Emerging Financial Models

By Adrian Ellis

The discussion of new business models in the cultural sector is generated by their absence rather than their prevalence. Arts organizations seeking philanthropic support are likely to over-emphasize the redemptive potential of these models because they imply a temporary rather than permanent reliance on philanthropic funding that is likely to appeal to the funder. A systemic lack of exploitable assets explains the absence of developed models in the sector. Furthermore, it is hard to exercise entrepreneurial skills within the 501(c) (3) framework, which impedes the exploitation of available assets, where they have been identified. In looking forward, the paper suggests that the cultural and social goals of funders may best be served by a more skeptical view of the rhetoric around new business models; a willingness to examine and develop case studies that may illuminate potentialities; a willingness to back niche organizations that do not seek to be all things to all funders, and that can therefore achieve excellence, irrespective of novelty; and finally, that private-sector organizations that fulfill cultural functions and can act entrepreneurially should not be eschewed by funders.

1 The Context of the Debate

I recently spent time with a friend who runs a distinguished jazz label based in New York. The label has a strong brand identity; an extensive back catalogue; and an ongoing knack for identifying, nurturing, recording and promoting new talent. But the business model that once made a strong brand, a deep catalogue, and good "ears" a lucrative business has been ruptured by changes in technology that have in turn affected distribution and consumer behavior.

It is hardly a secret that the recording industry is in a free fall – music is increasingly regarded as a free good by consumers, or if not free then worth only a fraction of its traditional price. Downloading, whether through legitimate sources or illegally, is inexorably replacing CDs as the medium of choice. This change is more disruptive than the shift from vinyl and cassette to digital recording had been. Apple's i-tunes is today the single largest music distributor.

My friend has been scrambling to address a new set of issues: What exploitable assets does his label have? How can they be leveraged to generate income? Should the label ally itself with a digital distributor (such as Apple) or compete with it? Can the brand attract online advertising? Should it be licensed to generate income? Jazz clubs? Coffee bars?

His mission and his commitment to the music are unchanged, but the context has been transformed. Ownership patterns have been too. About ten years ago, his then-independent label sold itself to one of

the major labels in order to generate capital. That label has since been sold to a financial institution. Any strategic decisions need to be signed off by a hedge fund in London.

This is not an unusual story. Changes in technology and consumption have transformed many sectors of industry since the industrial revolution. The process of "creative destruction," to use Joseph Schumpeter's famous oxymoron, is no less near the heart of late capitalism as it was to that of early capitalism. What happened to the horse and buggy also happened to the typewriter and the Polaroid camera. And as innovation accelerates, so will social upheaval. Cultural activity is particularly subject to these forces as it is linked umbilically to tastes that are rooted in contemporary sensibilities. Artists are drawn to the new.

Markets translate technological change into industrial transformation through access to capital. If you can't access financing – from retained profits or from capital markets – then you are unable to invest in the exploitation of your innovation. The insulation that non-profit status gives arts organizations from capital markets (i.e. having trustees rather than shareholders as the sovereign body of the organization) affects *how* the sector accesses capital (allowing it to add philanthropic sources to commercial ones). But it does not immunize organizations from the *need* for capital.

The sector is experiencing stress associated with challenges in accessing capital. *There is a shortfall in the capital investment required for the level of activity that the sector is seeking to sustain.* What's happening to opera in LA or New York is different from what's happening to community theater in rural areas. The stresses manifest in different ways, but they are there.

Our society has deep-seated assumptions about the normality of growth and the inevitability of disruption caused by growth. "Rationalization" – brutal though its implications may be – is seen as a necessary corollary of development, tempered by social policies, but never thwarted. By contrast, one of the premises of non-profit status in the arts is that some intrinsic benefit, irrespective of demand, obtains from the activity of a cultural organization. This means that resistance to adverse changes – termed "progress" in the private sector – is, *prime facie*, to be valued and supported.

This does not mean that non-profit cultural organizations live outside the market. What it means is that *in addition to living in a consumer market and in a capital market, non-profits also live in a philanthropic market*. The third of these markets is needed (and institutionalized through section 501(c)(3) of the federal tax code and through a state and federal laws) because of the difficulties in developing a viable business model based on access to the first two. *The greater the challenges in the first two markets, the greater the reliance upon the third, philanthropic, market.* (No one who could make a go of it in the first two markets would expend the time, effort and ritual humiliation required to raise capital in the third market.)

Because of the non-financial criteria that inform decision making in the philanthropic market, securing funding from it often requires arts organizations to present arguments according to which investment from philanthropic sources will, in the long term, *decrease* reliance on that market and, correspondingly, increase the organization's viability in the first two (consumer and capital) markets. When it comes to support for intermediate industry associations, the argument will revolve around increased self-sufficiency of a whole cohort of organizations. For this reason, the rhetoric of self-reliance is understandably (if sometimes ironically) the starting point for many pitches to and exchanges with philanthropic sources by cultural organizations. The more threatened the self-reliance, the greater the emphasis on it as a goal for philanthropic support.

The key point here is that – in fashionable Freakeconomic counter-intuitive logic – *ceteris paribus* the more critical the reliance on philanthropic sources by cultural organizations, because of adverse conditions and accelerated change in consumer and capital markets, then the larger one may anticipate the part played in the dialogue between funders and funded by rhetorical appeals to the potential of new business models.

The imperative behind the development of new business models is decreased reliance on traditional philanthropic sources of funding. The development of these models is encouraged by philanthropic market makers because they in turn want to maximize the gearing on their finite resources.

My friend, ruminating on how to use his label's brand appeal to develop a new business model, is attempting, with some desperation, to escape what looks to an outsider like his company's destiny – that is, its obsolescence. In escaping his historical fate of closure, in the context of the private sector he can only appeal to investors, perhaps abetted by some canny financial public relations company. His arguments need to have a financial rigor that is independent of and does not address the enormous cultural value he (and I) attach to his back catalogue, of which he is *de facto* head curator. The leap from executive record producer to brand stretcher can be made, but it requires a level of entrepreneurial skill that sits uncomfortably with a strong if nostalgic commitment to the *status quo*.

If one looks at the discussion of new business models in the non-profit sector, I would suggest that much of it looks similarly like an attempt to avoid destiny, an implausible sharp jump for which the average arts organization is as ill equipped as my old jazzer.

2 Old New Business Models

I suggest as a *definition of a new business model* the following: a robust way of generating new sources of net income that is mission-congruent; one that does not put at risk an organization's charitable status; that is not dependent upon some temporary tax or legislative loophole; and that has the

potential to meet a significant proportion of the total operating budget (say arbitrarily 7% or more) within three years of being launched.

The last generation of new business models revolved around the development of retail and catering in museums and performing arts facilities. These have now become standard fare. AEA undertook an extensive analysis of catering and retail in the museum sector a decade ago. The conclusions were clear and have wide ramifications.

First, *mission and money often pull in different directions*. Catering and retail strategies that seek to function as an addition to the visitor experience that reinforces and supports the performative or curatorial agenda usually fall well short of the sort of strategies that would lead to profit maximization. *Over time, mission and organizational culture trump money as an imperative, and operations tend toward revenue neutrality*. In other words, we tend to use our shops and catering as ways of enhancing the visitor experience rather than as a means to contributing to the bottom line. Most such operations analyzed by AEA covered their marginal costs but not the full costs of operation (when one inputs the full overhead, maintenance, etc.).

Second, and of more general significance to the consideration of new business models, successful entrepreneurial activity in the cultural sector is no different from that in any other sector in requiring three conditions to be met:

- *(a)* There needs to be a commercially exploitable *asset* of some sort;
- *(b)* There needs to be *capital* available to exploit the asset; and
- *(c)* There needs to be the ability to apply an *entrepreneurial skill set* to the exploitation, with the *freedom available to take risk*.

These three lenses provide a salutary perspective from which to review candidates for new business models and their prospects of success. The view may differ, but the lenses are no different for the beleaguered jazz label than for the Metropolitan Museum.

2 (a) Assets

The checklist of assets usually considered as commercially exploitable include *intellectual property* (recordings, videos, scores, artifacts suitable for licensing, protectable brand identity, consulting, exhibition management and programming skills); or what one might call *contingent assets* (real estate or services that can exploit locational advantages or sheer footfall generated by the core business).

The challenge for the non-profit sector is that these assets are either "there" or difficult to create if they are not there (such as the British Museum's 6 million visitors per annum) or ones that *the private sector itself is searching with difficulty to find ways to exploit commercially* (such as the NY Philharmonic' archive of recordings).

We are in the throes of a well-publicized revolution in the valuation of intellectual property. And although there is a widespread conviction that the monetary value attached to "content" and brand will increase over time, distribution models that allow it to be monetized remain poorly articulated. Content, alas, is not king; it is subject.

The Metropolitan Opera's well-publicized venture into high definition video recording; Instant Encore pressings of live recordings of concerts; the Natural History Museum's exhibition loan program – all these are laudable forays into content-exploitation territory. None, however, meets the definition of a new business model (as articulated above). They are peripheral to basic concerns of viability. They will not save the day.

Where income streams are potentially higher, organizations can run into political, administrative or legal constraints: Those institutions that have financially valuable assets other than intellectual property often have a duty of stewardship that is related to their ownership (most obviously museums, whose collections are rarely listed on their balance sheets). Those assets can in theory be monetized through sale or long-term loans (i.e. leasing) to third parties. In this way, a cash-poor but asset-rich institution could, in effect, engage in a form of trade with a cash-rich but asset-poor institution. However, the challenge is to do this in a way that does not breach stewardship responsibilities (as interpreted by professional associations such as AAM and the AAMD). The Louvre is pioneering this model in Abu Dhabi and Atlanta, but it is controversial, and for an organization with less gravitas it could mean reputational suicide.

There are *ad hoc* opportunities for IP and brand exploitation that can be grasped by a savvy, entrepreneurial organization. The Smithsonian's recent sponsorship arrangement for *Night at the Museum 2: Escape from the Smithsonian* comes to mind. But these one-off arrangements rarely amount to systemic and replicable new business models.

An exception that should be noted and celebrated: large-scale non-profit theaters in the US and the UK that periodically transfer plays (more often musicals) to commercial presenters on Broadway and the West End which bankroll the production for long periods of time – and handsomely reward their artistic directors.

Adrian Ellis, May 2008

2 (b) Available Capital

Financing models are not business models, but they are a component of them.

By financing models, I mean models for accessing capital for investment purposes below market rates, often by virtue of the tax status of the borrowing organization. They include tax-exempt bonds, soft loans from agencies such as the Nonprofit Finance Fund, sales and leaseback of buildings, microfinance, etc. The key issue is that they are primarily relevant to cash flow and not balance-sheet issues. Obvious examples are smoothing out cash flow shortfalls caused by the different timing of incoming pledges and outgoing expenditures in a capital campaign, or meeting start-up costs of a new business venture.

Where financing *per se* generates income that does not require repayment (i.e. surpluses), it is dependent critically on the exploitation of tax legislation that may or may not be transitory. There is frequent discussion about whether such an "opportunity" is likely to endure or if it would be noticed and choked off by the authorities. Financing measures can occupy a disproportionate amount of board time and organizational attention inside non-profits. (This not because of their critical long-term contribution to the organization, but because their technicalities are within the comfort zone of board members with financial backgrounds, who want to make themselves useful.)

The current credit crunch notwithstanding, we live in a time of unprecedented availability of capital to support new ventures. Growing wealth distribution inequality and the emergence of fabulous sovereign wealth in the Middle East and Asia are generating large liquid pools of capital. Venture philanthropists and venture capitalists share an appetite for "startup" projects that allow them to withdraw over time and harvest the (financial or programmatic) fruits of their investment. They look for business plans that have plausible assumptions and at least a flash of black ink by year three or four. Their challenge is to find new business ventures (philanthropic or otherwise) that have a reasonable prospect of breaking even or making a profit.

In short, the impediment to the development of new business models it is not lack of capital to invest. Rather it is the lack of suitable projects in which to invest.

2 (c) Entrepreneurial Skill

Capital and an exploitable asset represent unrealized potential unless there is someone with the skill and appetite and "permission" to exploit them. The current charity model is problematic for entrepreneurial activities. Moreover, commentators have observed that entrepreneurial 501(c)(3)s are

provoking legislative disfavor. *There is a potentially debilitating tension between the development of new business models and the conditions surrounding charitable status*.

Non-profits have, in any case, systemic tendencies toward the hierarchical, and the rule driven, with low levels of financial delegation and a tendency to under-invest in skill building. These tendencies can be kept at bay by energetic leadership, but any model that depends on transformed organizational features (i.e. flatter organizations, delegation of financial decision-making, heavy investment in human resources) will also require alternative organizational forms to encourage and enable them.

Joint ventures with the private sector, or shareholding in private-sector subsidiaries by parent non-profits, provide alternatives. But non-profits of any scale, including charitable foundations, are innately risk-averse.

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In sum, if one is looking for new business models that could make a consistent contribution to the financial viability of non-profit arts organizations, then one needs to examine what commercially exploitable assets the organization has; whether it has access to capital; and whether it can realistically apply entrepreneurial skills to exploit those assets. As noted, such exploitable assets are significantly scarcer than capital and are mostly found in conventional areas such as real estate. Commercially exploitable IP is rare in cultural organizations, and the private sector is finding the exploitation of IP assets challenging.

I therefore suggest that *a significant proportion of the debate around new financial models may be a displacement activity*, drawing focus away from long-term truths about the conditions for underlying financial vitality in support of mission.

3. *Old Business Models Anew*

I am not sure I can provide a robust rationale for all the propositions below. But they embrace the insight that new business models are unlikely to be a *deus ex machina* for the cultural sector:

- Survival is the mission of many arts organizations. They can, and maybe should, be ruthless in rallying their arguments. But the veteran UK commentator Jeremy Paxton says that when he is interviewing a politician, his frame of reference is: “Why is this lying bastard lying to me.” This

may be extreme, but foundations are understandably reluctant to make tough calls about institutions, similar to calls the markets make on an ongoing basis, by withdrawing capital. These institutions go around grant officers directly to the board, they flatter, they bully, they do what they need to do... Yet without tough calls, and in the absence of a capital market, we get a landscape silted up with organizations without robust rationales but with effective spokespersons at the helm. *New models need incentives. These may be sticks as well as carrots*.

- Most non-profits that have reached a scale that warrants a sophisticated strategy for contributed income have been at least partially corrupted by that process. Development – working the philanthropic market for capital – requires spin. Foundations with their own agendas inadvertently stimulate spin by encouraging organizations to repurpose themselves rhetorically. There is a systemic incentive to inflate their anticipated responses from the capital and consumer markets. Message to foundations: Resist coercive philanthropy. Do not require nonprofits to be all things to all funders. Distinguish between planning and bidding. *Allow non-profits to specialize and to eschew the market if it pulls them off course.*

- *If an organization does not have commercially exploitable assets, but still has a wider social and artistic value, it is not obvious that it should go off and try to manufacture those assets*. It may well require ongoing philanthropic support. This is not a source of shame. Whether it is because it is preserving the canon, or providing access to cultural experiences, or providing opportunities for artistic self-expression, these are all of value. Foundations should not get bored by their commitments and roll organizations off simply because they want to create a rationale for their own activities.

- *If we want to encourage entrepreneurial skills, then non-profit funders should be more willing to fund for-profit organizations and develop hybrids*. The challenges of acting entrepreneurially in a non-profit are almost overwhelming if the current board expectations and fiduciary frameworks remain. There may be examples outside the cultural sector from which we have to learn, but *most entrepreneurial action in the cultural sector is clandestine*.

- The non-profit arts sector is carrying big overhead – big buildings, complex all-embracing agendas, etc. *Incentivize simplicity instead of complexity.* Discourage agendas that embrace a high ratio of fixed costs to variable costs, as this encourages inflexibility.

- *Do not expect non-profit cultural organizations to solve problems that a more entrepreneurial for-profit sector has not solved.* Much of the territory that is being explored by non-profits is unresolved by all players.

- Invest in understanding exemplars: *where there appear to be new business models, back them, of course, but as important, study them and disseminate the lessons.* We have precious few.

And my friend should probably seek 501(c)(3) status and a benefactor and get his stunning and important back catalogue out on the web under his benefactor's aegis instead of jumping through the inappropriate hoops of the new economy.

Adrian Ellis, May 2008