National Center on Nonprofit Enterprise

Advisory Letter

How Much Borrowing and Debt is Healthy for My Organization?

Thad Calabrese

Businesses that wish to expand or invest in certain assets (such as real estate) might raise capital from investors, borrow money from a bank, or use some combination of both. The final decision often comes down to which financing option is cheapest for the business. Nonprofits also require financing for the same reasons – perhaps they want to expand an existing program to reach new clients or start a whole new program to reach different populations, or perhaps they wish to expand into new locations to provide the services. Or maybe the nonprofit needs to invest in or upgrade real estate to better serve its client populations. However, nonprofits face different financing choices than for-profit businesses. Nonprofits might ask donors for the needed money, although such an appeal may be costly, time-consuming, and the end result uncertain. This stands in stark contrast to the relatively inexpensive equity markets of the for-profit sector. Due in part to the lack of efficient equity markets for nonprofits, debt is a more important financing option for nonprofit organizations. A frequent question from nonprofit managers and board members is "how much borrowing and debt is healthy for my organization?" While there is no one-size-fits-all answer to this query, there are important and critical questions to ask that will inform whether your organization should borrow, what type of borrowing is appropriate, and what are the consequences of too much or too little debt.

The first question to address is *what specifically is the reason for debt funding?* If the nonprofit is purchasing a building, for example, borrowing long-term is appropriate; on the other hand, if the nonprofit is simply managing a cash shortfall due to timing issues in receiving revenues owed to it, then short-term borrowing is appropriate. Long-term borrowing to finance long-term asset acquisition makes logical sense – it is a mechanism for matching the costs and benefits of the assets over many fiscal years. It would not be appropriate to finance a short-term cash shortfall with multi-year borrowing. Further, borrowing to fund routine operations suggests a structural problem that debt is unlikely to fix on its own. In this situation, managers would serve their organizations better by trying to address these operational issues (either increasing revenue, decreasing costs, or some combination of both).

The second question to ask is *what type of debt should we use?* Nonprofits have access to many debt instruments. Short-term debt includes lines of credit and short-term notes. These may require no collateral (that is, assets that the lender can acquire if the loan is not repaid), but many do require some collateral. Long-term borrowing includes mortgages (loans that use property as the collateral), and bonds. Bonds deserve special consideration here. These tend to be large borrowings that are repaid over many years. Nonprofits may issue taxable and tax-exempt bonds. Taxable bonds may be used for any purpose that the nonprofit sees fit, and the investor pays income taxes on the interest he or she receives from the nonprofit borrower. Tax-exempt bonds must be used for qualified purposes (usually related to core mission services), and they are issued through conduits – either government agencies or public authorities. The investor pays no income taxes on the interest received from the nonprofit, however, and so the interest cost on tax-exempt debt tends to be lower than that for taxable bonds. Therefore, if the debt is being used to finance core services of the nonprofit organization and the size of the borrowing is substantial enough, managers may wish to investigate the use of tax-exempt debt by speaking to financial advisors and conduit agents. Frequently, tax-exempt debt is m the least expensive debt financing available to nonprofit organizations.

The final question to ask is *what are the consequences of too much or too little debt?* Many nonprofits are instinctively hesitant to borrow at all; based on analysis of 2017 Form 990 data, only about one-third of nonprofits that file with the Internal Revenue Service report having any outstanding debt. Debt can provide money to the organization, but it also locks the nonprofit into repayment schedules that are non-negotiable. Missing these debt payments (called "default") can lead lenders to take actions against the nonprofit to recoup their money. While debt is appropriate in some situations, nonprofits sometimes borrow (unwisely) to manage poor financial operations. For example, in early 2015, Federation and Employment Guidance Services (FEGS), one of New York City's largest social service providers, closed its doors almost without warning. Except in the prior year, it had missed debt payments on borrowings it had made to hide unprofitable business lines. Still, failing to use debt may also be unwise. For example, it may result in nonprofits missing strategic investment opportunities, or it may stunt the natural growth of some nonprofit organizations. While the dangers of too much debt are widely recognized, those associated with too little debt ought to be acknowledged as well. Nonprofits committed to meeting social need must operate at an adequate scale, and fears of too much debt should not overshadow the potential positive outcomes when debt is used properly.

Thad Calabrese
Associate Professor of Public and Nonprofit Financial Management
Director of Finance Specialization