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About FSG

FSG is a professional consulting firm exclusively dedicated to helping community, corporate, private, and family foundations increase their effectiveness.

We offer objective analysis and confidential counsel on strategy, organizational alignment, strategic communications, governance, leadership, foundation-wide assessment, and community foundation donor development.

We invest in innovative ideas and we partner with our clients to help them do good, better.

For more information call us or visit our Web site.

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Perspectives
for Community Foundations

Foundation Strategy Group, LLC
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In this issue:

New Revenue Models for Community Foundations

FSG FOUNDATION STRATEGY GROUP
Perspectives
for Community Foundations
Fall 2002

In Search of New Revenue Models for Community Foundations

Paying the Price of Innovation

By Mark R. Kramer and John V. Kania

The last twenty years have been a remarkable period of innovation for community foundations. Inspired by both changing donor needs and increased competitive pressures—and sustained by extraordinary financial returns on their endowments—community foundations have become increasingly diverse. Today, the kinds of funds they hold, the range of services they provide, and their role in the community varies widely from foundation to foundation. But this innovation has come at the cost of marked increases in cost structure.

Now, with operating budgets shrinking in response to the recent stock market decline, community foundations find themselves facing difficult choices at a time when the need for philanthropy is increasing: Do we lay off staff? Reduce services? And while it makes little sense for institutions with a focus on the long term to reshuffle themselves with every fluctuation of the stock market, prudent boards cannot permit fiduciary institutions to operate at a deficit. Yet cutting services threatens to decrease donor loyalty and to sap the foundation's perceived vitality.

Cost, however, is not the sole lever available to community foundation leadership. In most cases, community foundations never redesigned their revenue models to fit their new strategies and enhanced donor services. The result is a serious imbalance between the services offered and the revenues available to pay for them that, until recently, was masked by the unprecedented stock market boom.

Certainly our communities would be poorer were community foundations to forego the rich range of services they provide. On the other hand, community foundations cannot be expected to sustain these services without paying for them somehow. The time is ripe for a realignment of fee structures with true costs.

How Did We Get Here?

Most of the early community foundations were established by bank trust departments and, naturally enough, adopted their revenue model: an annual fee based on a percentage of assets. Such a fee structure is highly favorable when new funds are commingled with existing funds, and no additional services or administrative burdens are taken on. This structure fit the older model of a community foundation quite well.

But times have changed and with them community foundations. Two critical factors have driven substantial innovation in the sector:

- *The rise in commercial charitable gift funds.* These funds provided an instant tax deduction, excellent reporting, and an opportunity for the donor to become more involved in giving. In the decade since its inception, for example, Fidelity's Charitable Gift Fund grew to $2.7 billion in assets—making it larger than any single community foundation. Between 1996 and 2000 its growth rate was more than four times that of the average community foundation.
- *A shift in donor priorities away from unrestricted giving.* This change is chal-

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FSG News

West Coast Office

Effective December 1, we have added a new office in San Francisco to better serve our West Coast clients, under the leadership of Vice President Fay Hanleybrown. Our address is:

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Clients

FSG has worked with a wide range of clients and issues so far this year:

- We worked with *MELMAC*, a new educational loan conversion foundation, to conduct a scan and **needs assessment of education in the State of Maine**. Beyond assessing need, we worked with them to identify high-potential **opportunities for intervention**.
- A large European private foundation with a desire to promote greater global engagement by U.S. philanthropic institutions retained us to **map the overseas funding patterns of U.S. foundations** and to detail both the motivations for and obstacles to increased overseas funding.
- For *The Pittsburgh Foundation*, we conducted a complete **strategy assessment**, including an examination of the Foundation's donor market and **development strategies**, a **scan of the funding landscape** in its issue areas, and a narrowing of **grantmaking objectives**.
- We helped the *Pfizer Foundation* **design a grants selection process** for a new

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Paying the Price of Innovation

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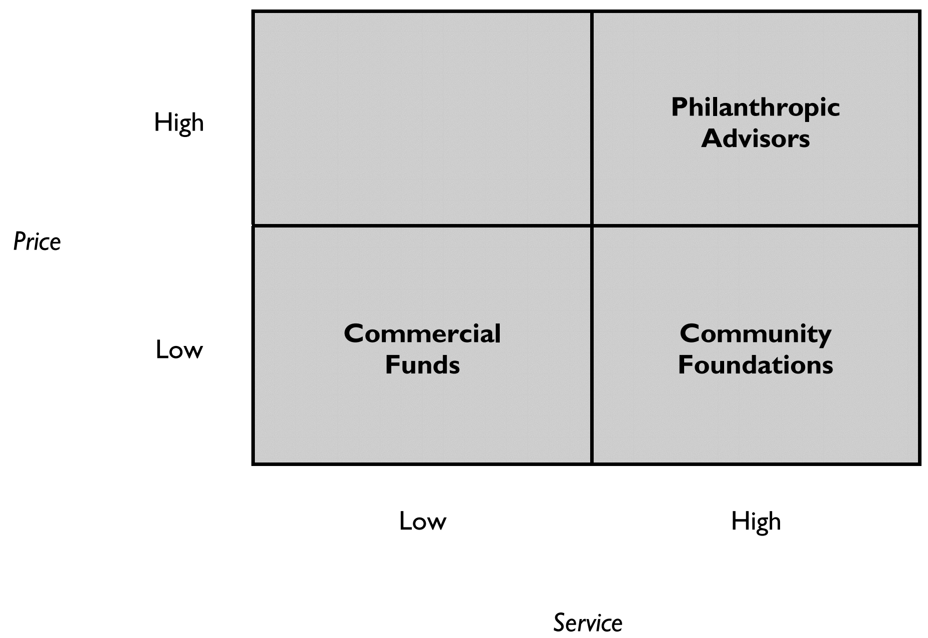

FIGURE 1

lenging the traditional division between donor development and grant making that has long been part of most community foundations' operational model. Donors are looking for more involvement, better service, and investment flexibility.

These factors drove community foundations to move into donor-advised funds and to compete for donations on the basis of superior service to individual donors. For example, community foundations have increasingly taken on the role of advising and educating donors about their giving, providing advice and continuing education to estate and tax professionals, helping local nonprofits raise funds or develop their own endowments, convening funders to organize solutions to community problems, compiling studies of the local philanthropic and nonprofit sector, and a long list of other efforts that provide value to their communities.

Yet despite taking on a range of philanthropic services that bank trust departments never contemplated, community foundations maintained their old revenue model. In most cases, they merely absorbed the cost of these additional services within their operating budgets, or counted on case-by-case grants to themselves and the growth in their investment portfolios to cover their additional costs.

An Unsustainable Situation

Community foundations have tried hard to outshine commercial funds through the level of advice and personal service they provide and the good works they perform in their communities—increasing their costs. At the same time, they have viewed the commercial funds' pricing as a *de facto* market ceiling, creating a conundrum: how to deliver superior donor services at rock-bottom prices?

Adding to this challenge is that the underlying incremental donor servicing costs of the commercial funds are far lower than those of the community foundation. Some community foundations have responded by setting a minimum annual fee or a small service charge per distribution, though often without any careful analysis of the full cost of services provided. This is a step forward in covering administrative costs, but it is only a stopgap measure.

The growth in paid philanthropic advisors, however, points to the potential for a different model. In many ways, the advice and services that these advisors provide parallels those offered for free by community foundations. Yet advisors typically charge $100-$250 per hour for their counsel, or 5%-10% of the annual grants for managing a small foundation, on top of whatever investment advisory fees donors already incur. These advisors set an independent market price for many of the services that community foundations offer, and demonstrate a potential willingness on the part of donors to pay substantially more–in different ways–for the services that they obtain from their community foundations. (See Figure 1)

The Way Out

Rather than continuing to absorb program costs as part of their overhead, community foundations should view them as a valuable service for which others in the community charge. But making this transition successfully requires a dispassionate look at both the demand for services and the true cost of providing them:

- *Understanding Donors' Priorities*. Which services are most important to our most valued donors? For which are donors willing to pay?
- *Understanding True Costs*. How much do our programmatic and administrative services cost? What does a rigorous cost accounting analysis tell us about the real cost of individual donor services?

It is then critical to devise new revenue models. For example, those foundations that want to offer high levels of service might establish a tiered pricing structure for services to donor advised funds. Instead of merely distinguishing between accounts on the basis of size, donors at any level should have the option of purchasing the package of services they would like.

Valuing the advice of program staff at the market rate set by independent philanthropic advisors is one possible approach. A substantial donor advised fund might be entitled to 10 hours of philanthropic advice from program staff for free, but each additional hour would be charged to the account. Similarly, philanthropic services rendered to the community might be paid for by a grant from the community foundation itself.

But merely covering costs is not the ultimate goal. Community foundations must study what fee structures will enable them to operate in a stable and predictable manner without putting themselves at a competitive disadvantage. And they must learn from each other, studying the best practices in revenue models and the experiences—both good and bad—of other community foundations around the country.

Joint Study Opportunity:

New Revenue Models for Community Foundations

Today, each community foundation is struggling to balance its budget alone. Yet the shift in services and costs is a field-wide phenomenon that demands new thinking—not just for one foundation, but by pioneering solutions that will work broadly for the field.

To this end, FSG is working to apply these ideas in two ways:

- *A customized multi-foundation study*. We are interested in assembling four to six foundations to participate in a study during the fourth quarter of this year. The goal is to identify a new revenue model for each participants as well as to develop general learnings that can be shared with the field. Specific financial information of participating foundations will be kept confidential. This project would begin either in fourth quarter 2002 or first quarter 2003.
- *A field-wide study*. We are proposing to the Community Foundations Leadership Team that FSG undertake a study for the benefit of all member organizations. This project would include primary research to understand donor priorities and alternate pricing models. As part of this work, we would also develop a methodology to assist foundations in performing their own cost analyses.

For more information, please contact Mark Kramer or John Kania at 617-357-4000.

FSG News

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program area. FSG created a four-stage proposal review process, selection criteria, and **facilitated initial proposal ranking** with foundation staff and external experts.

- We **expanded the strategy and created a new business plan** for *Medicines for Malaria Ventures*, a Swiss-based foundation that is the leading global funder of R&D for anti-malarial drugs. Our work encompassed the development of a **complex model** to simulate drug development outcomes, developed in cooperation with a leading authority from Harvard Business School, as well as the **organizational structure, financial plan, and performance metrics** needed to ensure success.

Seminar

Our seminar Strategies for Impact was a great success. Over 60 senior foundation executives and Trustees—from organizations ranging in size from $10 million to $9 billion—attended the two-day session.

A Growing Team

We are delighted that three new Consultants have joined our team:

Fay Hanleybrown, Vice President, responsible for FSG's West Coast office. Having helped to establish FSG in Boston, she subsequently worked for McKinsey & Co. in San Francisco, where she served both nonprofit and corporate clients before returning to FSG this summer.

Henry Culbreath, who joined us after completing his MPP at Harvard's Kennedy School of Government, has significant nonprofit experience both through his strategy and evaluation work at Catalyst Alliance as well as at a nonprofit that he co-founded to mentor underprivileged youth.

Sunder Ramakrishnan, joined us from Vertex Partners/Braun Consulting where he focused on strategy. His nonprofit experience includes work with the Longwood Symphony Orchestra and Rhode Island Legal Services.