Driving Financial Sustainability In The Next Normal

Meeting Dates: May 24th, 2022 10:00AM
May 26th, 2022 1:00PM

Agenda

I. Financial Sustainability Planning
II. Key Financial Metrics By Domain
III. Indicators Of Financial Strength
    A. Credit Strength Indicator
    B. Financial Vulnerability Index
IV. Case Study

Learning Objectives

- Understand how monitoring key financial ratios and assessments can help an organization identify potential financial issues and drive long-term sustainability.
- Identify the role service portfolio management plays in the financial strength of an organization.

Why Focus On Financial Strength?

1

- Rapidly changing economic factors can bring sudden crises that impact cash.

2

- Changing business model focus from volume to value requires increased need for cash and focus on managing financial risk.

3

- Competitive service models are increasing use of technology to deliver more effective outcomes requiring cash for capital investments.

4

- Increasing competition from large service organizations, many of which are funded by private equity.

5

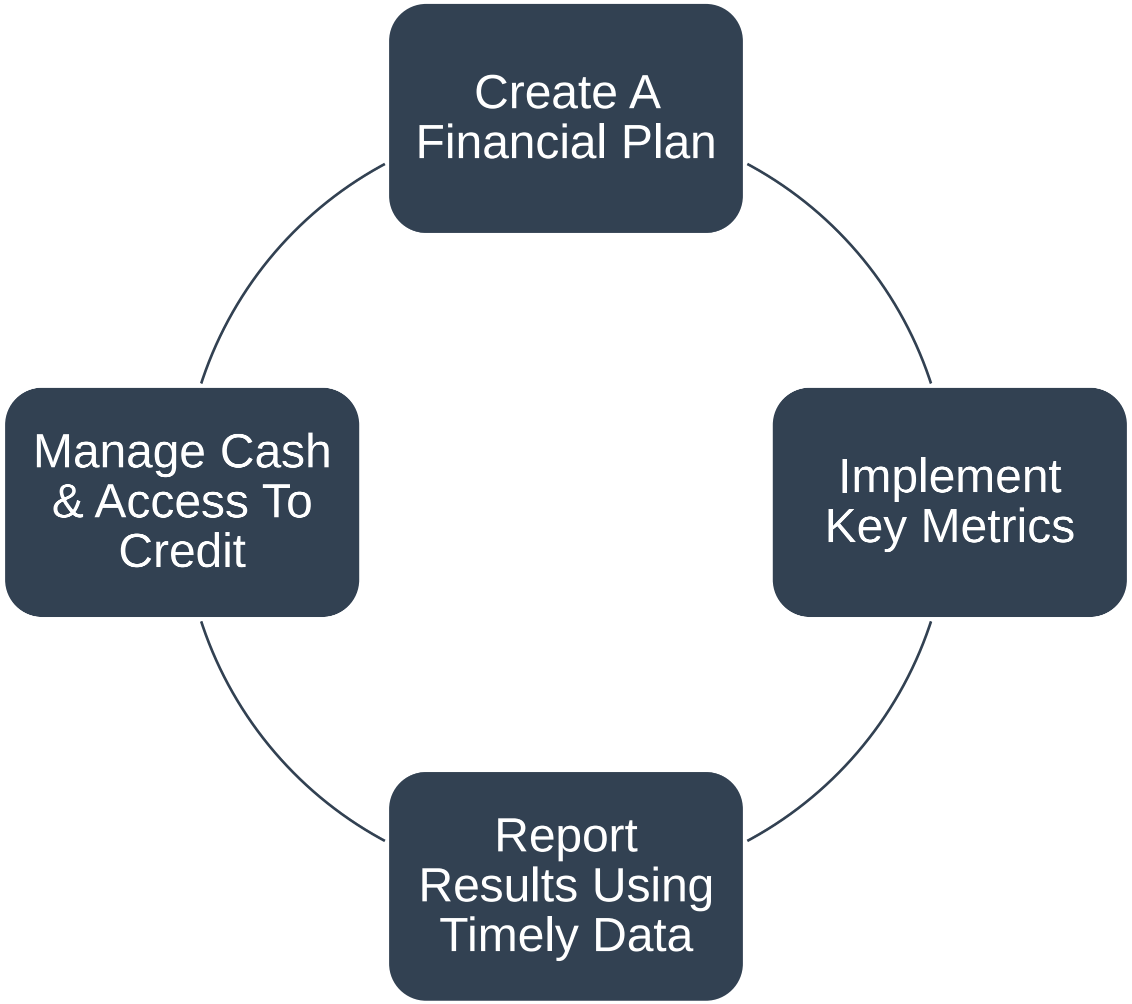
- Financial strength can change rapidly, so a structured approach will identify increasing financial risks.

How Does A Non-Profit Build Financial Strength?

- Manage & Monitor Key Financial Ratios
- Assess Financial Vulnerabilities
- Implement A Financial Sustainability Plan

I. Financial Sustainability Planning

Creating Financial Sustainability



Create A Financial Plan

An organizational financial plan is made up of the following components:

- An operating budget that is tied to organizational strategy goals, including revenue and expense projections, and profitability targets.
- A multi-year capital budget built on investments to drive strategic goals and maintain current operations.
- A cashflow budget that projects and monitors cash requirements and balances for the next 12 months.
- A rolling forecast that projects near-term financial results (often 3 months) based on current operating activities.

Implement Key Metrics

Metrics ensure that results will be data-driven and align with strategy goals and operating requirements.

- Operating metrics that track drivers of revenues and expenses – referrals, service utilization, revenue producing staff openings, etc.
- Financial metrics that assess organizational strength and sustainability – liquidity, performance, debt leverage and process efficiency.
- Assessment metrics that add in financial decision-making – organizational cost of capital, return on invest thresholds, etc.

Report Results Using Timely Data

Timely data is needed to assess operating and financial results with metrics and ensure that strategic and operating goals are met.

- Distinguish between financial data and reporting to drive daily operations, and monthly data to create internal and external financial reports.
  - Leading indicator metrics will drive financial results by facilitating timely decisions.
  - Relying on traditional financial reporting to drive results to will create a lag in decisions and a delay in addressing issues.
- Most large organizations have re-engineered the monthly close process to produce financial statements within 3 to 5 days of the end of each month.
- Every staff member in the organization should know the metrics that are important for success in their role, have data on those metrics, and have authority to act on that data.

Manage Cash & Access To Credit

A strong cash management plan, along with intentional management of credit sources is critical to consistent operations, implementing growth initiatives and weathering financial crises.

- Implement an efficient revenue cycle process that integrates payer contractual requirements at all stages of the service process, automates processes to reduce errors, and utilizes data analysis to improve billing and collections issues.
- Analyze important liquidity and leverage ratios and build relationships with bankers and other sources of capital.
- Strategically balance the level of cash and credit with uses to drive strategic growth.

II. Key Financial Metrics By Domain

Building Blocks Of Financial Strength

Liquidity

Performance

Leverage

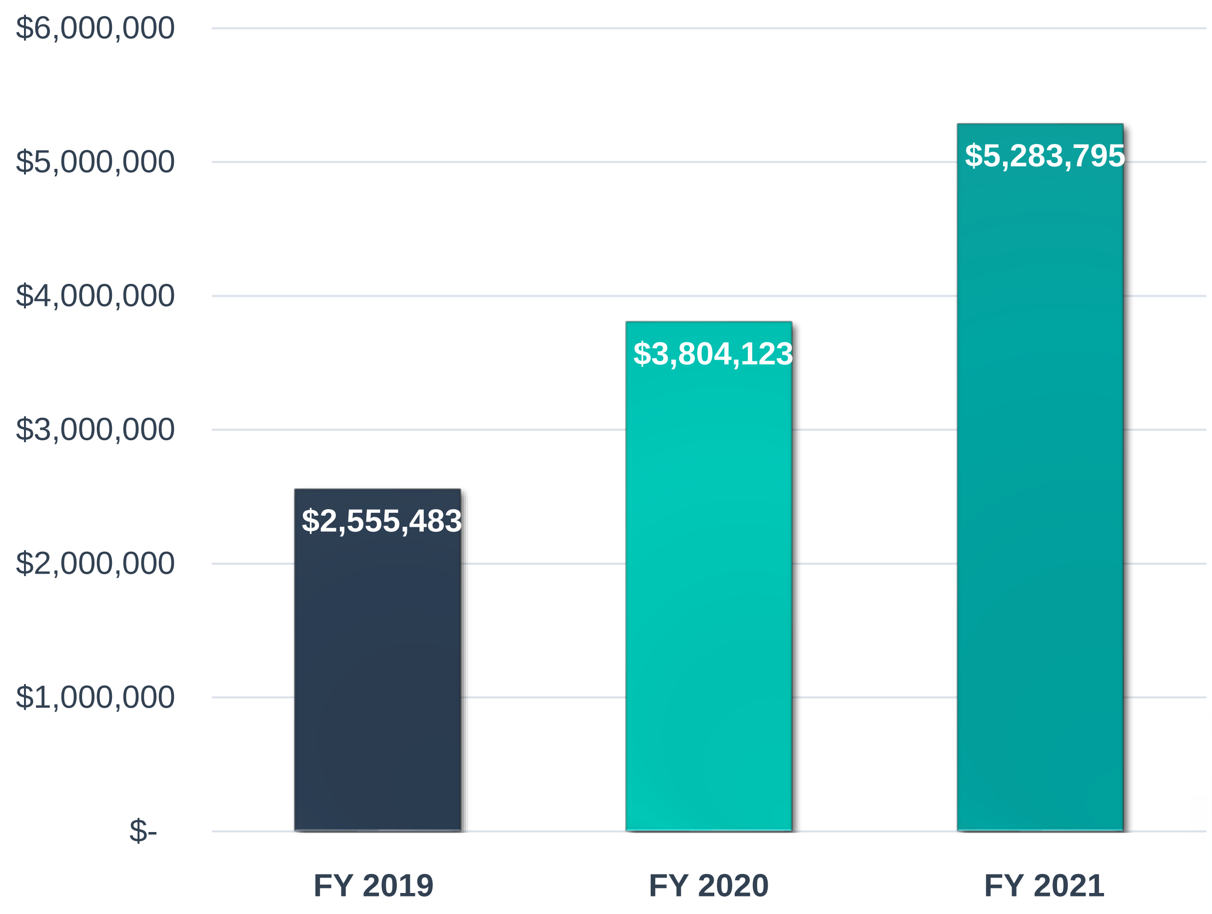
Process Efficiency

Liquidity Analysis

Liquidity metrics analyze the ability of an organization to pay off both current liabilities as they become due as well as long-term liabilities as they become current.

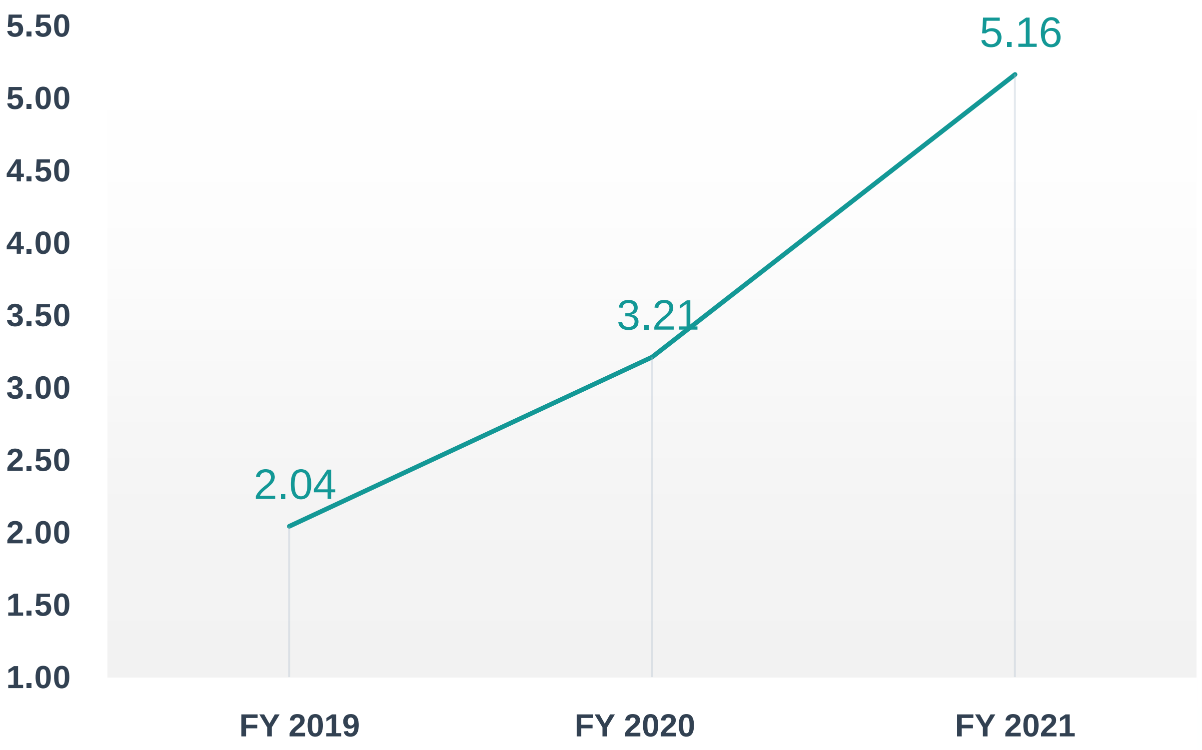
1. Working Capital
2. Current Ratio
3. Days Cash On Hand

Working Capital



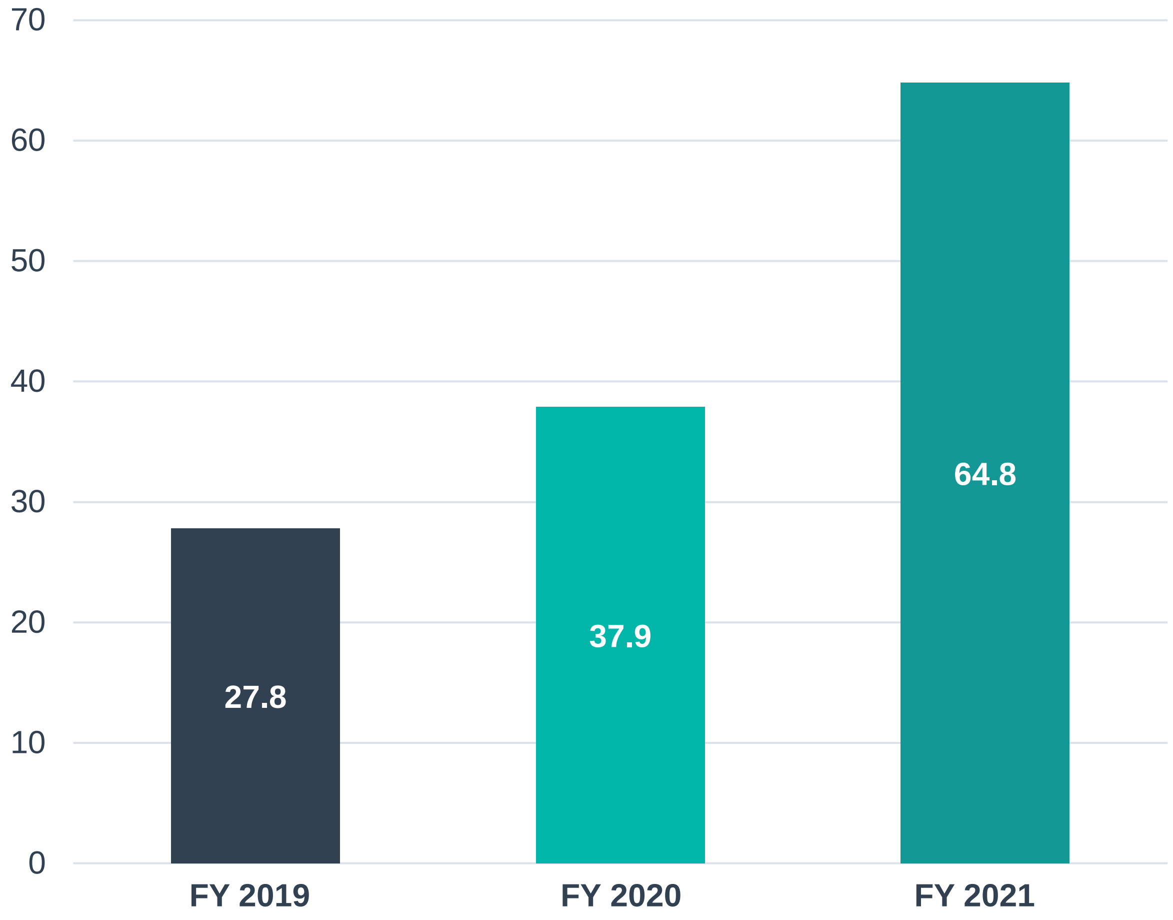
Working capital is the excess amount of cash available if all short bills were paid. This is the amount we have for dealing with negative events or planning growth.

Current Ratio



The Current Ratio restates the proportional relationship of liquid assets to total short-term debt. It is a quick indicator of reserve cash at any point in time. A benchmark of 2:1 – 2 dollars of current assets for every dollar of current liabilities is considered healthy.

Days Cash On Hand



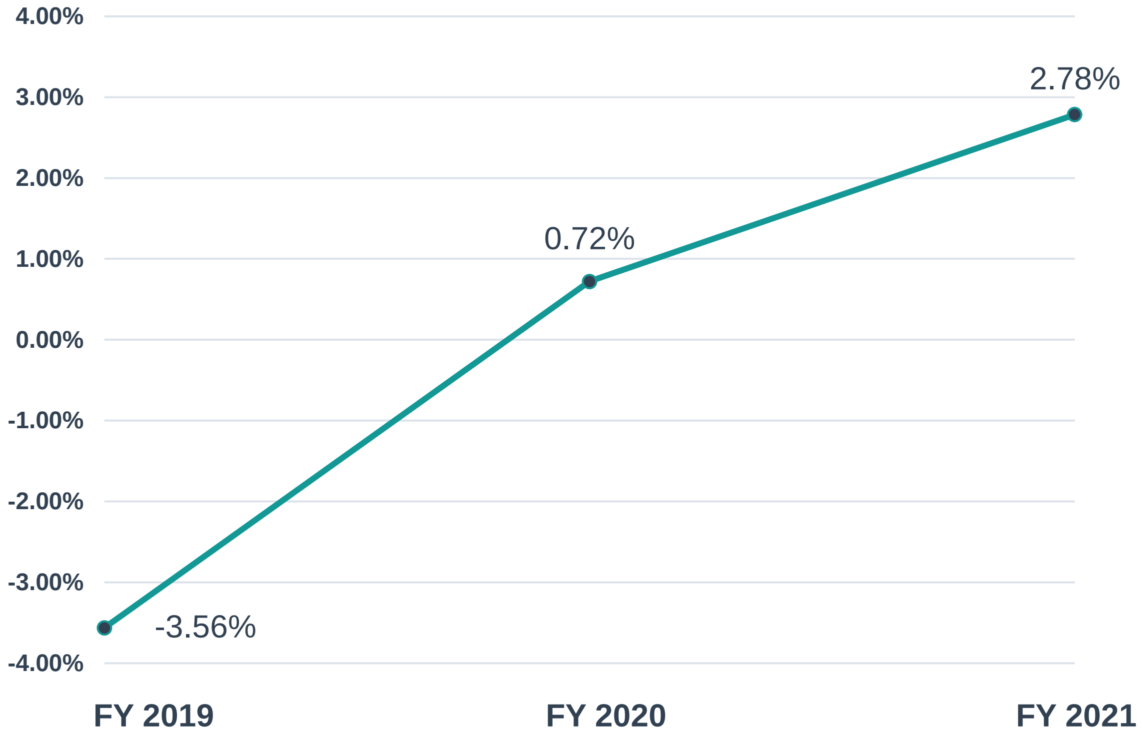
Days Cash On Hand estimates the number of days an organization can pay its daily operating expenses with the cash presently on hand. It is recommended that organizations maintain 60 to 90 days of cash on hand to cover operating needs and unanticipated crises.

Performance Analysis

Operational performance metrics measure the short-term trends in generating financial reserves.

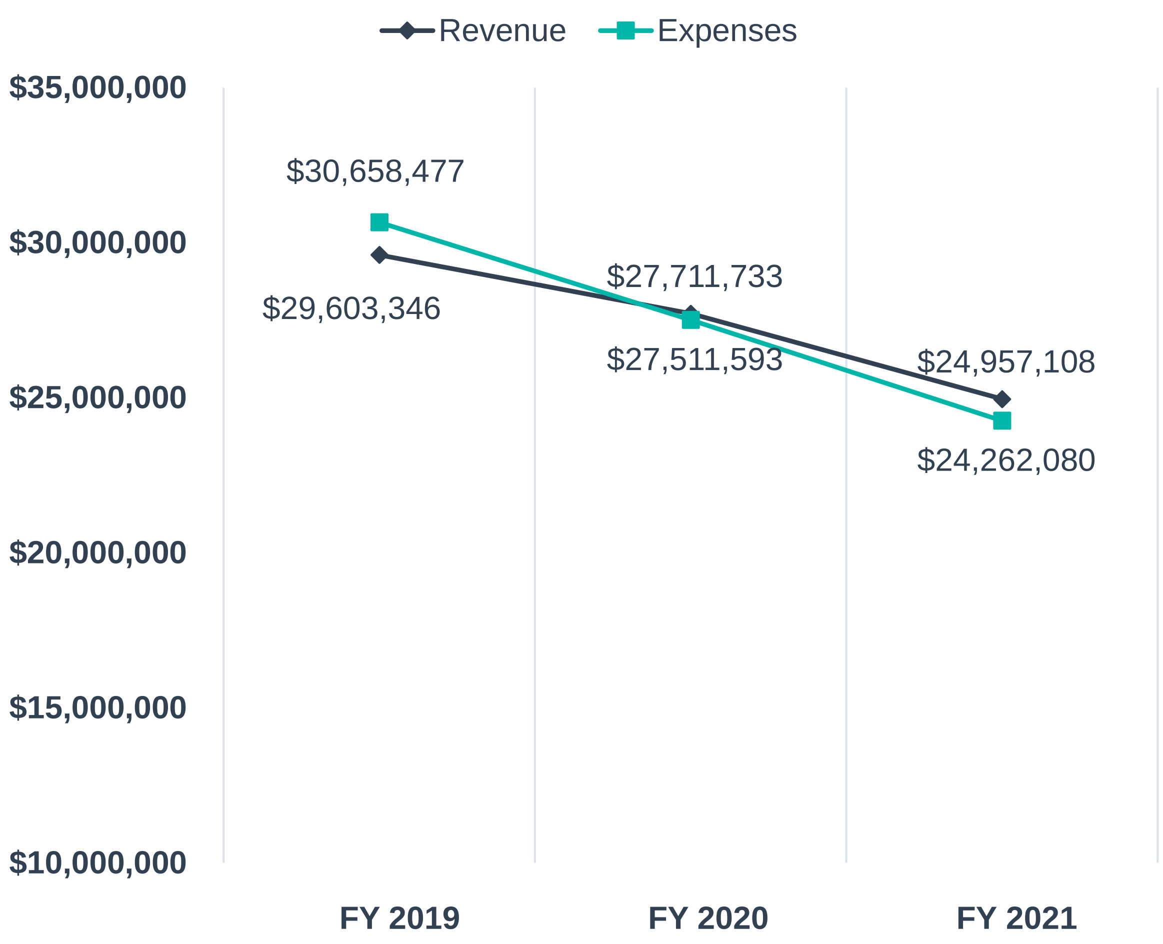
- Net Margin Percentage
- Revenue & Expense Growth
- Administrative Ratio

Net Margin Percentage



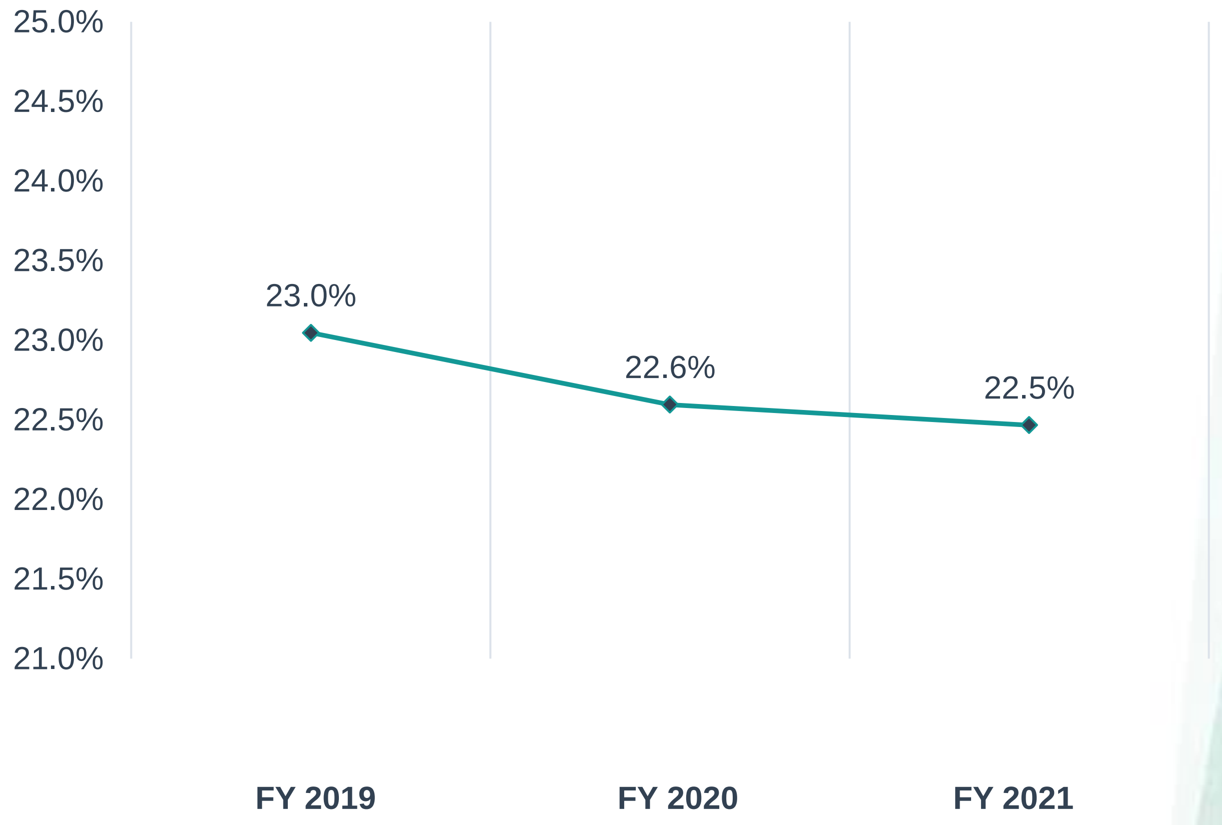
Net Margin Percentage shows profitability as a percentage of the of revenue generated. This metric is important for generating cash for sustainability during a crisis and funding organizational growth. It is recommended that organizations have of a net margin goal of 5% - 10% to position the organization for stability and to pursue growth opportunities.

Revenue & Expense Growth



Revenue and expense growth or shrinkage over time indicate whether an organization is effectively meeting market needs, strategic targets, and operating efficiency. Trends should be analyzed and corrective plans implemented to grow revenue and ensure an adequate operating margin.

Administrative Ratio



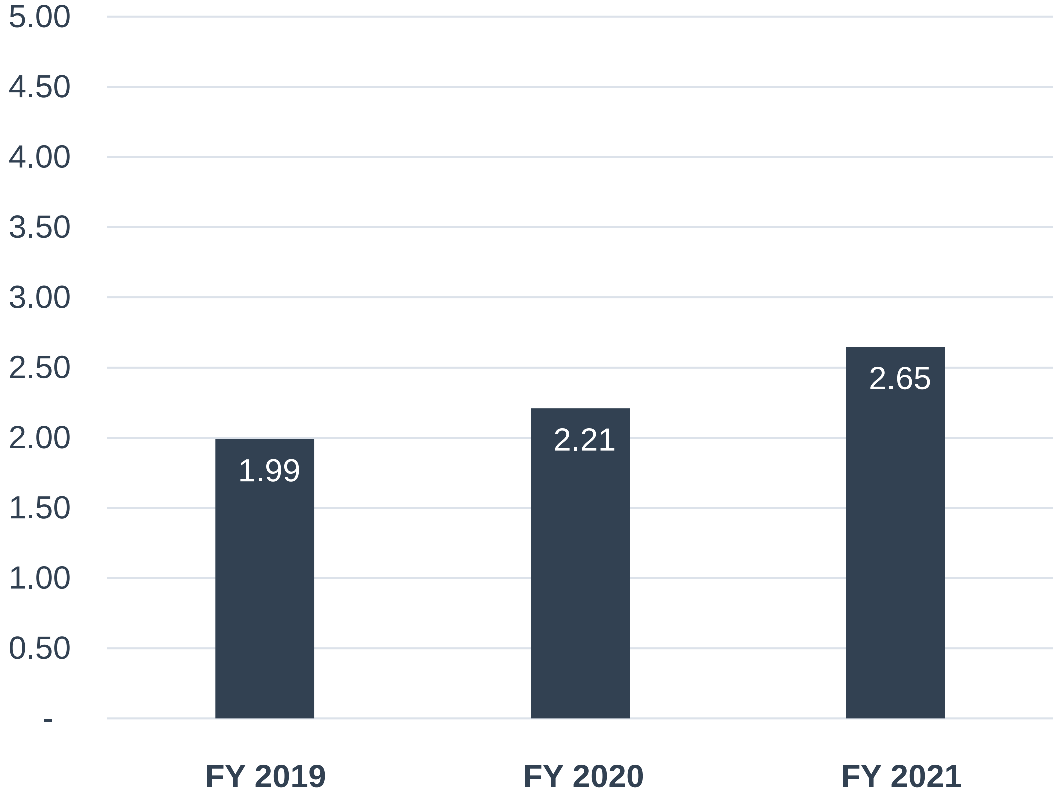
The Administrative Ratio is the percentage of management and general expenses as a percentage of total expenses. Lower administrative costs are considered by funders and donors as assurance that adequate resources are designated for direct services, however an adequate level of administrative expenses is required for a stable infrastructure.

Leverage Analysis

Leverage measures the amount organizational long-term debt commitments and the ability to grow by investment in the future.

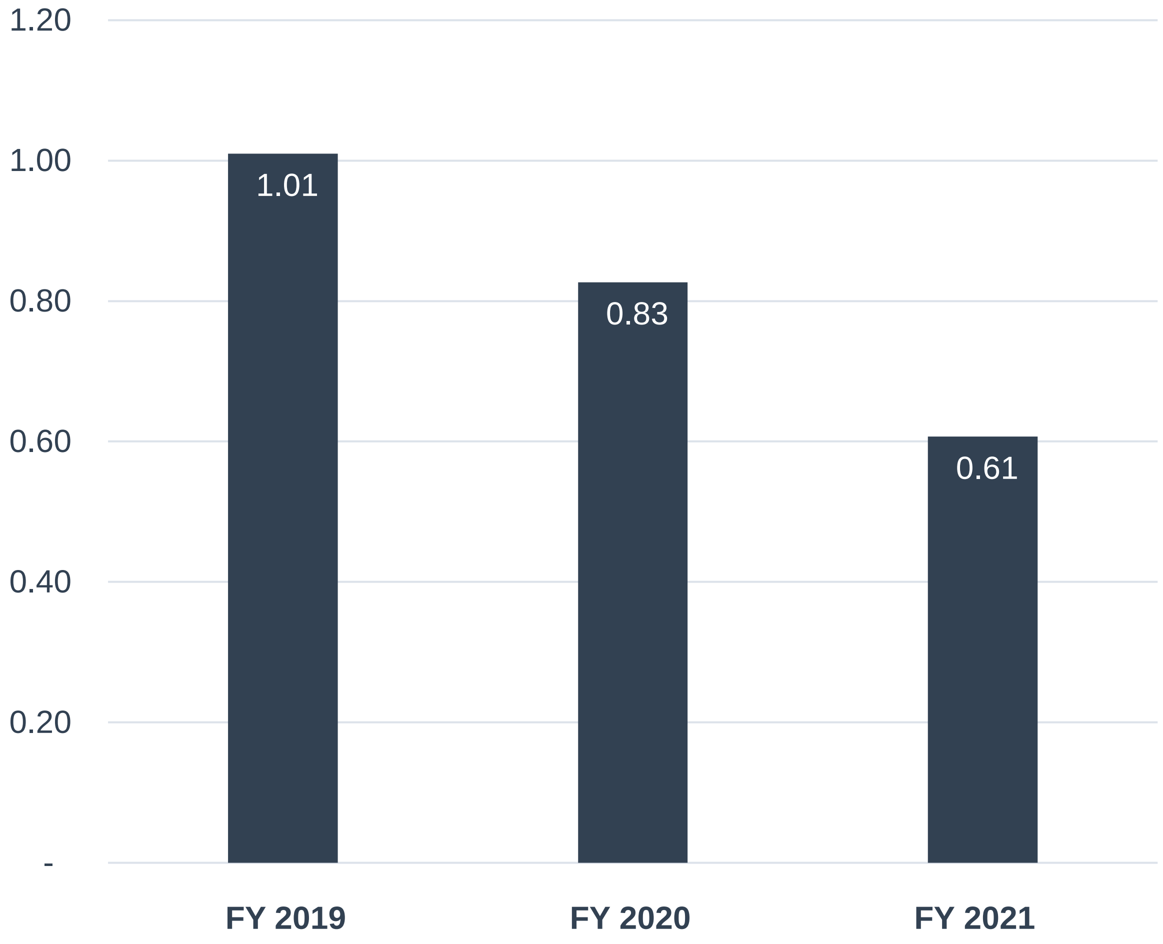
- Ratio of Assets to Liabilities
- Ratio of Debt to Equity

Ratio Of Assets To Liabilities



The ratio of assets to liabilities measures the value of assets the company owns versus the long-term debt that would apply to it. There is some cushion in this since assets might well have appreciated in value since they were added to your financial books. Calculated as Total Assets divided by Total Liabilities with an acceptable ratio is 2.5 to 1.

Ratio Of Debt To Equity



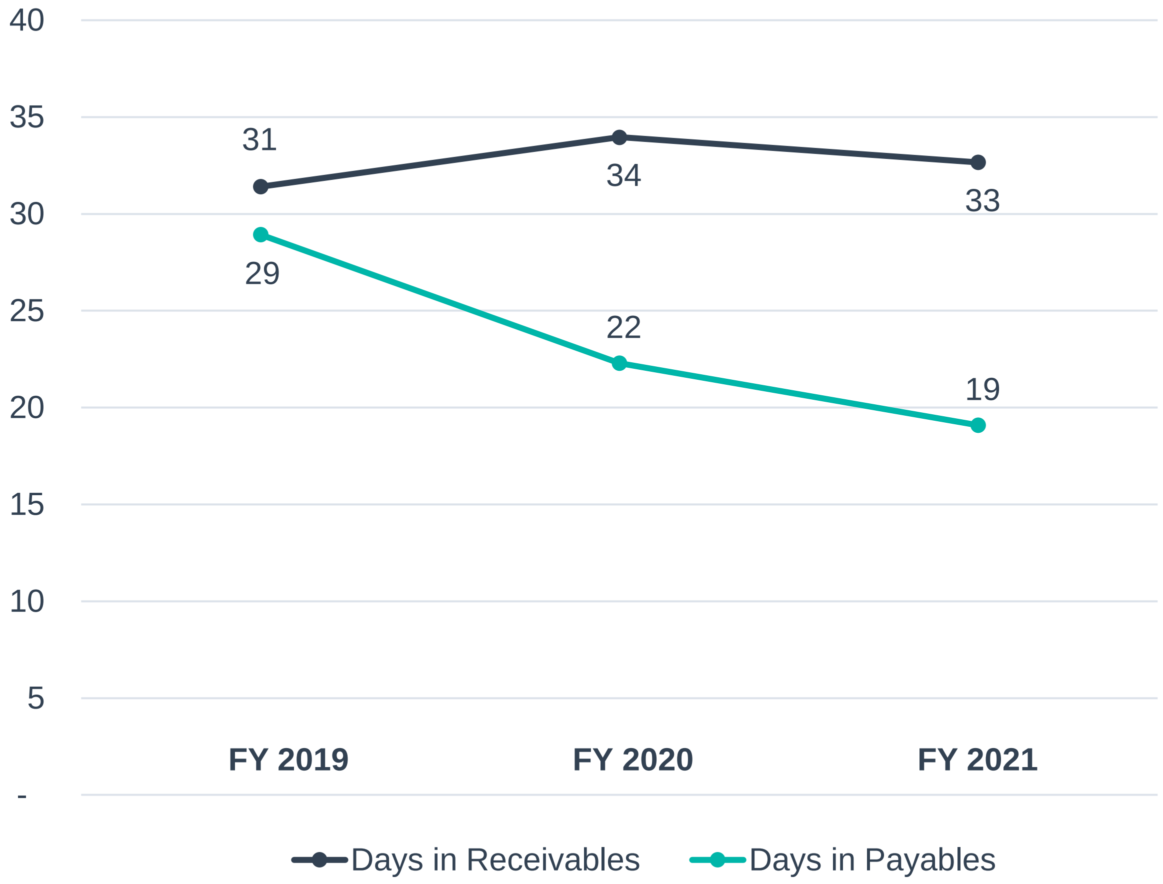
The ratio of debt to equity measures the level of debt compared to the accumulated net margin of the organization. This is a key consideration of banks in the lending process because it assesses debt capacity. Calculated as Total Liabilities divided by Net Assets with an accepted benchmark of 2 to 1 or less.

Process Efficiency Analysis

Process efficiency measures assess the speed to convert services to cash, conserve cash, and identify the overall return on return of organizational assets.

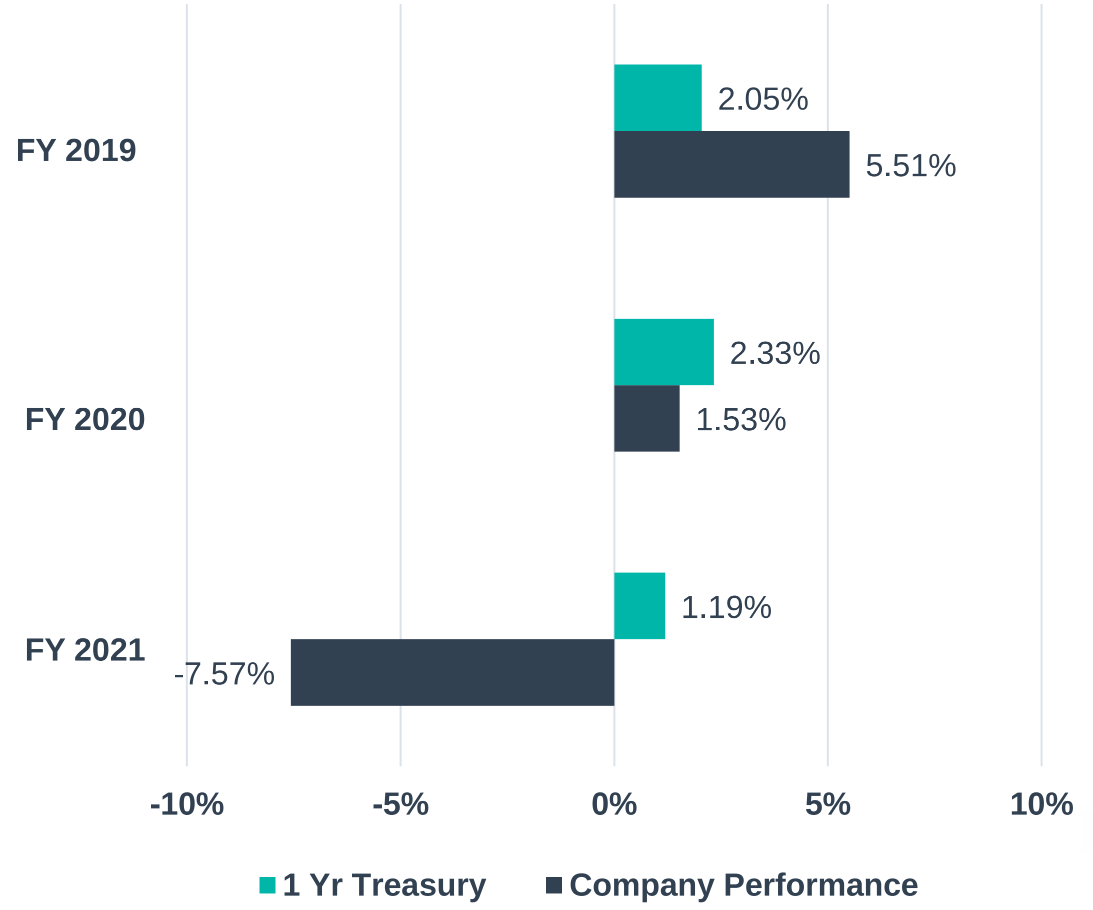
- Cash Conversion Ratios
- Return On Assets

Cash Conversion Ratios



Cash conversion ratios measure the efficiency in turning services to cash, and using cash to pay obligations. Days in A/R reflect average billing and payment speed, with an industry average of 42 days. Days in payables reflects how quickly bills are paid. This metric reflects vendor payment terms and should reflect a policy of paying close to due date to maximize cash, but not past due to preserve credit strength.

Return On Assets



Return on assets measures how effectively the assets of the company are being used to produce earnings. This measure can be compared to other uses of cash that would yield a return on organizational assets.

III. Indicators Of Financial Strength

Financial Indexes

A financial index uses numerous financial measures to assess the overall creditworthiness or financial strength of an organization.

- Credit Strength Indicator
- Financial Vulnerability Index

Credit Strength Indicator

- Net Margin
- Ratio of Revenue to Cover Debt
- Ratio of Assets to Liabilities
- Months of Cash

Credit Strength Indicator assesses overall financial strength from the lender perspective and scores results according to bond ratings. The rating is based on net margin, level of revenue to cover debt, the ratio of assets to liabilities, and the month of cash on hand.

Credit Strength Indicator

Rating Description	Range	Score
“AAA” rating.	>19	
“AA” category credit. National leader. Ability to invest heavily in product development and process improvement.	15-19	
Sustainable with significant cushions. Able to grow in multiple directions and serve as an effective platform for expansion and higher risk projects to be a market leader. “A” category credit.	12-15	
Long-term sustainability. Investment grade rating (“BBB” category) should be attainable. Long-term borrowing with reasonable restrictions and reasonable tax-exempt rates (about 1-2% above Treasuries) possible.	8-12	10.7
Long-term non-investment grade (financing) may be possible. Long-term prognosis is fair. Downturns will be difficult but should survive.	7-8	
Short-term stability. High risk if disruption occurs.	5-7	
Organization is not sustainable. No effective long-term planning is possible.	3-5	
Serious bankruptcy threat.	0-3	

Financial Vulnerability Index

- Debt Ratio
- Revenue Concentration Ratio
- Net Margin Percentage
- Administrative Ratio
- Organizational Size Factor

The Financial Vulnerability Index assesses how well positioned a non-profit organization is to withstand an expected economic crisis. The individual indexes are assessed to market benchmarks and an overall financial rating is assigned. A strong position also indicates the potential for organizational growth.

Financial Vulnerability Index

Ratio Analysis	FY 2019	FY 2018	Trend	Benchmark	Indication
Debt Ratio	0.38	0.45	Favorable	0.47	Better
Concentration Ratio	0.33	0.34	Favorable	0.13	Worse
Margin Ratio	3.0%	1.0%	Favorable	5%	Worse
Administrative Ratio	0.22	0.23	Unfavorable	0.13	Better
Organizational Size Factor	17.0	17.1	Unfavorable	15.8	Better

Financial Vulnerability Ratio	Indication	Ratio
If Financial Vulnerability Ratio is greater than .20, then your organization is financial vulnerable.		
If Financial Vulnerability Ratio is less than .20, then your organization is financial vulnerable.	Not Financially Vulnerable	0.15

IV. Case Study

Case Study – Selected Measures

Measure	Year 1	Year 2	Year 3	Benchmark
Current Ratio	2.2	1.8	1.5	2.0
Days Cash On Hand	9	13	37	60
Margin %	- 0.5%	-8.9%	-14.4	5.0%
Debt to Equity	1.5	2.9	9.9	2.0
Days In Receivables	84	76	40	40
Days In Payables	49	54	54	30

A large non-profit services organization has these financial ratios.

- **What concerns do the financial measures indicate?**
- **What trends are apparent?**
- **Is the organization moving toward financial strength or vulnerability?**

Case Study: Credit Strength Indicator

Rating Description	Range	Score
"AAA" rating.	>19	
"AA" category credit. National leader. Ability to invest heavily in product development and process improvement.	15-19	
Sustainable with significant cushions. Able to grow in multiple directions and serve as an effective platform for expansion and higher risk projects to be a market leader. "A" category credit.	12-15	
Long-term sustainability. Investment grade rating ("BBB" category) should be attainable. Long-term borrowing with reasonable restrictions and reasonable tax-exempt rates (about 1-2% above Treasuries) possible.	8-12	
Long-term non-investment grade (financing) may be possible. Long-term prognosis is fair. Downturns will be difficult but should survive.	7-8	
Short-term stability. High risk if disruption occurs.	5-7	
Organization is not sustainable. No effective long-term planning is possible.	3-5	4.7
Serious bankruptcy threat.	0-3	

Case Study: Financial Vulnerability Index

Ratio Analysis	FY 2019	FY 2018	Trend	Benchmark	Indication
Debt Ratio	0.91	0.74	Unfavorable	0.47	Worse
Concentration Ratio	0.24	0.25	Favorable	0.13	Worse
Margin Ratio	-14.0%	-9.0%	Unfavorable	5%	Worse
Administrative Ratio	0.15	0.14	Favorable	0.13	Better
Organizational Size Factor	19.0	19.3	Unfavorable	15.8	Better

Financial Vulnerability Ratio	Indication	Ratio
If Financial Vulnerability Ratio is greater than .20, then your organization is financial vulnerable.	Vulnerable	0.250
If Financial Vulnerability Ratio is less than .20, then your organization is financial vulnerable.		

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