SeaChange

TOO BIG TO FAIL

NEW YORK CITY'S LARGEST HUMAN SERVICE NONPROFITS

APRIL 2020

Executive Summary

The government distinguishes "large" from "small" organizations in many ways, but the most common is whether they have 500 or more employees. On this basis, while small nonprofits are collectively important, the large ones do most of the work, particularly in areas like residential care (e.g. homeless shelters, foster care, homes for the developmentally disabled, etc.) They are individually critical partners to state and local government in maintaining the social safety net.[1] They are on the front lines of the COVID-19 crisis. And they are at the breaking point.

Unfortunately, policy makers and funders underappreciate the importance of the large groups and often believe that they are stronger, more resilient, and less worthy of support than their smaller brethren.[2] Nothing could be further from the truth. Yet, so far, the large groups have been excluded from the most important federal aid—The Paycheck Protection Program—because of their size. Without immediate assistance, some large nonprofits may not make it through May; few, if any, will be in a position to continue services that will be needed more than ever during the COVID-19 crisis and its aftermath.

The failure of Federation Employment & Guidance Service (FEGS) in 2015, then New York City's largest social service agency, demonstrates how damaging it can be when a big nonprofit fails, leaving vulnerable people—the home-bound, the developmentally disabled, the homeless, foster children—without services. But FEGS failed for idiosyncratic reasons and was surrounded by healthy peers who were able to step into the breach. This is not the case today. The failure of any large group—and it will likely be more than one—will tear the fabric of the city's social safety net with devastating consequences for all. Even if the government somehow picks up the pieces, it will end up costing far more in financial and human terms than it would have to prevent the failure in the first place.

New York City's Big Nonprofits

Out of the roughly 4,000 nonprofits receiving funding from the city, we analyzed the 50 largest human service nonprofits based on the volume of work they do in partnership with New York City and their total budgets.[3]

A few observations:

1. They represent \$2.8 billion (about 50%) of New York City's \$5.8 billion in annual social service spending with nonprofit partners.

2. Substantially all of them have more than 500 staff.

3. They are extensions of government from a financial standpoint, with philanthropy representing only 4% of their total budgets.

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1 This note focuses on the human services sector (excluding hospitals), but cultural Institutions are also under enormous pressures.

2 There are lots of reasons for this: an inclusive nonprofit culture that keeps large and small "in the same tent"; a widespread feeling that small is a proxy for diverse, community-based, mission-driven or otherwise inherently valuable over and above the efficiency and effectiveness of their programs; donors preferring to make a large number of grants to small organizations.

3 The underlying analyses are in this Technical Appendix.

4. Under *normal* circumstances, they have two weeks of cash; very few have any meaningful endowment; and most have limited access to credit.

5. Their operating margins are razor thin (an average of 1%), even before the reduction of revenue and increase in expenses associated with the COVID-19 crisis.

The precarious financial condition of large nonprofits is not a function of inefficiency or poor management. It is the inevitable consequence of the context in which they operate. Philanthropy is finite in any given market. Larger human service organizations are overwhelmingly funded by government. Most government funding does not cover the full cost of doing the associated work. Government funding also creates cash-flow issues since, unlike grants, it is paid after the work has been done and can be subject to long and unpredictable delays.[4] Large groups also have fixed and semi-fixed costs: real estate, workforces with collective bargaining protections, and government contracts with detailed stipulations about exactly what is to be delivered.[5]

As a result, cash is always an issue for large nonprofits but, unlike large for-profits, they do not have access to the capital markets, cannot easily unlock illiquid assets, and are unable to use bankruptcy to restructure while continuing to deliver services.[6] They are too big to hibernate or easily reconstitute themselves after failing. So any increase in costs, reduction in revenue, or delay in cash receipts will put some of them permanently over the edge. Yet all of these things are happening simultaneously as they scramble to maintain essential services, keep staff safe, and not run out of money during May, a three-payroll month.

A Modest Proposal

These groups cannot be allowed to fail. Although small groups are vitally important, they do not have the capacity (technology, HR, finance, compliance, etc.) and scale to do the work of their larger brethren particularly in areas like residential care. In the wake of the 2008 credit crisis, government realized that it needed to build different mechanisms to support and regulate the systemically important financial institutions. In aftermath of COVID-19, government and human service nonprofits may need to do the same thing. However, in the short run, urgent steps are required to avoid a cascading series of failures.

Here is what must be done:

1. Policymakers should follow the plea of the broad nonprofit community that the CARES Act and all other federal aid be amended to be available to larger nonprofit groups.

2. New York City and New York State should make large advances against registered government contracts to any large, long-term nonprofit partner in good standing that faces immediate liquidity challenges. The normal procurement procedures—

4 See New York City Contract Delays: The Facts

5 By contrast, philanthropic funders are quite vague about what must be delivered giving smaller groups, which are often more reliant on philanthropy, an element on wiggle room.

6 Bankruptcy is impractical as private and government funders flee, there are no assets to support debtor-in-possession financing, and legal fees will consume any residual charitable assets.

proposing budget modifications, negotiation and delay, after-the-fact funding—must be waived. Getting the money to them *now,* and accounting for it later, while entailing a small amount of theoretical risk, is the only viable strategy.[7]

3. Government, philanthropy, and the banks should set up a structured facility to provide working capital for the large NYC human service organizations of a scale to match the need. Two months of expenses for the largest groups would probably total about $500-$750 million.[8]

4. New York City and New York State should immediately commit to reimburse nonprofits providing essential services for COVID-related increases in costs (i.e. overtime, temporary costs, shift differentials for direct care, etc.) There will never be enough philanthropy to pay these costs. The groups do not have the cash to use their pre-existing resources. If the government does not pay these groups will either stop doing the work or go bankrupt. (Reimbursement is a separate issue from the need for immediate cash under #2 and #3.)[9]

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It is a great strength that New York City and New York State have outsourced much of the social safety net to nonprofits. These mission-driven organizations have done a far better job than the other two options: direct government provision or profit-seeking corporations. In COVID-19, these nonprofits face an extinction-level event. Yet so far, the largest of them have been excluded from the most important COVID-related assistance. If things don't change immediately, some of these nonprofits will falter, leaving the vulnerable people they serve, their employees, and our city far worse off. It is an economic and moral imperative that government rescue its long-standing partners. The total dollars required is a minuscule fraction of what is being spent to support for-profit businesses while the return on investment is larger in human and financial terms.[10] The clock is ticking.

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7 Nonprofits are legally prohibited from distributing cash. With one or two unfortunate exceptions, the large ones have sophisticated finance and accounting systems, well-functioning boards, and have been fraud and scandal free.

8 The COVID019 Response & Impact Fund is helpful but its size (less than $50 million) and loan-size limit ($3.0 million) means that it will not be enough for groups with bi-weekly payrolls of $2 million+. A larger fund must be government-led with banks and private philanthropy playing a secondary role. While the City has its own cash pressures and limitations on its borrowing, creative minds should be able to find a solution.

9 The consensus view among nonprofits is that of New York City government agencies, the Department of Homeless Services has been the least responsive and the most resistant to action on a timetable that is practical given the crisis. But in general, New York City has done much more than New York State in terms of reimbursement.

10 The Federal Reserve's new Main Street Lending Program is intended to "help all small and mid-sized businesses that were in good financial standing" but it only offers loans of up to 4.0x EBITDA (i.e. historical profitability) so large nonprofits are penalized for having agreed to partner with government on a low and no-profit basis

SeaChange is the champion of nonprofits facing complex challenges and the partner of choice for funders seeking to help. **SeaChange** has been active over many years in the financial analysis of the nonprofit sector. This briefing note is based on these reports which include:

- The Financial Health of the US Nonprofit Sector
- Risk Management For Nonprofits
- Philadelphia Risk Report
- Overhead for Trustees
- New York City Contract Delays
- Closing the Gap: A True Cost Analysis
- Tough Times Call for Tough Action

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