

White Paper #4

Anatomy of the Nonprofit Business Model: A Key Driver of Organizational Performance

Summary

An organization's business model frames how it will pursue its purpose. But the concept is often misunderstood in the nonprofit sector. In this paper, we identify the five components of nonprofit business models, and de-mystify the nature of sound, sustainable and healthy models. Drawing on current applied research, we outline best practices for linking a sound business model to effective organizational strategies and, ultimately, performance in achieving a nonprofit's mission and financial goals.



pimgconsulting.com | (206) 282-7464

Introduction

Like all enterprises, every nonprofit organization has a business model. As public and private funders have focused on measurable performance, accountability, and financial sustainability, the nonprofit business model has drawn increased attention in the sector.

In this paper, we define and describe the composition of the nonprofit business model, and illustrate how the business model influences an organization's success in achieving its mission and sustaining its work. We then review Public Interest Management Group's applied research findings related to business model health, and present a framework for strategies to boost programmatic and financial performance.

Business Model Defined and Deconstructed

The term "business model" entered the mainstream lexicon of the nonprofit sector in the past decade. The term is used in a variety of different ways, however, creating confusion about its meaning and significance. We'll therefore start with a clear definition:

A business model is a conceptual framework describing how an organization will fulfill its purpose.

Note that, contrary to common usage of the term, a business model is not strictly about financing an organization's work. And the model itself is a *concept* conveying the intended logic of how the purpose should be fulfilled. Execution may vary from this intention, and poor performance may be a function of a flawed business model, poor execution, or both. The inverse, however, is not similarly true; strong performance generally requires both a sound business model and effective execution.

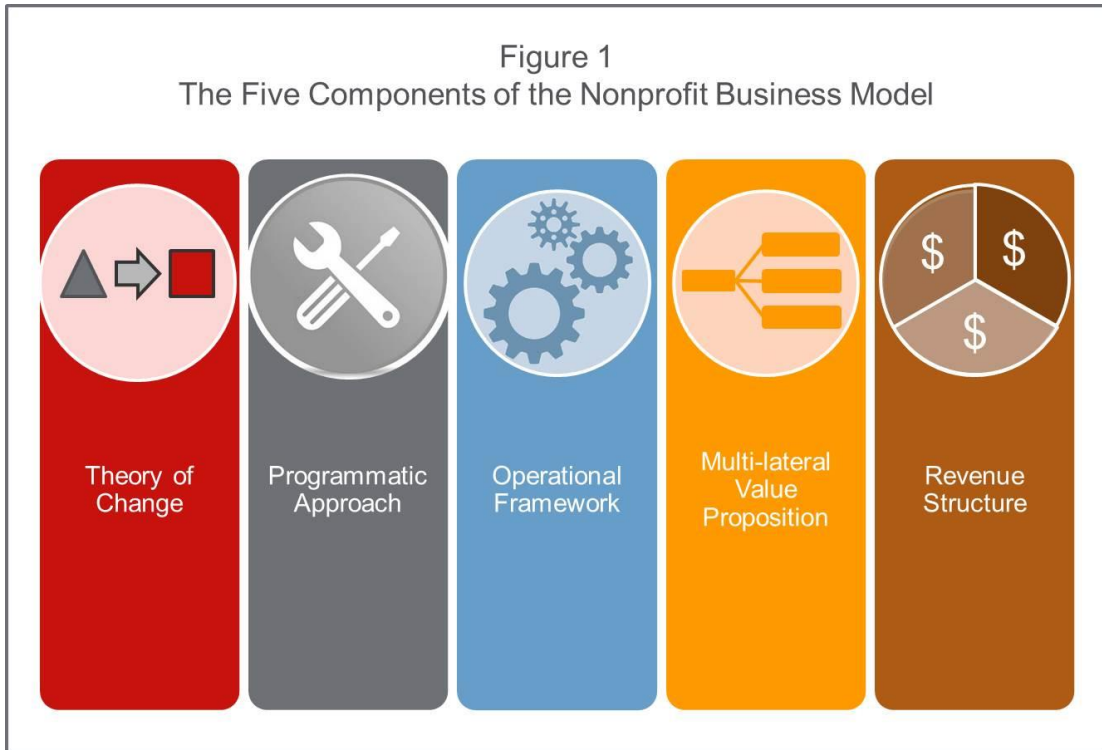
Further, soundness and sustainability of a business model are two separate traits. *Soundness* refers to the logic of the model, given available evidence and theory. *Sustainability* refers to soundness over an extended time period, and thus includes the added element of resilience to a changing environment. A *healthy* business model is logically sound, well-executed, and sustainable over time.

So, when analyzing a nonprofit's business model, we must consider three dimensions: the soundness of the concept, the effectiveness of execution, and the concept's durability.

Note also that while the definition above can also apply to for-profits, nonprofit (and social enterprise) business models have important distinguishing features.

We identify five essential components of business models, summarized in Figure 1, and discuss each below.

Figure 1
The Five Components of the Nonprofit Business Model



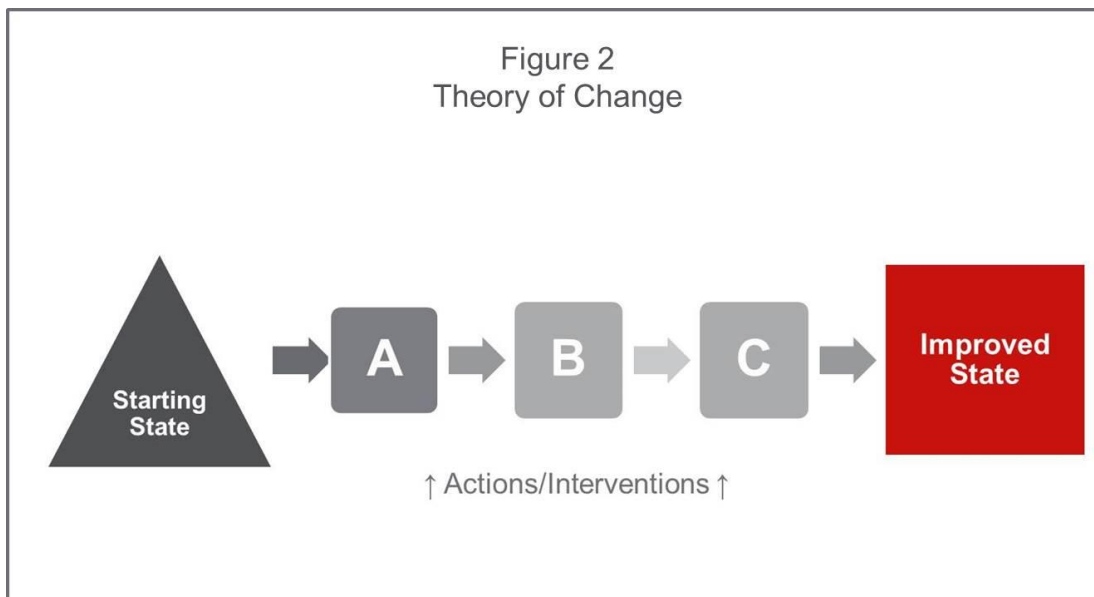
1. Theory of Change

Every enterprise has a theory of change, which is the logical pathway of how the organization will accomplish its purpose. For nonprofits in any field of work, this purpose is a tangible improvement to the world. Some nonprofits have explicitly defined theories of change, while others have theories that are either implicit or unclear.

Consider the illustration in Figure 2, an abstraction of the concept. The starting state is a set of conditions that can or should be improved, such as a community with a problem or an unmet need. A mission-based organization takes on the task of facilitating a positive change. In this case, three actions (A, B and C) are deemed theoretically necessary to effect the change, and this nonprofit will directly address one of them (A). Other actors will be addressing actions B and C, and if all three do their work effectively, the result will be an improved state.

As an example, let's picture a community with an elevated high school dropout rate. This is a problem, for obvious reasons, such as the negative impact on students' long-term prospects and the community at large, which may see higher crime rates or a diminished pool of skilled labor. Let's say we have evidence that three changes are likely to increase graduation rates: greater parental involvement in schoolwork, focused tutoring of 9th and 10th graders, and enhanced guidance counseling services. Let's create a hypothetical nonprofit, the Community Alliance for Educational Achievement ("the Alliance"). Our new organization intends to work with families to

ensure a greater number of parents take active roles in their teens' education. The Alliance will also partner with a separate community group to provide tutoring, and has a commitment from the high school to deliver enhanced counseling to high-risk students. In concept, the Alliance will do its part in concert with other necessary elements, and the result will be higher graduation rates moving forward.

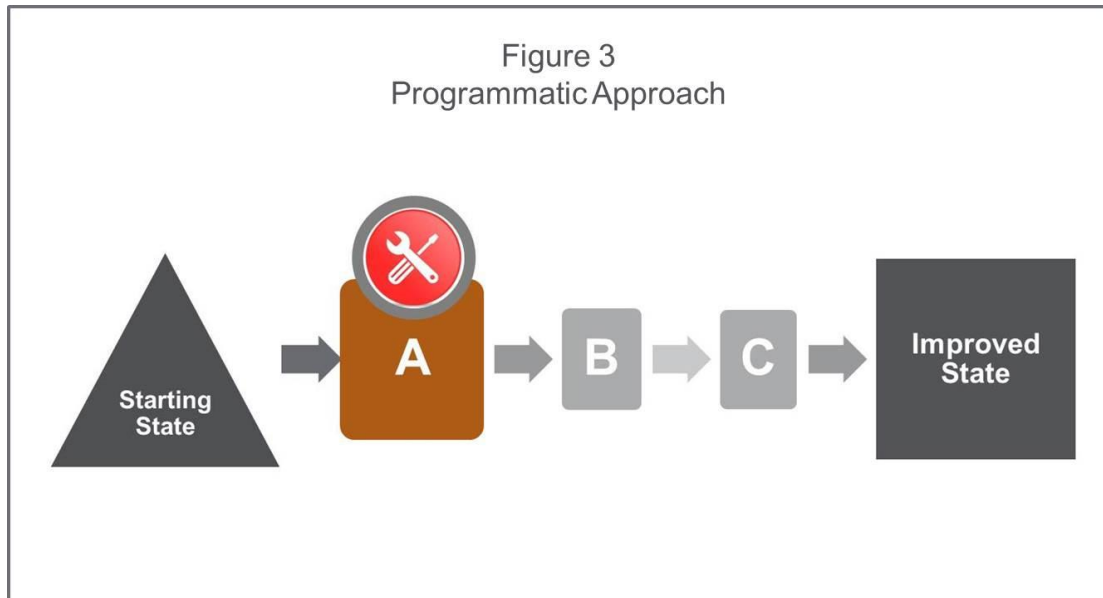


Note that the theory of change requires several conditions. Our organization does not directly control all of them, but nonetheless incorporates the big picture view into its theory of change. The theory defines this organization's focus, as well as the context of its work. The theory has a clear outcome, which is measurable.

A theory of change forms the foundation of a business model. Theories do not need to be complicated, and are often most effective if they are simple and easily explained to various stakeholders. (And the denser the logic, the harder it can be to define desired outcomes.) Theories of change should be testable; with data collected over time, the Alliance can evaluate the soundness of its theory, adjust the logic, and establish evidence, or *proof of concept*, over time.¹

2. Programmatic Approach

The next component of the business model is the general methodology for conducting the work highlighted by the theory of change. As Figure 3 illustrates, this is where element A of the theory of change gets more specific.



In our example, the Alliance’s programmatic approach is how this community-based organization will do its part, getting parents involved in students’ education. There are many ways this might, in principle, take shape. The organization’s leaders must identify one, or several, method(s) for carrying out their role. For example, the Alliance could make social workers available to consult with parents and individual students to identify and resolve distracting family problems, it may form and facilitate peer-to-peer parent support groups, and/or it may educate parents about grade-specific curricula. The Alliance’s leaders can base this decision either on evidence – there may be existing best practices backed up by research and evaluation – or, if they are pioneering a new methodology, a logical theory on why this approach is likely to be effective. Let’s assume that, after doing research on these approaches, the Alliance board decides it will form and facilitate parent support groups as its method for pursuing its mission; this approach is now hardwired into the theory of change.

Whether choosing an established or a new programmatic approach, every organization can collect data to help assess the program’s effectiveness. This data can help leadership adjust its methods in the future.

Note that since the theory of change in this example requires two other actors to do their jobs effectively, the Alliance may also need to conduct advocacy as an essential part of its scope of work, to help ensure those services are intact.

A *logic model* (sometimes confused with theory of change) is a description or graphic representation of the relationship between specific activities and outcomes, and can be useful for clarifying resource allocation for more complex programs.²

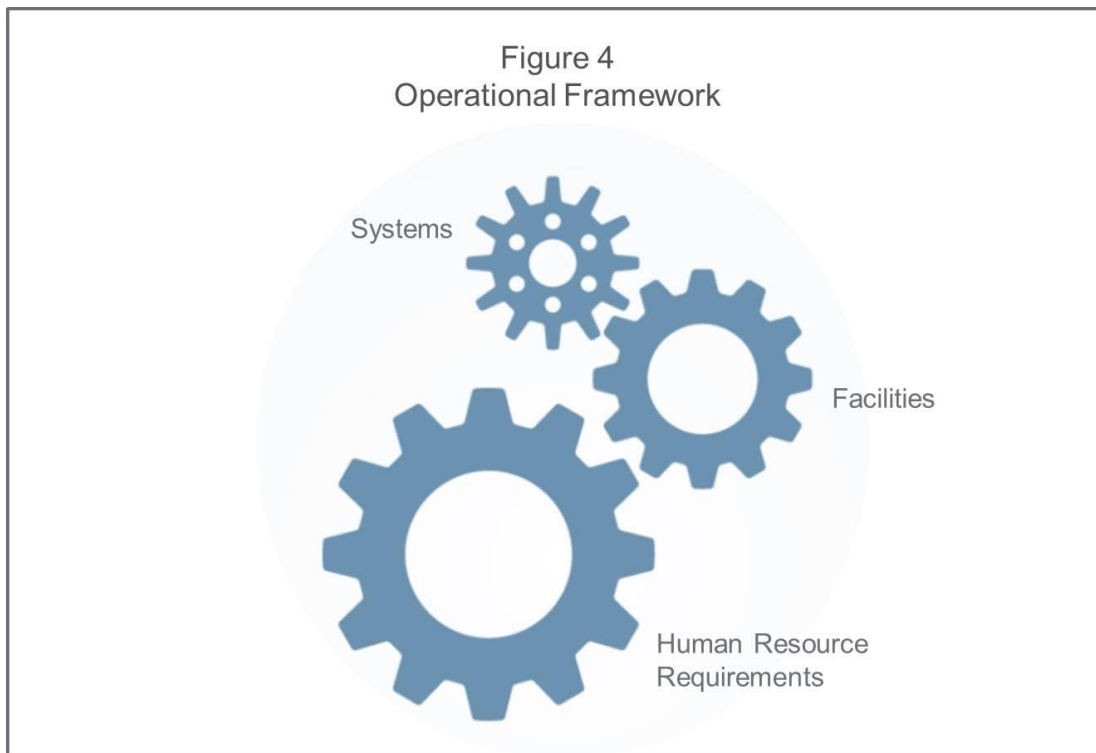
3. Operational Framework

Once the mission-related activities are determined, an organization must determine how it will conduct – or operationalize – them. The operational framework is a specification of the facilities, systems, and human resource requirements to conduct an organization’s work, which includes service delivery, revenue generation and administration. This framework is a blueprint for operating a particular organization.

Facilities may include physical space for service delivery and office functions, as well as needed hardware (equipment) and software.

Systems include policies, procedures, and other guidelines for conducting the organization’s work, which may include administrative and financial management protocols, human resource management guidelines, training curricula, service delivery practices, data management processes, data reporting formats, fund raising, sales and communication methods, board policies, a succession plan, and procedures to ensure legal compliance.

Human resource requirements include several components: an organizational structure for paid (and in some cases volunteer) staff; a structure for governance (i.e. volunteer leadership); job descriptions; selection criteria; and performance standards.



Each of the possible programmatic approaches the Alliance may have considered (see above) has its own operational requirements, and the framework will vary depending on the chosen methods. Funding sources and administrative support needs may also differ from one approach to another, and this in turn may impact the operational framework's content.

The Alliance's chosen approach requires outreach to enlist parents, a registration system, facilitators for the support groups, training for the facilitators, a documented methodology for facilitation and conflict resolution, a procedure for gauging participant satisfaction and outcomes, a method of communicating with all parties, databases to track participants, and so on. The Alliance will also have administrative requirements, such as a phone system, computers, and an office, not to mention the legal requirements of establishing a nonprofit. To pay for all this, which we may estimate will cost \$150,000 annually for the foreseeable future, the Alliance will need fundraising and/or fee processing capacity, which requires its own human resources and systems. And so on.

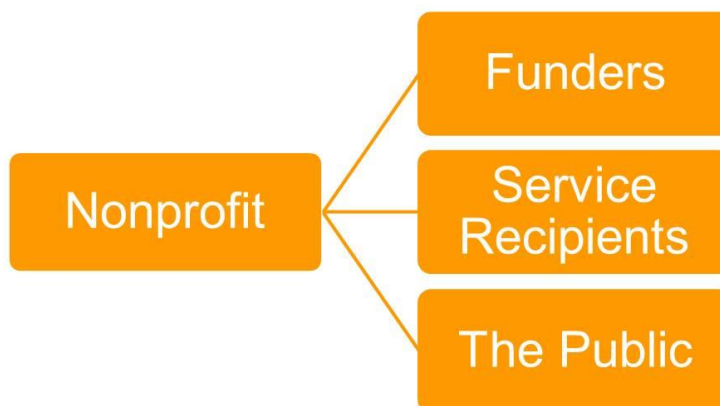
The operational framework defines the guts of a nonprofit's capacity to pursue its mission. As the blueprint is realized, operational infrastructure, administration and staffing will constitute the expense sides of a nonprofit's operating and capital budgets.

4. Value Proposition

A nonprofit can identify a need, specify how it will achieve its purpose, and define how it will operationalize its work, but it still needs the buy-in of key constituencies. The root of this buy-in is a value proposition – a mutual understanding of how the nonprofit's work will meet the needs of various parties impacted by the work.

Every successful enterprise establishes a value proposition with external parties. This is where the nonprofit business model fundamentally differs from most for-profit business models. A typical for-profit must establish mutual value with buyers of its goods or services, which are usually the consumers. A nonprofit must establish a value proposition with buyers, but since those buyers are often third parties that purchase services on behalf of recipients (who often either pay less than the full cost of services or receive services at no charge), this is only part of the picture. As Figure 5 illustrates, typical nonprofits must establish a *multi-lateral* value proposition – with service recipients, buyers (or funders), and the general public, since nonprofits' operations are subsidized through tax exemption.

Figure 5
Value Proposition



In general, nonprofits cannot succeed without clear value propositions to these groups. The business model includes articulation of these propositions, either based on tangible evidence or, for new enterprises, logical principles based on indirect evidence.

In our example, the Alliance, must establish that parents, school administrators, local donors, and members of the community (who may or may not be donors) support their chosen approach. A critical mass of parents must commit to participating in the support groups. If there are program fees, parents must be willing to pay them. If the Alliance decides to seek charitable contributions, donors must write checks. Schools must cooperate. And the general community must support the idea that high school dropout rate is, in fact, a significant problem. The Alliance can collect data (market research) to confirm intuition that this initiative will fly with key constituents.

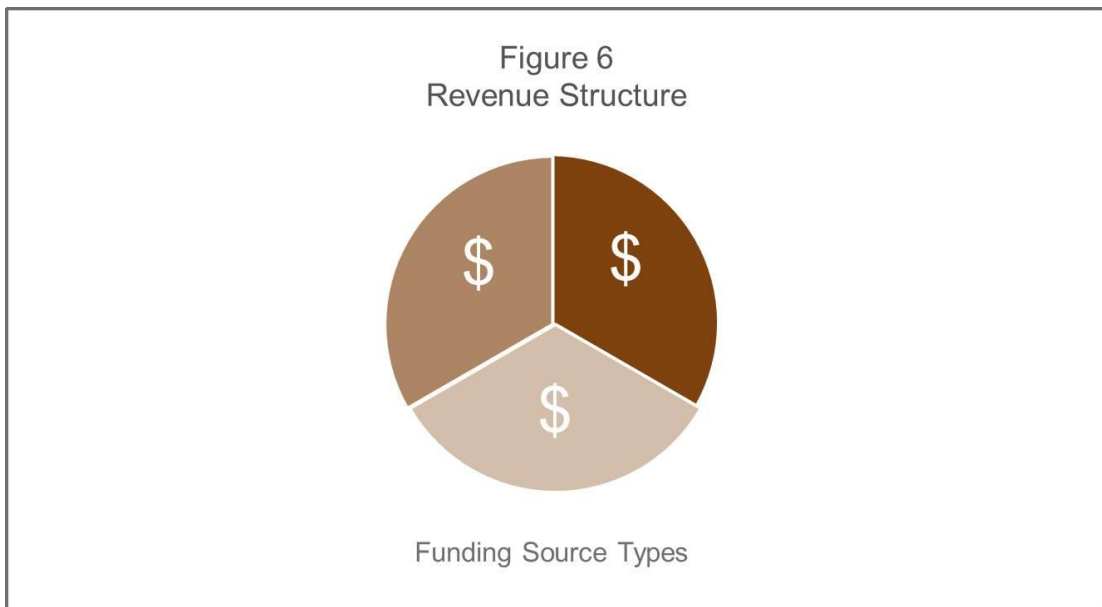
The multi-lateral value proposition is where a nonprofit establishes and maintains relevance. Conditions and priorities change, and a strong value proposition today may not be compelling ten years from now. The elements of the business model must therefore be dynamic and subject to evolution.

Once critical value propositions are established, the organization's business model is nearly complete. There is one more critical component.

5. Revenue Structure

Every enterprise must finance its operations. A century ago, many nonprofits operated on a voluntary basis, without expenses. Most nonprofits now have operational frameworks that require expenditures, and therefore revenues.

The revenue structure is essentially a pie chart, with different slices corresponding to various types of operating income sources.³ A nonprofit must offer a clear value proposition to each group represented by a slice of the pie. These revenue sources may vary widely, another contrast between nonprofits and for-profit businesses, and must ensure the organization can deliver services that will accomplish intended results. Nonprofits share a fundamental challenge: ensuring an adequate revenue structure to support both current services and growth to meet emerging needs.



In addition to clear, and possibly unique value propositions, slices in the pie chart often require different methods of securing revenues. Executing contracts with institutions, identifying paying customers, selling tickets to events, writing grants, and cultivating individual donors are common revenue-generating tasks in the nonprofit sector, and each requires separate capacities. The revenue structure therefore informs the needed operational framework, and vice versa.

Nonprofits with multiple programs have another challenge: understanding the full costs and net revenues of each program, as well as the subsidies that effectively flow between different programs. Some of which may generate internal surpluses, and others may require subsidy from profitable programs as well as fundraising. A healthy business model incorporates subsidies *by design*, and excludes activities

that may hinder success. Analysis of full costs and revenues of all activities thus supports a viable organizational strategy.

A nonprofit's revenue structure supports operational capacity and translates to sustainability over time. A healthy revenue structure will reinforce a strong ongoing financial position, as well as investments needed to update and grow capacity. Organizations that are either growing, under fiscal stress, or engaged in strategic planning can benefit from financial modeling to help clarify assumptions required for a viable revenue structure.

Our example nonprofit, the Alliance, will need to generate enough income to cover its costs – we've estimated \$150,000 per year – and maintain a balance sheet strong enough to ensure stability. In principle, the organization could charge fees to participants, request donations, or identify third parties, such as the local Parent Teacher Association or the school district, to either sponsor the Alliance or contract for services. Market research can help establish the feasibility of these sources. Let's say the Alliance has determined it can raise 50% of its needed operating capital from donations, split about evenly between local individuals and businesses, 20% through sliding-scale fee structure for participating parents, and the remaining 30% from net proceeds of a PTA event. The organization now has a revenue structure.

If the resulting pie chart is large enough to cover annual expenses, the organization is viable. If the revenue structure is robust enough to build and maintain adequate operational capacity, ensure high quality of services *and* generate consistent surpluses over time, it can support a sustainable business model.

Figure 7 summarizes the five components of the Alliance's business model.

Assessing the Business Model

In evaluating a nonprofit's business model, we can scrutinize each of the five components for validity and functionality. We can then assess the model for soundness, sustainability, and overall health.

Nonprofit leaders and their teams can evaluate the theory of change for clarity and validity – the former by determining how the theory is understood by different stakeholders, and the latter by looking at external research and thought on current best practices. Managers can evaluate the programmatic approach through measurable outcomes, for example on client and community impact, as well as achievement of results targets.

Nonprofits and their professional consultants can appraise the operational framework by determining capacity-limiting factors and stress points in service delivery, administration and generation of revenues, by way of internal stakeholder research and comparison to similar organizations in their field of work.

Figure 7
Business Model Description:
Community Alliance for Education Achievement

Theory of Change

The Alliance engages parents of at-risk teens in their children’s education, giving them skills and motivation to support students’ attendance and attentiveness to schoolwork. In combination with enhanced tutoring and guidance counseling, this will increase graduation rates, which in turn will improve students’ economic prospects as adults, while also decreasing crime in the community.

Programmatic Approach

The Alliance will engage parents by forming and facilitating peer support groups for parents of at-risk teens. The groups will meet one evening a week in each of five target neighborhoods throughout the school year. The Alliance will provide trained facilitators, who will adhere to a set of guidelines based on evidence-based practices, and adopted by the Board’s Program Committee.

Operational Framework

Human Resources: Paid contract Facilitators, an Office Coordinator, a Communication Coordinator, a Bookkeeper, and volunteer Support Group Hosts.

Governance: 12-member Board of Directors, President is volunteer CEO, committees for Finance, Development, and Program have specific oversight.

Facilities: Subleased office, phone and internet service, three computers, a contact management database, a website, hosted email, and other basic hardware and software.

Systems/Processes: HR management, staff training, accounting, client recruitment/ registration, client satisfaction surveys, and data tracking for communications, funding, and participant outcomes.

Value Proposition

Participants: Build skills, improve family relationships, and gain a support network

Children of Participants: Improve school performance and outcomes

School District: Improve graduation rates, gain esteem, and increase State funding

Funders: Enrich community, reap tax and/or public relations benefits

Community at Large: Benefit from reduced crime rate, enriched local workforce

Revenue Structure

Participant Fees (20%) · Individual Giving (25%) · Businesses (25%) · PTA (30%)

External stakeholder research can shed light on the state of an organization's value proposition to key constituent groups. Leaders and their consultants can analyze the strength of a nonprofit's revenue structure through financial modeling and market research.

A sound strategic or business planning process can tie together essential information in each of these areas, and help lay the groundwork for a healthy business model moving forward.⁴

In summary:

A *sound* business model is characterized by clarity, logical validity and tangible evidence backing up each of the five components.

A *sustainable* business model has resilience over time, assuring mission effectiveness and favorable financial performance for approximately five years or more.⁵

A *healthy* business model demonstrates soundness, sustainability and effective execution, i.e. consistent achievement of desired programmatic results and a positive financial bottom line.

Note that while our illustrative example is a small nonprofit, the concepts we describe apply equally to organizations of any size; like the Alliance, any large nonprofit will need all five components to be clear and synergistic to meet its potential.

Applied Research Findings: Success Factors for Healthy Business Models

Public Interest Management Group has conducted applied research on nonprofit management practices and organizational characteristics. Using an organizational assessment methodology called *Success Factor Analysis*, we've analyzed a wide range of variables to identify patterns of association with organizational success, which we define as a composite of programmatic performance, financial performance and growth, represented in a metric called the *Organizational Success Index*.⁶ Between 2015 and 2017, we applied this methodology to 43 nonprofit organizations spanning diverse fields of work and budget sizes, based in Oregon, California and Washington.⁷

This research sheds light on factors that contribute to business model health. We summarize selected findings here. Points below include correlation values between a given variable and the Organizational Success Index within the study population (in parentheses).⁸ The following factors show significant associations with organizational success:

Theory of change

- The degree of clarity of an organization's theory of change among key internal and external stakeholders (.5)
- The presence and strength of data demonstrating validity of the theory of change (i.e. proof of concept) (.6)

Programmatic Approach

- Definition of programmatic results in an organization's strategy (.5)
- Use of data in program development and administration (.4)

Operational Framework

- Use of quality control systems in program delivery (.4)
- Staff recruitment skill and attribute fit (.3)
- Performance accountability system clarity (.3)
- Staff-board balance in decision-making (staff direct operations)⁹

Value Proposition

- External stakeholder involvement in strategic decision-making (.3)
- Partner engagement as a core strategy for delivering on the mission (.3)
- Establishment of active channels for constituent engagement and communication (.5)

Revenue Structure

- Diversity of the revenue mix pie chart (.3)
- Renewability of revenue sources from year to year (.3)
- Intentionality in the use of internal cost and profit data for organizational activities in calibrating the mix of chosen programs (.3)
- Proportion of revenues derived from major individual donors (.4).

By contrast, our research does not reveal significant associations with organizational success for a range of other factors, for example: degree of client involvement in service delivery; issue urgency/priority in the media; level of non-board volunteer engagement; external orientation of the CEO, and proportion of income derived from program fees. Business models that rely on new, nontraditional revenue sources or include a prominent role of the board of directors in operational decision-making show significant *negative* correlations with success. Some of these research results counter conventional wisdom in the nonprofit sector.

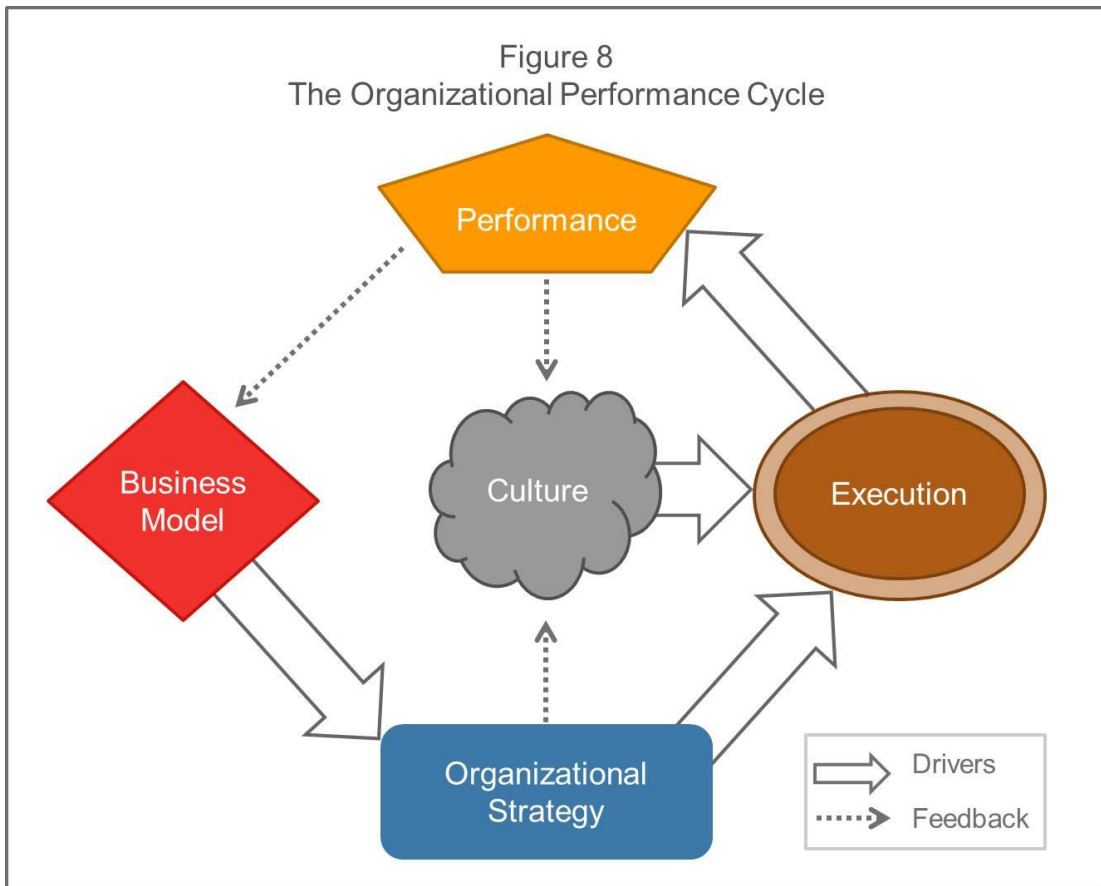
These findings suggest an emerging set of best practices for nonprofits around establishing, executing, evaluating and refining business models.

The Business Model as a Driver of Organizational Performance

A nonprofit's business model lays the conceptual groundwork for conducting the organization's mission-related, administrative and revenue-generating work. An organizational strategy that directly addresses the business model's five components can, in turn, lay the groundwork for organizational success.

Figure 8 illustrates the Performance Cycle, which starts with the business model. A business model-focused organizational strategy outlines goals and requirements for achieving them in the context of the five components. Execution is where the business model and organizational strategy are realized – a programmatic approach guides service delivery, an operational framework guides a functional, staff, board and infrastructure, and a revenue structure guides fund development activity. Execution then leads to performance, where mission and financial goals are, to varying degrees, realized.

Performance feeds back to the business model, which itself is dynamic and subject to change over time. Here the cycle begins again.



By this construct, a combination of three ingredients will lead to organizational success: (a) a sound business model, along with (b) an organizational strategy that directly addresses business model components while employing critical success factors, and (c) effective execution of the strategy, i.e. achievement of mission and financial goals.

Note the important role of organizational culture in supporting the discipline needed to execute a focused strategy.¹⁰ Organizational strategy can directly address cultural needs of the organization. Performance also impacts organizational culture, as success helps to solidify effective practices and attributes.

Strategy for Improved Performance

Every organization has a business model and an organizational strategy, whether explicitly identified or not. Many nonprofits struggle to build capacity to operate effectively, grow, and achieve and sustain success. The nonprofit business model has inherent challenges, notably the complex revenue structure required by many public benefit services in the nonprofit domain. Public Interest Management Group's research suggests that flawed business models and flawed strategy often exacerbate these inherent challenges.

This analysis supports a case that strategy for improved organizational performance should start with ensuring an organization has a sound business model, as outlined above. Once this step is achieved, strategy should follow emerging best practices. Execution justifies considerable attention from staff and board leadership, but does not by itself resolve an unsound business model. Organizations with flawed business models or strategies may succeed for short periods of time, but may be unlikely to sustain success, as it struggles with relevance or capacity in a competitive marketplace. Conversely, organizations with sound business models and appropriately focused strategies can more easily adjust to or overcome execution problems.

Nonprofit culture is often characterized by hard work and deep commitment of staff and volunteers, united by a spirit of improving the world. Many mission-based organizations struggle to meet goals and sustain performance. Nonprofits apply considerable effort to execution, i.e. their day-to-day activities, and much less attention to two essential functions with broad implications for long-term performance: defining and understanding the business model, and developing effective strategy.

This analysis suggests a clear path to sustainable nonprofit success, starting with sharp focus on the organization's business model.

Notes

¹ More detailed discussion of the theory of change concept are on the [Harvard Family Research Project](#) and [Center for Theory of Change](#) websites.

² We don't go into detail on logic models here. Resources can be found at the [University of Wisconsin](#) and [Pell Institute](#) websites.

³ A capital budget will have a corresponding pie chart, for non-operating needs.

⁴ The methods for evaluation of business model components are discussed in more detail on the [Public Interest Management Group website](#).

⁵ Public Interest Management Group defines strong nonprofit financial performance as a combination of consistent annual operating surpluses of 1% or greater, and a stable operating reserve averaging over 120 days' expenses.

⁶ For more details on the Success Factor Analysis methodology, see <http://www.pimgconsulting.com/success-factors-for-nonprofits>.

⁷ Results from the first cohort of 15 nonprofits are summarized here: <http://www.pimgconsulting.com/or-pilot-study-report>; results on the full sample will be published on [pimgconsulting.com](http://www.pimgconsulting.com).

⁸ Correlation values range from -1.0 to 1.0. Values of .5 or greater are considered large, values of .3 to .49 are considered medium, and values of less than .3 are considered small. Values cited here are Spearman coefficients. For more detail on the study methodology, see publications at [pimgconsulting.com](http://www.pimgconsulting.com).

⁹ The degree of Board involvement in decision-making has a -.3 correlation with success, supporting a "strong staff leadership" model, balanced by a policy-level board, is associated with success.

¹⁰ Organizational culture is an expansive subject and a critical ingredient of organizational success, and will be addressed in a subsequent Public Interest Management Group white paper.