# ECLIPSE OF THE NONPROFIT CORPORATION

***The Market for Nonprofit Control: Why it Matters***

With revenues of more than $362 million, Devereux Foundation was the nation's largest nonprofit provider of human services at the end of 2004 – far larger than the $97 million in revenues reported that year by Providence Service Corporation (NASDAQ: PRSC), an Arizona-based publicly-traded company founded just seven years earlier. Ten years later, century-old Devereux's revenues had grown to slightly over $400 million - a compound annual growth rate of just 1.0% - while Providence's revenues had reached nearly $1.5 billion – a compound annual growth rate of more than 31%.

Providence's impressive growth over this ten year period was not extraordinary among for-profit service providers of human services. By 2014, the behavioral health division of Universal Health Services generated 2014 revenues of nearly $4 billion, and Civitas Solutions, Inc. (which markets its services nationally as The MENTOR Network) and ResCare – like Providence - each generated revenues in excess of $1 billion. The key to these for-profit organizations' exceptional growth in each instance was the same: mergers and acquisitions. In fact, my firm, Angler West Consultants, closed eleven transactions with Providence between 2004 and 2010 - and the pace and size of transactions at the other for-profits rivaled or surpassed Providence's performance. Meanwhile, not a single human services nonprofit corporation in the United States today generates revenues of even $600 million, and no significant market for nonprofit control has yet evolved.

In the absence of any effective response from nonprofit service providers to the rapid and accelerating capture of market share by for-profit competitors, private equity firms - plush with cash they were unable to profitably deploy during the Great Recession – have now identified human services as a growth industry. Private equity currently own multiple platform investments in the substance abuse, behavioral health, developmental disabilities, autism, special education, juvenile justice and foster care segments of human services. Given that these platforms are assured superior capital access, along with the governance and management attributes associated with the private equity business model, there is a sound basis for assuming that these platforms will prove as formidable as their for-profit predecessors in stealing market share from legacy nonprofits.

The failure of nonprofit organizations to effectively compete with their for-profit brethren was foretold years ago in an editorial in Barron's predicting that assets that are not privately owned will frequently be misused by managers who owe no duty to specific owners, and who are not effectively constrained by trustees. Yet agency theory alone cannot account for the absence of a market for nonprofit control; the evolution of these markets requires the presence of "consolidators" with substantial capital and execution capability, and very few nonprofit organizations can lay claim to having either.

Still, one might have supposed that chief executives of large human services organizations would have been prompted by observation of the experience of nonprofit hospital executives to adopt a more

proactive approach to the inevitability of the industry consolidation ahead. Alternately, the impending tidal wave of disruption resulting from Medicaid managed care and at-risk contracting arrangements might have been expected to awaken at least the largest and best capitalized nonprofits from their zone of indolence.

**Evolving A Market for Corporate Control: Five Factors That Can Make A Difference**

Sustaining the role for nonprofit organizations in the human services system requires that nonprofits maintain a market share substantially greater than 50%, as a lesser share will lead to questions as to why only certain market participants are permitted to claim exemption from income and real estate taxes. Indeed, these questions are being posed to nonprofit hospitals currently as for-profit hospital's market share pushes beyond 25%.

To halt the decline in nonprofit market share, growth-oriented nonprofit management teams must fortify their sustainable growth rate. The sustainable growth rate of a nonprofit organization is the annual rate of growth in revenues feasible given the capital resources available. The capital resources available are ultimately a function of the organization's unrestricted net assets because the revenue growth reported on the Income Statement necessarily entails the growth of assets on the Balance Sheet, and the growth of nonprofit assets is ultimately limited by the organization's Unrestricted Equity. Easily the most effective means to increase a nonprofit's net assets is through business combinations, as the merger or affiliation of nonprofits essentially results in combining the net assets of each – with certain deal structures requiring the write-up of the newly-combined assets to fair market value.

The evolution of a marketplace in which nonprofit consolidators can compete for control of other nonprofits, and thereby expand their capacity for sustainable growth, will entail a variety of new policies and practices. A few of these are summarized below:

***Governance***: A recent study by McKinsey found that the primary source of value creation in the majority of acquisitions by private equity firms was the outperformance of the company – not price arbitrage, not financial engineering and not overall sector gains or stock market appreciation – just better management of the business. Even more surprising, however, was McKinsey's finding that this outperformance was primarily driven by changes to the way the boards of these enterprises worked. Private equity boards are characterized by focus, decisiveness, results orientation and engagement – referring to robust and regular communication within the board and with the executive team. Of course, private equity directors have the benefit of representing relatively homogeneous shareholders, have significant personal vested interests and clear risk return expectations.

In contrast, governance of the typical nonprofit human service organization includes significant participation of trustees who are well-intentioned, but who have little or limited industry knowledge and experience, limited time to contribute, and frequently, insufficient capabilities to properly fulfill their duty of care as trustees.

Inadequate governance and limited capital access are structural deficiencies of the nonprofit model. To effectively compete in the emerging competitive marketplace, nonprofit boards must become smaller

with membership dictated exclusively by the requirements of effective governance. In the years ahead, improved nonprofit governance will become the single most important source of competitive advantage for nonprofit consolidators.

***Succession Planning**:* Traditional approaches to succession planning should be revamped in light of the compelling need to build the scale and capital capacity of nonprofit consolidators. Specifically, the familiar routines of filling CEP slots vacated by retiring baby-boomers with internal candidates or engaging search consultants would be better addressed by executing timely business combinations with organizations with compatible missions and elevating the target company chief executive to the parent CEO role. The impact of such transactions will be to combine the balance sheets and income statements of the formerly separate nonprofit entities under common control, while increasing the capacity for sustainable growth of the combined entities.

***A Role for Foundations***: In their efforts to enhance shareholder value, for-profit consolidators in human services benefit from their ability to access the leveraged loan market. Foundations can play an analogous role in enabling nonprofit business combinations by providing financial supports and incentives targeted at nonprofit consolidators that have demonstrated execution capabilities.

Presently, Angler West Consultants – in conjunction with an investment banking group and expert counsel – is soliciting program-related investments, in the form of loan guarantees, from major foundations in support of Midlantic Nonprofit Acquisition Fund L.L.C. ("Midlandtic"). Midlantic would encourage and facilitate the development of a market for corporate control of nonprofit organizations in the Midlantic Region by providing below market rate, subordinated financing to nonprofit consolidators. Loan proceeds would be used by borrowers for expenses related to: (1) cash transfers to facilitate acquisitions, (2) interest, (3) costs of obtaining take-out financing, (4) appraisals, (5) surveys, (6) counsel fees, (6) brokerage and financial advisory fees, (7) environmental assessment /soil sampling, and (8) other due diligence costs. Cash for debt repayment would be derived from balance sheet restructuring at the parent level and deal synergies.

Vehicles like Midlantic have the potential to replicate many of the capital access advantages enjoyed by the private equity platforms in support of a continuing role for nonprofit providers in human services.

***Changing Deal Structures***: Inadequate governance and agency costs have proven to be formidable obstacles to the evolution of a market for nonprofit control, and overcoming these obstacles will require adaptations to the deal structures currently in use. The increasingly common incorporation of cash transfers from consolidator to new affiliate at Closing has been a useful technique in concluding transactions that might not otherwise have transpired, but relatively few nonprofits have sufficient capital to close multiple deals on this basis. A more recent development involves the issuance by a nonprofit consolidator of a subordinated five year note to a target company. The Note incorporates an option that will enable the consolidator to obtain control of the Target at the expiration of the Note subject to (1) forgiving the Note and (2) an additional cash transfer. This deal structure will enable the Target Company's founder to continue to grow their currently undercapitalized organization during their remaining years as CEO, then transfer control via affiliation to a larger and better capitalized nonprofit.

Unsolicited offers seldom, if ever, play a role in nonprofit deal making, and there is no nonprofit equivalent of shareholder activists. These differences between the for-profit corporate control marketplace and an emerging nonprofit control ultimately need to be eliminated because the circumstances that drive unsolicited offers and activism among for-profits – specifically, sustained underperformance by governance and management – are commonplace in the nonprofit world.

***Social Entrepreneurs***: Social entrepreneurs draw upon business techniques to find solutions to social problems. Recent years have witnessed the advent of innovations such as low-profit, limited liability companies ("L3C's), social impact bonds ("SIBs"), and nonprofit employee stock ownership plans ("C3SOPs"), but these are essentially sustaining innovations. The evolution of a market for nonprofit control will require social entrepreneurs to design and execute disruptive organizational and financial innovations that move beyond adoption or adaptation of for-profit business models and processes. Not without irony, nonprofits are ideally suited to introduce disruptive innovations because these innovations are characterized by lower gross margins, smaller target markets, and simpler products and services than those being displaced – each of which makes these new approaches unattractive to large, for-profit providers.

In 1989 Harvard Professor Michael Jensen authored an article in the Harvard Business Review, titled "Eclipse of the Public Corporation". In this article, Jensen predicted that publicly traded companies – that is, large companies listed on the stock exchanges – would soon be extinct as a result of structural limitations associated with how they were governed and financed, and that they were destined to be replaced by a new type of entity that now goes by the name "private equity". In the years since Jensen offered his prediction, the number of publicly traded corporations on American stock exchanges has declined by more than half.

Jensen's prediction was based upon shortcomings he associated with public companies that could have just as easily been used to describe nonprofit organization. Like their public company counterparts, nonprofit organizations must adapt - quickly and in fundamental ways - or they will be eclipsed by competitors created by private equity that are better suited to the changing marketplace.

Think it can't happen? Companies that dominated industries from vacuum tubes to video rentals thought the same thing.