The cushion ratio is investment grade. The capital ratio, debt to total assets, is in the double-A or above category.

This organization is at a greater risk of failure because it can run out of cash. As it receives more equity, it needs to increase liquidity by keeping cash or short-term securities on its balance sheet, rather than paying off more debt.

While this example is a health care illustration, the information and methodology exist to do this analysis for many types of non-profits.

The way to optimize the capital structure is to maximize the relative credit characteristics of the organization to achieve the highest possible credit quality. This minimizes the risk of default. The optimal structure varies from organization to organization, but one rule of thumb is consistent: optimal value avoids both debt and liquidity extremes, but is biased towards more liquidity.

We highly recommend regularly using implied credit ratings as a diagnostic tool. The example illustrates that using the analysis can prevent well-intended actions from threatening your organization's financial future. Lancaster Pollard is ready to assist your organization in determining its optimal capital structure.

To learn more about how your organization can determine its optimal capital structure, please contact William M. Courson at wcourson@lancasterpollard.com

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