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Buy to Build: Nonprofit M&A as an Impact Enhancer

Mergers among nonprofits don't have to be distress-oriented deals of survival. Rather, M&A can offer some compelling opportunities that are unique to nonprofits.

By Gil Pereg | Feb. 28, 2022

From left to right: Dr. Gil Pereg, CEO of Darca Schools; Lt. Gen. (Ret.) Gabi Ashkenazi, former IDF Chief of General Staff and Chairman of Rashi Foundation; Mr. Marc Rowan, CEO of Apollo Global Management and chairman of YRF; Ms. Danna Azrieli, chair of Azrieli Group and chair of Azrieli Foundation Israel. (Photo by Maxim Golovanov)

2021 proved to be a bumper year for global M&A, which according to Refinitiv Data, surpassed $5.8 trillion last year. The drivers, of course, differ by each deal. But one can assume, in the cases of for-profit businesses, the acquisitions are mostly strategic in nature and either create a better competitive alternative or help navigate obstacles standing in the way of future growth.

Similarly, many charitable organizations face their own competitive pressures, particularly as the number of nonprofits continues to grow and as donors increasingly demand accountability. Yet, within philanthropic circles, M&A is still generally considered an option of last resort. Mergers aren't necessarily a foreign concept among nonprofits; there are even organizations, such as SeaChange Capital, the Bridgespan Group, and others, who can play an intermediary role to help NGOs and philanthropic organizations scale their impact (not unlike a traditional investment bank or business broker). However, the financial incentives that motivate corporate sellers don't exist. In fact, nonprofit executives are well aware their jobs may be made redundant. Funders, similarly, often perceive that their board seats and influence could be put in jeopardy. These fears, which aren't unfounded, help explain why the default among philanthropies of a certain size is to view dealmaking as a tool for survival rather than growth.

As a result, M&A among nonprofits, when it does occur, tends to be countercyclical. It rises as the economy decelerates and fundraising dries up, and slows during periods of sustained economic growth, when funding may seem more accessible. It's during these "periods of plenty," when it becomes easy to overlook M&A, and instead focus on fundraising initiatives or deploying newfound resources. But it's also during these upcycles that M&A can be most effective—not as a lifeline—but as a strategic tool to engender a more pronounced and sustainable impact.

Borrowing From History's Playbook

Consolidation among nonprofits wasn't always uncommon or confined to the unfunded. At the turn of the 20th century, when the Rockefeller Foundation first sought a national charter, the effort was premised on merging the family's many charitable endeavors under one umbrella, according to the book *Beyond Charity*. The Rockefellers were effectively trying to create the Standard Oil of the philanthropic world, observed one reporter at the time.

Other captains of industry in this era were just as innovative, in part, because they applied the same business lens to their philanthropic pursuits. Take Julius Rosenwald, the architect behind the growth and success of Sears Roebuck. While he was best known for his work to help fund over 5,300 "Rosenwald Schools" across the Jim Crow South, his efforts to disrupt and reimagine philanthropy tend to be overlooked. He was an early proponent of challenge grants to incentivize other stakeholders and promote a sense of "ownership" among those he aimed to help. He also espoused a "give while you live" philosophy—a movement gaining renewed momentum today. And while less celebrated, he saw M&A as an invaluable tool to eliminate overlap and enhance the scope and capacity of like-minded organizations addressing the same or similar causes.

For instance, Rosenwald spearheaded the consolidation of Chicago's leading Jewish charities to create the Jewish Federation (FKA: The Associated Jewish Charities). According to his biographer Hasia Diner, he also sought to broker a merger between the Urban League and the NAACP to fight the disenfranchisement of African Americans on a national level. (That proposed marriage, however, never did come to pass.) The point wasn't to merge for the sake of merging but to eliminate waste and better direct resources toward an acute issue during the post-Reconstruction era.

More recently, however, M&A in the nonprofit space—if it's not already viewed as a distraction—tends to require more time and resources than many leaders believe they have at their disposal. This is a point that Christie George and Taren Stinebrickner-Kauffman highlighted in an *SSIR* article last year. The impact is that when deals do occur, they often become a last-ditch endeavor marked by "hasty and suboptimal decisions." And these deals of necessity, orchestrated at the eleventh hour, tend to produce outcomes that reinforce the negative perceptions around nonprofit M&A.

Collective Impact: M&A Lite or Collective Chaos?

It would be disingenuous to imply that nonprofits today don't appreciate the value of collaboration. And it's quite common for organizations pursuing the same cause to identify where their objectives may intersect and determine how they can best align their resources to pursue some truly ambitious initiatives. Indeed, the movement toward collective action or impact has yielded notable results.

A survey from BoardSource, for instance, found a distinct correlation between "high impact" nonprofit boards and an openness among directors to consider strategic alliances. And who can argue with high impact initiatives, ranging from rapid COVID-19 response efforts to coordinated relief that delivers aid in the immediate aftermath of natural disasters. The same BoardSource survey, however, revealed that fewer than one out of every 10 respondents had participated in a formal merger or acquisition over the previous five years.

What many fail to consider is that M&A has the power to pick up where alliances leave off. For instance, in Israel, hundreds of charitable organizations have been established to help Ethiopian Jews, a racial minority in the country who often suffer from higher rates of poverty and unemployment. While each charity is virtuous in its respective mission, the fragmentation creates challenges across the larger philanthropic ecosystem. Prospective donors confront a paradox of choice in determining which organizations may be most deserving of their gifts, while similar challenges among potential ally charities leave many unsure of who might represent the best partner.

But the bigger challenge, one that's rarely seen on the surface, is that the fragmentation can also create collective chaos. It's akin to a houseplant that receives too much water from too many people. The recipients, themselves, are often unsure of where to commit themselves with so many organizations seeking to intervene. The result is often a patchwork of aid that lacks the follow-through or accountability required to promote end-to-end outcomes.

Perhaps the most glaring challenge, at least among prospective donors, is the extent to which fragmentation translates into waste. Money, to a certain extent, will gravitate to the most efficient, well-run organizations. Still, the administrative overlap should be obvious. Through an investment lens, most private equity professionals looking at the problem and the jumble of would-be solutions would likely discern that it's an area ripe for a rollup.

Overcoming Obstacles

The caveat is that if M&A in philanthropy was easy, it would certainly be more common. The scarcity of formal combinations, beyond the deals of necessity, speaks to the heavy lift required to gain internal consensus. M&A can be intimidating for any organization, but especially for potential targets who didn't initiate the proposed combination. In the business world, the prospect of a financial reward at least provides a starting point for discussions; for nonprofits, the strategic benefits have to be glaring and unmistakable. Even in these cases, navigating a merger is less rocket science than it is behavioral psychology, as the biggest roadblocks are generally political in nature.

Funders, especially at the board level of charitable organizations, are often motivated by the opportunity to be actively involved in a cause and eager to play a hands-on role to effect positive change. Increasingly, the desire to start a foundation in the first place is viewed as an opportunity to leave a legacy and help impart an altruistic disposition to future generations. Any deal that threatens to put funders on the sideline, however strategic or impactful, won't necessarily align with the "soft" objectives often at the heart of charitable giving. Executives, of course, also recognize that consolidation can leave them on the outside looking in, and without a golden parachute so common in for-profit deals. For these reasons, just initiating deal discussions can be fraught with tension.

Assuming everyone is aligned around a common mission, these sensitivities can indeed be addressed and managed when navigated with thought and care.

The Darca Schools Case Study

Strong business sense and a knack for identifying opportunity in the combination of two organizations can go a long way. In the case of my organization, Darca Schools, for instance, the idea of a formal combination was first articulated by the Youth Renewal Fund's (YRF) board, private equity leaders well-versed in recognizing when a merger stands to optimize results.

For context, YRF was founded in 1989 in New York City as a grassroots effort to implement supplemental education programs in secondary institutions across Israel's periphery communities. Darca Schools, meanwhile, was established in 2010 by the Rashi Foundation in partnership with KIAH-Alliance Foundation and the Adelis Foundation. Similar to charter school programs in the U.S., Darca operates a network of schools in the underserved periphery communities across Israel, with an emphasis on school leadership and innovation to improve outcomes.

The premise behind the deal was multifold. For instance, at the highest level, the merger was initially motivated by YRF's challenges to sustain their supplemental programs over an extended period of time, across disparate school districts, amid teacher and administrator turnover, and as administrative priorities within each district shift from year to year. Darca's centralized management structure could provide a platform upon which YRF's programs would mature and take root, while also expanding YRF's reach as the broader network of schools, itself, expanded.

From the perspective of Darca's leadership, YRF's turnkey programs for professional development and its documented success improving high school matriculation rates offered a playbook approach that could be replicated across different schools and communities. This would allow the combined organization to accelerate and amplify the cultural change necessary to advance Darca's core mission to close the education and achievement gaps that exist between Israel's wealthier areas and the state's peripheral communities.

The deal was also motivated by awareness on each side that a formal combination could eliminate redundancies and overhead costs, while savings could be redeployed toward new educational initiatives or to expand Darca's network of schools.

While this made for a convincing case on paper, even the earliest discussions about a potential merger incorporated thoughtful planning to account for any and all sensitivities, whether they materialized or not. On both sides of the deal, for instance, were devoted directors whose contributions were integral to the growth and impact of YRF and Darca, as independent organizations. The very idea of a 20-person board, the deal architects recognized, would not appeal to anyone on either side.

Multiple layers of governance were thus created, with checks and balances, comprised of a traditional board with representation across key stakeholders as well as a general assembly and newly created roles for other valued observers to guide discrete initiatives. Through addressing these types of questions early in the process and being transparent as different scenarios were considered, we were able to create alignment around the more material goals of the combination, which was to amplify the reach and the impact of the combined organization.

A Darca school in the city of Lod, Israel. (Photo by Maxim Golovanov)

Even something as simple as branding, for instance, was carefully mapped out. Today, while Darca represents the operative organization in Israel, YRF maintained its legal independence in the United States given the brand equity it developed over the previous 30-plus years and its presence in the U.S. market. Moreover, the decision to maintain both brands reflects our desire to preserve the history of each organization and ensure stakeholders on either side wouldn't feel marginalized.

We've also taken pains to quantify and report on Darca's impact to both create accountability and also demonstrate how the combination continues to contribute to positive outcomes. Darca, since the merger, has roughly doubled the number of institutions within its network, and today runs 43 secondary schools with approximately 24,500 students. More importantly, matriculation rates increase exponentially once Darca assumes control of a failing school. The most mature programs within the Darca network, today, boast a matriculation rate of 93 percent, which is on par with many leading schools in wealthier districts, but also significantly ahead of the national average in which fewer than 50 percent of students pass the Bagrut (required for eligibility to attend Israel's post-secondary schools). To put the impact into perspective, schools new to the Darca network generally start with a matriculation rate well below the national average.

Other, unexpected benefits, also emerged over time. The scale of the combined organization had a gravitational effect as other programs with complementary missions were drawn to the Darca platform to gain both efficiencies and traction. For instance, The Azrieli Foundation integrated its Azrieli Institute for Educational Empowerment into the Darca Network, an affiliation that provides a powerful resource to reach at-risk students. The Azrieli Institute for Educational Empowerment, like YRF, also gains access to a captive audience of administrators with committed strategies to integrate these resources into the supported curriculum.

The Payoffs (Through a *Nonprofit* Lens)

If the Darca/YRF merger occurred in a corporate setting, it would be classified as a vertical acquisition, in which the combined entity adds critical components of the value chain to build out a more comprehensive and integrated offering. Horizontal deals, by contrast, might include absorbing other challenged schools and leveraging the proven Darca model and available resources to quickly catalyze change.

In either case, efficiencies are achieved through the elimination of administrative redundancies, and enhanced as the combined organization adapts best practices. Economies of scale also become more pronounced as size yields influence. This is not an insignificant consideration in education, where other stakeholders – such as unions and local governments—can either limit or facilitate the ability to effect change. And growth, of course, is inherent to any merger, but acquisitions can also streamline the path to accelerate "organic" growth in the future.

These synergies, of course, are not exclusive to nonprofit deals. They also tend to characterize the thesis behind most corporate mergers. However, other overlooked benefits are unique to nonprofits.

New funding streams. Funding stability, of course, is the primary motivator for nonprofit merger activity that occurs during periods of economic distress. For healthy and thriving organizations, however, this benefit is often amplified as *both sides* are bringing financial resources to bear. In most cases, the combined organization is able to expand its reach into new circles of influence, within new geographies, and across certain professions.

The newly constituted Darca board, for instance, enjoys deep networks extending from North America and Europe to the Middle East. The philosophy is not unlike any investment thesis in public or private markets, to eliminate "concentration" risk and proactively facilitate stability through creating a "diversified portfolio" of funding sources. Moreover, by reducing the organization's cost structure, charitable contributions go even further. This is a compelling proof point that now distinguishes Darca among prospective donors.

Cognitive diversity. While some may be dissuaded by the perceived political hurdles that confront nonprofit M&A, most also overlook the extent to which a merger can bring together accomplished leaders able to impart a more ambitious vision. Just as important, they can bring together the skill sets to execute against it.

One of the greatest payoffs for Darca has been the cross-pollination of different ideas and perspectives. The "newly" constituted board is comprised of leaders from the Rashi, KIAH-Alliance and Adelis foundations, YRF, and the Azrieli Foundation. It boasts deep experience in banking, private equity, and real estate investing, as well as expertise in law and education, and deep familiarity with the socio-economic challenges confronting families in Israel's periphery communities.

This wealth of experience was the catalyst behind the creation of a robust set of measurable KPIs tracking the extent to which the new organization is meeting expectations, and the creation of a long-term strategic plan borrowing elements from the leaders' corporate playbooks. This cross-section of different backgrounds also allows the board to make connections that wouldn't otherwise be discernible and devise new solutions that advance the collective mission.

The general assembly, too, has proven to be critical to ensure key contributors and former board members still have a venue to stay involved and reinforce governance. Other valued patrons have assumed new roles to observe and guide new streams of activities, which adds bandwidth as our ambitions for change also grow.

Innovation. Any merger will re-energize an organization and create a shared sense of excitement. This alone can stimulate action. But coupled with the resulting cost savings, administrative efficiencies, and diversity of thought, mergers provide the wherewithal to tackle the issues that may have previously seemed out of scope.

Darca, for instance, recently launched an "Educational Leadership Accelerator" to help recruit and train managerial talent. Through the rapid growth of the network, a pressing need in the market for experienced administrators quickly became apparent. In fact, it's an issue shared by schools across the country. According to a 2019 report in *TheMarker*, a leading newspaper in Israel, the State's Ministry of Education needs to fill some 600 school principal positions each year and generally faces a shortage of 200 to 300 certified administrators each September.

Accentuating this problem, approximately a quarter of new principals end up leaving the job within their first two years, underscoring inadequate preparation and training. Darca's scale, when the program is fully ramped up, should provide the resources and reach to recruit as many as 70 fellows annually and put them on a track to assume managerial responsibility within three years.

This type of program, which involves case-study driven lessons, on-the-ground job shadowing, and in-person site visits, wouldn't be possible without the combined resources and skill sets available through the partnership. The program is completely aligned with Darca's existing efforts and mission, but the upshot is that it will have a material impact on the entire educational system in Israel.

Julius Rosenwald, in discussing the philosophy behind his charitable efforts, once noted, "Benevolence has become altogether too huge an undertaking to be conducted otherwise than on business lines."

This doesn't just explain *how* he gave, but also helps to illustrate *why* his gifts were so effective. M&A isn't just about scaling an organization; deployed strategically, it's a tool to help formulate a more complete solution.

Read more stories by Gil Pereg.

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