



# **A Business Model Innovation for Nonprofit Human Services Consolidators The Practitioners' Perspective**

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*The human services industry is being disrupted, and will soon be transformed, by shifts in the technologies essential to delivering and collecting for services, and the basis on which services are purchased. This transformation of human services, and indeed of the global economy, will be driven by the implementation of 5G and its attendant technologies.*

*With increasing frequency, the strategic responses of human services providers to disruption have included greater openness to business combinations. Most nonprofit business combinations involve two providers operating in the same market seeking incremental improvements in pursuit of modest corporate goals. While these transactions are potentially useful and important in a local market, they fail to address the urgent challenges associated with nonprofit capital formation, governance, and business models. This urgency results from the existential threat that 5G poses to incumbent nonprofit providers of human services, whose prospects for survival rest on their ability to invest in new technologies while leveraging their specialized complimentary assets.*

*This essay focuses on the business model considerations relevant to nonprofit human services industry consolidators. We argue the holding company business model commonly employed by for-profit consolidators is suboptimal for nonprofits, and that an innovative network business model can yield far greater value for both the nonprofit consolidator and its affiliated service providers.*

## Part I: Introduction

**Background:** While the scale and scope of many nonprofit organizations may have little relevance to the achievement of their charitable missions, these elements are of great importance in realms such as healthcare, human services<sup>1</sup>, education, and housing. The revolution enabled by the implementation of 5G and its attendant technologies will magnify the importance of scale and scope in these industries, and potentially fortify the competitive advantages for-profit competitors derive from their superior capital access and transaction expertise.

Managements of nonprofit human services providers have struggled to contrive business models, strategies, and organizational structures suitable to the opportunities and constraints of their circumstances. Their frustrations can be attributed largely to the low-margin human services industry in which they operate, and to limitations inherent in the nonprofit corporate form. The future offers no respite as transformative technological change, new competitors, and more intense rivalry will increase industry complexity and amplify ambiguities. This essay describes an innovative nonprofit business model and strategy that enables nonprofit human services industry consolidators<sup>2</sup> to create and capture

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<sup>1</sup> The term "human services" refers to services including or akin to behavioral health and addictions, intellectual and developmental disabilities, adult and juvenile justice, low-income housing, child welfare and special and alternative education.

<sup>2</sup> Consolidators are enterprises that deploy capital in multiple transactions and view transaction execution skills as a source of competitive advantage. The business logic of consolidators is that such firms enable managers to pursue operating, technical, marketing or financial strategies not feasible for a single firm (Borys, 1987, p. 2).

extraordinary value and illustrates the performance potential of this business model by reference to a nonprofit organization whose design embodies the new approach.

The formidable challenges faced by nonprofit human services providers include shifts in the regulatory, technology and competitive environments evidenced by the emergence of value-based payments, increased pressure to adopt sophisticated client data systems with the associated complexities related to interoperability and data security, and the growing encroachment of for-profit competitors into niches historically the preserve of nonprofits. Looming challenges include providing services to an increasingly aged client population burdened by lifestyle-related chronic diseases, the integration of social determinants into healthcare practice, and the emerging focus on personalized health care enabled by the internet of things, artificial intelligence, augmented reality, polygenic scores and other emergent technological developments associated with the 5G revolution (*see 5G Changes Everything on Page 5*).

Value chains guide decisions about how organizations will create value *for customers*. They are reflected in firms' processes and the industry structure that evolves to execute them. Corporate strategy guides decisions about how an organization will create value *for itself*. Value chains and corporate strategy are distinct but interdependent. Historically, the business model adopted by nonprofit providers complemented a firm-based value chain logic in which services are conceptualized as the product of a series of coordinated activities performed sequentially by one or more professionals facilitated by the requisite support staff. This conceptualization was invited, enabled, and fortified by cost-based reimbursement schemes and payor's adoption of broad provider networks (Dafny, 2017). These elements of the historic service environment are transitioning to value-based payments and narrow networks with attendant risks for providers, prompting the search for a new provider business model.

As in other fragmented industries, turmoil and complexity have given rise to a small number of aspiring disruptors who believe their firms can deliver superior value through strategies focused on industry consolidation. This development is predictable and consistent with the evolution of other U.S. economic sectors. It proceeds from the premise that the value of firms is not fixed, but rather dependent upon the abilities of different management teams to maximize the value derived from the allocation of firm resources (Koller, T., & Dobbs, R., & Huyett, B., 2011, p. 51). Yet the nonprofit sector of the human services industry has long managed to elude the consequences of the creative destruction by which new product, process, or business model innovations replace outdated ones. Instead, the ability of certain providers to deliver superior value in the human services industry has routinely failed to dislodge entrenched incumbents. This inertia is especially regrettable in an industry where demand for critically important services for people in dire need is often unavailable due to resource constraints.

In part, the historical failures of aspiring nonprofit consolidators to overcome inertia and advance industry consolidation is due to consolidators adoption of a parent-subsidary holding company business model. Appropriated from certain of their for-profit counterparts, the holding company structure offers substantive benefits to taxable enterprises that are of limited or no utility to nonprofits. More importantly, the holding company business model for creating and capturing value is poorly adapted to the unique opportunities available to nonprofit consolidators, whose business combinations do not

typically involve a purchase price. The adoption of a better aligned nonprofit consolidation business model offers first movers the possibility of securing significant added value as the consolidation process evolves.

To satisfy consumer and payor expectations in the future while accommodating radical technological change, the sustainable nonprofit must design, adopt, and execute a business model that enables their organization to compete differently. This new business model must challenge the long-standing presumption that the firm is the relevant domain for strategic planning and replace it with a network-centric alternative. This paradigm shift is essential because in the emerging health and human services industry, *large diversified systems of interdependent providers with different assets and competencies, that address different diseases and populations by offering distinct services*, will compete with one another to create and capture value. Adoption of this next generation nonprofit business model will necessarily entail a new frame of reference for how value is created and captured, along with a new language. Neither value chain nor resource-based concepts can serve as the philosophical underpinning for this new business model, which has no parallel in the commercial world that historically has provided the framework for the strategic and organizational choices of nonprofits.

Inevitably, business model transformation is disruptive, but the benefits secured by early adopters will extend beyond positive abnormal returns and enhanced sustainability. Additionally, for the first time since Medicare and Medicaid established a “market” for human services, preeminent nonprofit human services providers will have a realistic opportunity to become national leaders as the occupants of the central position of a new value constellation.

## 5G Changes Everything

*“...The potential for data to build knowledge and knowledge to become useful information will lower the cost of delivering services at the very least, and at the very most, it will accelerate all of humanity to degrees of efficient and productive activity that were impossible during the 255 years since the dawn of the Industrial Revolution...” (Osseiran, 2016, p. 7)*

Technological progress is generally characterized as passing through long periods of incremental innovation punctuated by periods of radical disruption (Tripsas, 1997, p. 121). 5G, short for fifth-generation wireless broadband technology, will replace its 4G predecessor over a five to ten-year period that began in 2018. Heralding the emergence of the internet of things (“IOT”), 5G is a development being characterized as a general purpose technology whose significance will rival that of the printing press, electricity, and several other developments in the course of history whose profound impact on human and machine productivity has elevated the living standards of people worldwide. General purpose technologies lead to deep and sustained impacts across a broad range of industries that often redefine economies and transform societies (IHS Markit Ltd., 2017, p. 14). 5G is expected to allow the means to extend the human-dominated wireless communications of today to an all-connected world of humans and objects. Advances enabled by 5G will include not only the IOT but also big data, artificial intelligence, augmented reality, machine learning, autonomous vehicles, smart farming, and other technologies that will remake and revitalize industries including education, healthcare, energy, entertainment, manufacturing, construction, and agriculture.

Nevertheless, a survey by Accenture of nearly 2,000 technology and business executives in 10 countries suggests that many business leaders neither understand the technology nor its disruptive potential. This disconnect in company leaders’ perceptions may be attributable to 5G’s biggest impact being diffused across a range of industries and user communities, making its future value both difficult to see and hard to measure. Additionally, senior executives may be looking at 5G enabled technologies through the lens of incremental improvements to today’s businesses, rather than imagining how they could be used to reshape industries. In any event, if executives proceed on this path, it will inevitably attract new entrants and start-ups to challenge incumbent firms, culminating in a round of creative disruption, destruction, and transformation. While disruptors may be slow to gain traction in industries like healthcare and human services, once they do the race to deliver superior performance and profits will be over as soon as it begins (Abbosh, 2019).

The survival of incumbent nonprofit human services provider organizations in the 5G competitive environment will depend on their ability to invest in the new technologies, develop the technical capabilities required by the new technologies, and appropriate the benefits of technological innovation through specialized complimentary assets (Tripsas, 1997, p. 120). Given the industry’s low margins and nonprofits’ inability to issue equity, this challenge, can only be overcome by innovators armed with a business model that can produce the capital and scale essential to making the new technologies available and affordable.

**A Business Model Primer:** Research indicates that business models account for a significant portion of the heterogeneity in firms' profitability, comparable to the effect of the industry in which firms compete (Sohl, 2017, p. 32). While "business model" is a familiar term and an important concept, it became a topic of intense academic interest only in the mid-1990s. This interest was spurred by the evolution of information and communication technologies that have effectively blurred traditional industry boundaries, giving rise to firms such as Amazon, Google, and later, Facebook. Previously, the predominant corporate strategy frameworks, namely the positioning school and the resource-based view<sup>3</sup>, assumed value creation to be a supply-side phenomenon produced exclusively by the firm (and not by or with customers or suppliers). These frameworks further assumed the source of a firm's competitive advantage was to be found either in its position in the industry value chain or the firm's resources. In contrast, Amazon, Google, Facebook, and other entrepreneurial platforms have demonstrated that value creation is both a *demand-side and supply-side* phenomenon, and that value can be co-created with other participants in the ecosystem, including customers and suppliers. This change brings with it the prospect of shifting industry boundaries, new rivals and intensified rivalry, which has incentivized firms across multiple industries globally to rethink the nature of their business model, and to redesign their approach to value creation and capture (Massa, 2017, p. 75).

As used in this essay, "business model" refers to the logic of the firm, the way it operates and how it creates value for its stakeholders (Casadesus-Masanell R. R., 2010, p. 196). "Logic" and "value" are each central to the various definitions of a business model, which is distinguished from both strategy and organizational structure (Keen, 2006, p. 1). Business models establish the value-creation logic on which strategy is built, while strategy is focused on securing competitive advantage in the marketplace (Magretta, 2002, p. 89). Employing the business model as the reference point for strategy serves a dual purpose: it offers a reminder of the core logic driving value creation, and it provides a basis for building a corporate culture aligned around the approach to value that the firm seeks to adopt. Essentially, business models describe *what* the firm will do, while strategy defines *how* it will compete.

Describing "what the firm will do" was less difficult when industry boundaries were clearly defined, but many of the most successful businesses of recent vintage either disrupt existing industries or create niches that do not fit within traditional industry definitions. For this reason, business models have come to represent a new dimension of innovation, complimenting product, process, and organizational innovations as central to the achievement of the sustained abnormal returns of leading firms.

Several business model typologies have been proposed as recognition of their importance has grown; this essay adopts that proposed by Libert et al. suggesting four business model types based upon capital allocation, including (1) asset builders, whose focus is physical capital (e.g., manufacturers, real estate companies), (2) service providers, which invest in human capital (e.g., consulting firms, hospitals), (3) technology creators, which invest in intellectual capital (e.g., software, biotech), and (4) network orchestrators, which invest in network relationships (e.g., Facebook, eBay) (Libert, 2016, p. 15). The network orchestrators are distinguished in that they can provide access to any of the other asset types

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<sup>3</sup> The positioning school is prominently associated with Michael Porter and asserts that competitive advantage results from the firm's position in the value chain. The resource-based view is associated with Berner Wernerfelt and Jay Barney and asserts that competitive advantage is based on the firm's possession of resources that are valuable, rare, inimitable, and non-substitutable.

and leverage a digital platform for connectivity. Business models that succeed in the marketplace share several characteristics that include close alignment with the corporate mission, internal consistency such that all elements of the model are reinforcing and not contradictory, and sustainability. The best business models create virtuous cycles that are self-reinforcing and so create a competitive advantage over time (Casadesus-Masanell R. R., 2011, p. 101).

There is no evidence that unique business models require a unique organizational design, but it is not unreasonable to hypothesize that business models leveraging information and communication technologies will tend towards consumer-centric, non-hierarchical structures (Keen, 2006, p. 3).

Undoubtedly, transitioning a firm to a new business model is more challenging and disruptive than creating a firm's first one, and more complex still if the new model will be adopted in addition to (rather than instead of) the firm's existing business model (Markides, 2004, p. 22). Even so, business innovations are not limited to startups, and incumbent firms that unearth transformative opportunities must pursue them. This pursuit begins with the design of a sustainable business model that includes a convincing value creation logic and concludes with its effective execution (Keen, 2006, p. 5).

**Measuring, Creating, and Capturing Value:** Value in an economic context refers to the present value of a series of cash flows. Value creation as it relates to firms refers to changes in value associated with a firm's performance. Value creation is fundamental to the sustainability of all enterprises, whether for-profit or nonprofit; nonprofit organizations are distinguished from for-profits by the charitable purposes to which value is ultimately allocated.

Value creation by firms is measured by a combination of returns on invested capital ("ROIC"), growth rates, and the ability to sustain these factors over time. Understanding the contributions made by each of these factors to the value created *by each business unit of the firm* is important because this is the only way to gain the clarity necessary for strategy development and capital allocation. Clearly, not all growth is equal because some types of growth require relatively more invested capital or are less sustainable (Lawler, 2004, p. 3). For most businesses with high ROIC, increases in growth create the most value, while for businesses with low ROIC (which would include most human services businesses), improvements in ROIC create the most value (Koller, T., & Dobbs, R., & Huyett, B., 2011, p. 4). This concept is especially important in discussions of the nonprofit human services industry because nonprofit consolidators may have an extremely high ROIC while providers' ROIC is typically modest.

The logic by which firms create value has been categorized as value chains, value shops, or value networks (Stabell, 1998). The value chain logic focuses on cost drivers such as scale and utilization, and firms are rewarded for efficiently transforming inputs into products. The value shop logic focuses on value drivers such as reputation, and firms are rewarded for providing effective solutions to customer problems, essentially moving the customer from an existing status to a preferred one, with cost a secondary factor<sup>4</sup>. Value networks mediate direct and indirect exchanges between customers who wish to be interdependent. Adding one customer to a network directly affects the network value captured by other network participants. This network characteristic by which third parties benefit from economic transactions in which they are not directly engaged is termed a "positive externality." In networks,

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<sup>4</sup> Historically, there were limited advantages of scale in value shops, but substantial advantages associated with location, stemming from the need for effective communication in identifying and solving problems. Technologies such as telehealth may be changing this.



customers become a key part of the product and of the value created, and the size and composition of the customer base are critical value drivers (Stabell, 1998, p. 431).

Value chains are useful in describing manufacturing processes, but of limited utility in conceptualizing service delivery because they presume that value is produced sequentially and by individual firms. Value shops more nearly describe how health and human services providers create value, which entails an iterative process of problem definition and solution, guided by workers with specialized knowledge and expertise. Health and human services providers have been very late in their appreciation of value networks, which create value by leveraging intangible as well as tangible assets. Intangible assets in the context of value network analysis include relationships, employee know-how and competencies, the effectiveness of the organization's work groups and structure, and the trust between the people or organizations engaged in the network. These intangibles are increasingly recognized as responsible for the largest share of value creation, yet they do so through conversion mechanisms that are not fully understood and that are difficult to map directly to lines on a financial statement (Allee, 2008).

Consolidators are hybrid organizations employing multiple value creation logics, which increases complexity and consequently, the challenges faced by management. When firms with different value creation logics in dynamic environments are networked as a result of mergers and acquisitions, the complexity is further compounded. Coordination of distinct value creation logics is the task of organizational design (Stabell, 1998, p. 433).

The focus of this essay is value in relation to the alternative business models available to consolidators of nonprofit human services providers. Valuation has always been central to discussions of commercial business combinations because of its role in transaction pricing. More broadly, academics have invested considerable energy in defining the modes by which economic value is generated in commercial transactions and the various levers that contribute to acquirers' returns from acquisitions (Berg, 2005). In commercial transactions, these levers are employed during different phases of a transaction, which include the acquisition, holding, and divestment phases. Value is *captured* during the acquisition phase through superior deal making capabilities (evidenced by the negotiation of an attractive purchase price) and through decisions associated with deal structure, leverage, and related matters. During the subsequent holding period, value is *created* through the introduction of strategic, organizational, and operational improvements to the acquired company, and reductions in agency costs. During the divestment phase, acquirers attempt to capture value by leveraging their superior knowledge of the industry, its business, and the economic environment to exit at elevated valuation multiples and thereby maximize returns on invested capital.

It is important to note that transaction value may be *created* by the acquired company (e.g., by increasing EBITDA) or *captured* outside the acquired company (e.g., through increases in market multiples). The distinction between *value creation* (referring to changes in the value of an acquired company linked to changes in its financial performance) and *value capture* (referring to changes in the value of an acquired company that are unrelated to change in its financial performance) is critical to understanding the economics of business combinations. (Koller, T., & Dobbs, R., & Huyett, B., 2011, p. 3). Value creation can be generated along a continuum. On one extreme would be value generation that occurs entirely in the acquired company that would have occurred independently of the characteristics of the acquirer. On the other extreme would be value inherently linked to specific characteristics of the

acquirer, and resulting in the improved financial performance of the acquired company that could not have been achieved by the acquired company independently.

Valuation is a much-neglected topic in the assessment of nonprofit business combinations, presumably because the incremental wealth conveyed to nonprofit consolidators via affiliation entails no purchase price, and because there typically is no divestment phase. This neglect is nonetheless surprising given that consolidators commonly encourage new affiliates to expand, and this revenue expansion necessarily leads to asset growth that must be funded either by increases in debt or equity. As nonprofits cannot issue stock and are engaged in a low margin industry, nonprofit consolidators must focus on alternative avenues by which value can be created or captured and reinvested. For this reason, wealth accumulation by nonprofit consolidators may be an appropriate objective because consolidators must construct a capital structure that is appropriate to the phase of their industry's life cycle, their corporate growth strategy, and the vast uncertainties associated with technological change.

**For nonprofit providers,** the value of affiliation is *the value created that could not have been secured absent affiliation*. Nonprofit human services providers typically engage in affiliations to reduce organizational risk, advancing the nonprofit's mission, providing the enterprise or its officers with economic benefits not otherwise available, or some combination of these. Transactions are complicated by the fact that nonprofit providers have no owners, are heavily regulated, and have social objectives as well as economic ones. These complications have implications for how nonprofit control is acquired and how nonprofit governance is constructed post-closing.

For nonprofit consolidators, the distinction between value capture and value creation is of critical strategic importance. This is because the value captured through the consolidation of a new affiliate's net assets at fair value as of the closing date often exceeds the sum of (1) the present value created from operating the businesses of the new affiliate and (2) the present value of the real options portfolio of the new affiliate with respect to which the acquirer can make different strategic choices<sup>5</sup>. This outcome is the result of the poor prospective profit performance of human services providers, which stems from an industry structure that includes powerful buyers, low barriers to entry, and (with respect to nonprofit providers) high barriers to exit. Consequently, the business model and strategic decisions of nonprofit consolidators should be directed at closing as many affiliations as practical during the initial phase of industry consolidation because virtually all such affiliations entail value capture and enable wealth accumulation as of the closing date, while expected returns thereafter may be modest.

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<sup>5</sup> A real option is the right, but not the obligation, to take an action in the future. Real options of nonprofits may have significant value to a new owner because nonprofit decisions may have been guided by non-economic considerations that a new owner could make on a different basis after acquiring control.

## Part II: Business Model Innovation and Nonprofit Consolidators

Business model innovation requires, as a precondition, the ability to identify and understand topics of strategic importance, thereby enabling evaluation and reconfiguration. This Part II discusses topics pertinent to business model innovation for nonprofit human services consolidators.

**Background:** Successful consolidators of nonprofit human services providers must deliver superior solutions to critical problems confronting providers and avenues to new opportunities not otherwise achievable. This requires an understanding of the history of nonprofit service providers and the structural constraints and opportunities associated with the nonprofit corporate form.

Nonprofit human services providers deliver services related to behavioral health and addictions, intellectual and developmental disabilities, adult and juvenile justice, low-income housing, child welfare and special and alternative education to beneficiaries requiring such assistance. Prior to the 1960s, human services, to the extent available, were delivered primarily by governments and faith-based organizations. In a capitalist economy, this is evidence of market failure, referring to a circumstance in which a public good or service is not available on a scale sufficient to satisfy demand because the economic returns from providing the service are insufficient to attract private capital investment. The adaptation by the government to this market failure was legislation authorizing the incorporation of “not-for-profit” enterprises that were exempted from corporate income taxes and were authorized to solicit capital investments in the form of tax-deductible donations. These provisions were intended to facilitate an accumulation of capital by nonprofits that would be otherwise unavailable. Essentially, the role of nonprofit organizations in human services originated as a response to the absence of a market.

The modern human services industry evolved as a result of the explosion in public funding that became available in the late 1960s. Public funding over the generation that followed enabled the development of a national service capacity previously unimaginable, created in large part by nonprofit providers who combined contributions and tax-exempt financing to create the industry’s infrastructure. Notably, the advent of Medicare and Medicaid, the adoption of the CMHC Act, and related state legislation created a market where one had not existed before – ***yet nonprofits, though they had been created as an adaptation to the absence of a market, continued in their traditional role despite the changed circumstances.***

By the early 1980s, two developments with long-term implications were already apparent. The first of these was the growing involvement of for-profit competitors in the health insurance and acute care hospital spaces that operate adjacent to human services; this development invited speculation that the human services industry would evolve similarly. With healthcare and human services constituting a growing portion of GDP, the encroachment by for-profits on the historic turf of nonprofits was unsurprising, but it invited questions about why nonprofits should be exempt from tax.

The second development was the rapidly growing capital investment needed to acquire and sustain information systems, which had limited useful lives and so could not be readily financed by tax-exempt bond issues. The prospect of increasing capital intensity in the human services industry served as a reminder of the Achilles heel of the nonprofit legal form: namely, the inability to raise capital through the issuance of stock because nonprofits have no owners. This structural constraint limited nonprofit’s capital access and consequently, their ability to achieve the scale necessary to benefit from economies made possible by the technologies that altered the structure of other economic sectors. Importantly, it

also impaired nonprofits' competitive position vis-à-vis for-profits (e.g., UHS, ResCare, The Mentor Network) that had embarked upon the creation of national (and not merely regional) provider networks.

Consolidation of the for-profit segment of human services proceeds at a brisk pace, driven largely by the need to deploy vast sums of private equity capital and historically low interest rates, and the belief that value creation via scale economies in human services constitutes low-hanging fruit. It seems probable that the current focus on integrating primary care and behavioral health, and the expanded focus on personalized health care and the social determinants of health, will further accelerate growth and consolidation of for-profit providers.

Recognition and response to these threats to nonprofit's human services hegemony were, to say the least, glacial. Starting around 2010, a few of the largest and best managed and capitalized human services nonprofits began to seriously explore the role that mergers, affiliations, and acquisitions could play in achieving key strategic goals. Several of these have now closed multiple transactions, and as a result, nonprofits are beginning to develop a set of best practices.

To the extent that business combinations have been concluded in the nonprofit sector, they have been local, provider driven, and a consequence of factors such as financial distress or the retirements of founders. Future provider consolidation will be motivated by payor's growing preference for risk-based reimbursement arrangements, and by a growing awareness that nonprofit affiliations offer an unrivaled path to capital accumulation because affiliations typically exclude any purchase price. Leading this process will be consolidators designed and established specifically to capture and create the substantial value achievable through nonprofit provider consolidation. Their business models and strategies will compete to close serial transactions enabled by cultivating M&A execution as a core competency and proceeding from an awareness that value for nonprofit consolidators means something distinct from value for the providers whose control it pursues. The path to success entails minimizing the impact of nonprofit's structural barriers, maximizing the wealth accumulation potential of affiliations during the early stages of industry consolidation, and efficient and effective execution of those provider shared services capabilities that yield the greatest value added.

**Structural Constraints and Advantages of the Nonprofit Form:** Corporations are complex organizations created to conduct activities which are impossible or impractical for individuals to pursue. This complexity is evident in the fragmented human services industry where providers operate in multi-sided markets<sup>6</sup>, and despite their modest size, sometimes resemble multinational conglomerates because they are operating diversified business units of different sizes, some tightly controlled by headquarters and some akin to equal partners, in dispersed geographies with different regulatory, market and payor environments.

Structural characteristics unique to nonprofit corporations have combined to complicate the execution of nonprofit provider consolidation strategies well beyond the challenges faced by for-profit consolidators. These structural characteristics include (1) the absence of an ownership interest, which has a significant impact on corporate governance and industry consolidation and (2) the constraints on

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<sup>6</sup> Multi-sided markets are those that require industry participants to serve two or more distinct groups of customers who value each other's participation. In the human services industry, providers effectively offer a platform delivering value to two different but interdependent customers, service recipients and payors for services. Multi-sided markets are inherently complex.

capital reallocation between affiliated nonprofits stemming from the duty of obedience imposed upon nonprofit directors and officers. A third structural anomaly, also resulting from the absence of any ownership interest, is the unique economics of nonprofit affiliations. While the first two anomalous characteristics tend to impede consolidators, the latter may prove their salvation. Nonprofit consolidators' strategy and business model choices must optimize performance in the face of these structural factors, and so each is discussed in more detail below.

*Governance Absent Ownership:* As firms expand, their growing complexity results in information asymmetries between firms' directors and officers and the parties whose interests they have contracted to advance, whether owners (in the case of for-profit corporations) or the public (in the case of nonprofit corporations). While state laws impose duties of care and loyalty on nonprofit directors and officers, information asymmetries and lax oversight can enable nonprofit leaders to pursue policies whose primary purpose is to advance their private interests. These private interests may be incompatible with change of control transactions. This conduct is the focus of agency theory, a topic that has received intensive and extensive academic scrutiny, and it has been a major factor impeding consolidation of the human services industry. Indeed, agency costs are the single greatest challenge that must be overcome by an aspiring consolidators' business model.

Agency theory implies that nonprofit organizations have higher agency costs than for-profits stemming from the complete separation of corporate ownership from corporate control. In contrast, shareholders of for-profit firms have a heightened interest in monitoring and restraining their agents (i.e., directors and officers) from advancing their private interests since they would do so at shareholders' expense. As for-profit firms grow and shareholder interests become dispersed, the board of directors elected by shareholders assumes the primary responsibility for monitoring management. Effective monitoring by this second set of owner's agents is enforced with varying degrees of effectiveness by external forces including the capital markets, the commercial world's robust market for corporate control, and ultimately, by activist investors. No similar structural constraints impede the actions of nonprofit officers and directors<sup>7</sup>. The importance and complexity of effectively monitoring agents have been a primary factor in the emergence of private equity (and the eclipse of public corporations) as foretold thirty years ago by Michael Jensen (Jensen, 1989).

Further complicating the analysis of nonprofit governance is evidence that agency theory's assumptions regarding directors' and officers' opportunistic and self-serving behavior do not always accurately describe nonprofit agents' behaviors, and so exclusive reliance on agency theory is unwarranted. Stewardship theory, which depicts directors and officers as stewards driven by non-economic goals, has been offered as an alternative or supplemental view. Stewardship theory proceeds from sociological and psychological approaches to governance and views leaders as motivated by objectives aligned with those of the principals of the organizations with which they are associated. Stewards strive to satisfy needs based upon growth, achievement, and self-actualization and best fulfill these needs by pursuing organizational rather than personal agendas. Directors and officers choose to behave as agents or

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<sup>7</sup> Agency theory would suggest the absence of effective performance monitoring is a source of inefficiencies in nonprofits, resulting in significant variations between the value created by assets under nonprofit control relative to that created by the same assets deployed by private owners. Historically, regulatory impediments to the purchase of nonprofit assets by for-profit buyers have impeded efforts to arbitrage the differing valuations, but this could change as the portion of GDP consumed by health and human services increases.

stewards, dependent upon changing circumstances and their psychological motivations (Davis J. S., 1997, p. 43).

While volunteer nonprofit trustees are customarily well-intentioned, and not infrequently highly sophisticated business professionals, their lack of human services industry experience and expertise most often mean that they are best able to advise management on matters such as financing, compliance and risk management rather than engage in strategic planning, capital allocation, and performance monitoring. This trustee predilection is evident in nonprofit management's disproportionate focus on income statement (i.e., short-term) metrics as the firm's key performance indicators rather than on the balance sheet measures. Further, research indicates that the actions by nonprofit boards to redress gaps in board composition – primarily through the election of new members with the requisite expertise – take place over extended and irregular time intervals, and so these new directors tend to have limited influence relative to the dominant social-oriented coalition (Bruneel, 2017). Simply stated, the ability to judge strategic issues is a precondition for board effectiveness, and the requisite abilities change during intervals of industry transformation (Hoppmann, 2019, p. 447). Nonprofits are thereby faced with a formidable competitive disadvantage relative to their for-profit competitors (notably platform investments of private equity firms), whose boards are comprised of a small cadre of highly incentivized industry experts fully capable of assessing strategic alternatives, allocating capital, monitoring management performance, and motivated to take timely corrective actions as necessary.

Major changes in an industry's technological, economic, or political environment may render firms' existing assets and capabilities obsolete, creating strategic challenges that require the development of new capabilities and entry into new markets. These intervals of disruption demand that officers and directors alter the ways resources are deployed. Path dependencies (referring to the phenomena whereby firms persist in the use of past practice rather than more effective alternatives because policymakers are risk averse or uninformed) impede timely resource redeployments, resulting in organizational inertia that impairs firm performance. In the absence of a Chairman or other officer able to initiate change in a top down manner, a board's self-evaluation and self-reconfiguration can be thwarted by directors' and officers' self-interest (Hoppmann, 2019). It is under these circumstances, which are routinely encountered in the nonprofit segment of the human services industry, that the structural limitations of nonprofit governance have their greatest impact.

While the corporate governance structure of voluntary nonprofit organizations in the United States is not unlike their publicly-traded corporation counterparts, a more useful reference may be the private family-owned firm (Dawson, 2011). Family-owned or controlled firms play a major role in both the American and global economies. As in nonprofit organizations, profit generation is rarely the exclusive goal of family firms, which often place a high value on control, because control allows the family to pursue its private interests through the firm. Socioemotional wealth ("SEW"), is a term coined to describe the nonfinancial social and emotional needs of family members, which may include the employment of family members, enjoyment of family influence over the business, and the preservation of benevolent ties among family members (Neckebrouck, 2017, pp. 4,5). Family firms differ widely in terms of size, age, the number of family members engaged, and the extent of non-family members participation. As a consequence of this diversity, the extent of agency costs in family owned firms is a topic of interest to academics, and conclusions differ as to whether stewardship or agency theory should prevail in assessing the basis for leadership actions.

Like nonprofits, family owned firms tend to be risk averse. In the case of nonprofits, this is because non-owner decisionmakers are not rewarded for assuming risks; in family owned firms, this is because the family's wealth is concentrated in the family business. While increasing efficiency has been a key mechanism for value creation in other enterprises, family firms sometimes eschew efficiency-enhancing restructurings, such as reducing the workforce or replacing family employees due to the socioemotional costs. Further, because traditional assumptions regarding profit maximization and rational economic behavior may not apply to family firms, they confront challenges familiar to nonprofits associated with capital access, efficiency improvements, and entrepreneurial growth. To a significant degree, these common challenges are evidenced by excessive reliance on debt rather than equity to finance growth, in the case of nonprofits because they are prohibited from issuing equity, and in the case of family-owned firms because the sale of equity would weaken family control.

Succession planning is a challenge for many family firms because there may be no family members suitable or interested in leading the enterprise into the future. While the sale of the family business to a private equity firm is rarely preferred to maintaining family control, such transactions may offer a superior outcome to alternatives because this course typically allows continuity of the firm (as opposed to a merger with a competitor) and in some cases, sustained family presence in the business. In assessing fit with prospective private equity buyers, family firms place great weight on perceived goal congruence because the family's identity is often connected to the identity of the firm, and the family hopes to continue to benefit from SEW post-closing (Ahlers, 2014, p. 175). This consideration manifests itself in the family's interest in the amount of leverage to be used by the private equity firm, as greater leverage increases bankruptcy risk and limits the firm's ability to invest for the long term. If the survivability or the prosperity of the family business is at risk, then SEW may be unavailable post-closing and family members may not want to continue their relationship with the firm following its sale.

For family firm sellers, company ownership may be associated with strong emotional attachment, and so the sale of the business can be accompanied by feelings of sorrow and regret or even perceived as defeat. In such situations, the role of trust for family sellers is critical (Ahlers, 2014, p. 173).

From a private equity investment perspective, family firms represent an attractive opportunity because they often lack the necessary resources for growth (which the private equity firm can provide) and they pursue noneconomic objectives (which the private equity firm can reverse). Other common sources of value creation include opportunities to divest business units that promise limited risk-adjusted returns, and the exercise of financial engineering options previously impeded due to fears associated with a loss of control (Ahlers, 2014, p. 82).

As with family firms and their non-family counterparts, the impact of nonprofit's governance on firm performance is most evident in the context of fundamental transactions such as change of control and bankruptcy. In these situations, value destruction may result from actions by directors and officers who lack the ability to judge strategic issues or from their unchecked pursuit of self-interest, or both. To illustrate, directors and officers assessing nonprofit change of control transactions frequently suppose that similarities in the language and process surrounding nonprofit and for-profit transactions means these transactions are equivalent, when in fact the deal economics and risks are quite different. Further, prohibitions on directors and officers obtaining a private benefit from nonprofit transactions effectively require decisionmakers to weigh the possible benefits for their organization and its intended beneficiaries against costs borne by themselves. For corporate officers these costs may include the

termination of the officer's employment or reduced status; for corporate directors, the costs may include removal from the board and thereby a loss of prestige, loss of influence over the nonprofit's strategy, and loss of control over the selection of the nonprofit's directors and officers. The consequences of leaders' limited industry sophistication and conflicting interests are that nonprofit officers and directors often fail to fulfill their duties of care and loyalty.

Other factors exacerbate this bias against change in control transactions. Nonprofit's diluted governance and the absence of a market for nonprofit control or any approximation of activist investors have tended to entrench nonprofit boards and managements who, unlike their for-profit brethren, have had no cause for concern that substandard performance might lead to a takeover<sup>8</sup>. To deflect growing consolidation pressures, nonprofit managements have sometimes sought to proceed with alternatives less threatening to their private interests than affiliation. These alternatives, which include various forms of collaborations and alliances short of a change of control, result in neither improved governance nor enhanced capital access and so are of limited utility.

For the above reasons and others, executing aggressive business development programs by nonprofits will require more than just better capital access and execution capabilities: the evolution of a market for control will demand shifts in the prevailing nonprofit culture, the composition of nonprofit boards, and the practice and monitoring of nonprofit governance.

*Capital Reallocation and the Duty of Obedience:* Duties of care and loyalty are imposed upon all corporate directors and officers, but only nonprofit leaders are called upon to comply with a duty of obedience. This duty compels directors and officers to ensure that the organization's resources are deployed for the charitable purposes specified in the nonprofit's corporate charter, and not diverted to non-charitable purposes or other purposes that, while charitable, are not their nonprofit's purpose.

Nonprofit strategies centered on industry consolidation are circumscribed by the duty of obedience because capital cannot simply be reallocated between affiliated human services entities in response to changes in the marketplace. In contrast, for-profit providers can reallocate capital from less profitable services to more profitable ones. There is compelling evidence that capital reallocation by commercial enterprises is associated with superior returns, and consequently, capital allocation and reallocation decisions are at the forefront of board policymaking at for-profit providers (Marco-Izquierdo, 2015). In contrast, directors and officers of nonprofit consolidators are precluded by their duty of obedience from reallocating capital between affiliated entities (e.g., behavioral health, intellectual disabilities, child welfare, alternative education) for the purpose of generating improved returns on invested capital ("ROIC") or for any other purpose, thus magnifying the limitations on capital access implicit in the nonprofit corporate form. The design of a nonprofit consolidator's business model must recognize and accommodate this constraint on capital reallocation.

*Unique Economics of Affiliation:* While agency costs and prohibitions on capital reallocation restrain nonprofit business combinations, the economics of affiliation offer powerful incentives to the creation of business models that surmount these obstacles. **Nonprofit business combinations differ**

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<sup>8</sup> While state laws impose duties of loyalty and care on nonprofit boards, these legal standards have proven ineffective, in part because of limitations on the ability of private parties to sue, and in part because Attorneys General are reluctant to litigate against volunteers. In fact, nearly half the states permit nonprofits to adopt protections shielding trustees from liability for breaches of the duty of care.



**fundamentally from commercial mergers and acquisitions because they do not involve a change of ownership but only a change of control**, as control of assets and operations is the most valuable right that exists in nonprofit organizations because they have no owners. While nonprofit business combinations are sometimes accomplished via merger, the member substitution legal structure is more commonly employed because consolidators prefer to avoid delays related to relicensing, contract assignments, and court approval. Membership substitution transactions convey control of one nonprofit organization to another while leaving both nonprofit corporations intact. These transactions are often referred to as “*affiliations*” to contrast them with the commercial transactions referred to as “*acquisitions*” in which both ownership and control are exchanged. Notably, nonprofit consolidators executing affiliations have typically adopted the parent-subsidary hierarchical organizational structure characteristic of conglomerates executing acquisitions in the commercial marketplace.

Affiliations of human services nonprofits are typically concluded without a purchase price, although a provision in the definitive agreement often obligates the consolidator to make cash transfers to the new affiliate on the closing date<sup>9</sup>. Financial reporting of affiliations (but not mergers) pursuant to generally accepted accounting principles typically requires the nonprofit consolidator to apply purchase accounting treatment to the transaction, and so the values of a new affiliate’s assets are reflected on the consolidator’s balance sheet at their fair value as of the closing date. Nonprofit affiliations have a very different risk profile than acquisitions because affiliations are immediately accretive to net income, while acquisitions proceed based on a probability distribution of the transaction’s impact on future cash flows.

As many older nonprofits’ balance sheets include real estate assets whose book value is far less than fair value, purchase accounting treatment can have a meaningful impact on the consolidated assets and net assets reported by the consolidator post-closing. *In fact, it is not uncommon for the incremental net assets recognized by the nonprofit consolidator on the closing date to exceed the expected present value of future earnings of the new affiliate, as many nonprofit organizations are engaged in low-margin businesses.* This transaction economics, in which most of the deal value is recognized on the closing date, has no parallel in commercial M&A with important implications for the nonprofit consolidator’s strategy and business model.

The unique economics of nonprofit affiliations allow consolidators to capture value – characterized in the consolidated income statement as a contribution of the new affiliate’s net assets – *without capital investment*<sup>10</sup>, resulting in maximum ROIC. As discussed previously, for business units with high ROIC, increases in growth create the most value, and so a consolidator’s business model and strategy will enhance wealth creation by prioritizing a high volume of affiliations.

***Industry Structure:*** The structure of an industry is defined by Porter’s five forces. The nonprofit provider segment of the human services industry is characterized by low barriers to entry, dominant public payors that regulate or otherwise constrain providers’ pricing power, and high barriers to exit. The industry is highly fragmented with only a few (for-profit) national providers whose combined share

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<sup>9</sup> In that the acquirer obtains control of the Target on the closing date, these cash transfers are inter-company transactions that have no impact on the acquirer’s consolidated balance sheet – and so do not constitute a “price”.

<sup>10</sup> While investor-owned companies sometimes utilize their stock as transaction currency, effectively combining the balance sheets of the transaction participants without capital investment as occurs in affiliations, few human services provider acquisitions are structured in this manner.

of industry revenues is negligible. Services offered are largely undifferentiated, and competitive rivalry is very limited for that reason and others described below.

A broad industry analysis is beyond the scope of this essay, and so this section will focus on aspects of the industry's structure that have received limited attention elsewhere yet have (or should have) significant impact upon the business models and strategies adopted by nonprofit providers and consolidators. These highlighted structural elements include (1) the impact of provider isomorphism on industry rivalry, innovation and industry consolidation, and (2) the differing paths to value creation and capture available to nonprofit providers and consolidators.

*Provider Isomorphism:* Competitive rivalry within the human services industry is of special interest given the uncommon mix of for-profit and nonprofit providers. Many industries with structural characteristics similar to human services (i.e., numerous competitors of roughly equal size, undifferentiated products, high exit barriers) are characterized by intense rivalry, but in human services these factors are overwhelmed by the absence of excess capacity, high switching costs (especially in sectors such as residential care and special education), the culture of the nonprofit provider segment, and institutional isomorphism, each of which subdue provider rivalry.

Institutional isomorphism refers to similarities between providers' organizational structures and processes. In some instances, these similarities are merely the result of firms responding independently but similarly to industry conditions. In other instances, however, these similarities result from conscious imitation of actions taken by competitors. This imitation of products, processes, and business models is fundamental to competition in any industry. Imitation occurs because providers believe that their competitor's actions convey superior information about the future in an uncertain environment ("information-based imitation") or because they seek to maintain competitive parity (rivalry-based imitation") (Lieberman, 2006, p. 366). To the extent that innovations are diffused within an industry, not because of an independent assessment of its efficiency, but rather because the pressures exerted by the sheer number of adopters, these actions are termed bandwagon effects (Abrahamson, 1993, p. 488). Academics have long recognized that increases in the number of organizations that adopt an innovation influence the number of organizations that will subsequently adopt the innovation, whether or not the innovations are efficient, and even when the inefficiencies are recognized by the adopters. The power of the bandwagon effect explains both why technically inefficient innovations can be diffused, and (*importantly for nonprofit consolidators*) why technically efficient innovations can be rejected (Abrahamson, 1993, p. 513). Recognition of the bandwagon effect has important implications for nonprofit consolidator's business model and strategy.

Nonprofits' historical preference for smaller organizations, local autonomy and boards, and consensus-driven decision-making predisposes nonprofits to imitative behaviors (Dees, 2003, p. 27). This is especially true of nonprofit providers in the fragmented human services industry, which share identical tax status, similar organizational structures, community boards, common licensing, accreditation, regulatory and reimbursement environments, and limited access to capital.

In industry environments like human services where change is incremental, providers tend to model competitors whose resource endowments and market positions are comparable. This practice affords imitators legitimacy and can defuse rivalry and reduce the risk for individual firms. Once multiple providers adopt a certain behavior, the behavior is institutionalized and thereafter adopted by others without extensive analysis (Lieberman, 2006, p. 372). When competitors take similar actions, there is

less chance that any firm will succeed or fail relative to others, and so imitation helps to preserve the status quo. This process explains in part how nonprofits have minimized competitive rivalry and creative destruction in the human services industry, an observation supported by the dearth of bankruptcy filings by nonprofit providers, many of which are very small firms.

Over time the knowledge that rivals will imitate new products, processes, and business models lowers the incentive for any individual firm to aggressively pursue competitive advantage through innovations or otherwise. Consequently, bandwagon behavior adversely impacts service beneficiaries and the general public because it effectively reduces competitive rivalry and discourages innovation by dissuading providers from pursuing differentiation strategies. It is noteworthy that provider managements may be beneficiaries of bandwagon effects because when evaluated on their performance relative to peers, homogeneous strategies matching the behavior of rivals is a means of reducing the risk of adverse performance comparisons.

*For nonprofit providers*, business models and growth strategies in this industry environment have focused on de novo development rather than affiliation. In those rare instances when affiliations have occurred, the transactions have been opportunistic rather than strategic. The business logic guiding nonprofit officers and directors has been that the human services industry will remain fragmented and planning should continue to target incremental improvements in service cost and quality *at the firm level*. In instances in which affiliations have been the product of strategic intent, nonprofit acquirers have most often sought one or a few transactions that fortify and sustain their firm by satisfying one or more of the following objectives:

- Risk reduction through growth and diversification of the sources of clients and revenues that enable improved economies of scale and scope;
- Enhanced negotiating power with payors or added allure to donors in the local or adjacent market through increased brand status derived from being a “buyer” rather than a “seller”;
- Establishment or reinforcement of perceptions that the nonprofit and its executives are industry leaders.

In these transactions, capital accumulation has historically been a secondary factor (if a factor at all) for pursuing affiliations, because wealth accumulation has not been viewed as an appropriate policy objective of nonprofits. Consequently, affiliations in these instances have been discrete and tactical rather than strategic, and management has not sought to establish M&A execution capabilities as a core competency, two factors distinguishing “acquirers” from “consolidators.”

*For nonprofit consolidators*, provider isomorphism has presented a formidable barrier to gaining broad acceptance of the benefits of affiliation, and yet this same predilection for imitative behavior may provide powerful tailwinds once actions by a threshold number of providers legitimize and institutionalizes affiliation. In fact, this has been the industry consolidation process observed in other economic sectors where acquisition waves have been the norm (McNamara, 2008, p. 113). Such acquisition waves are led by consolidators that undertake acquisitions regularly as part of their core business strategy. These serial acquirers seek to expand their business portfolios through a routinized acquisition process guided by management teams experienced in transaction execution. While numerous studies of acquisitions indicate that acquiring firms *on average* experience null or negative

returns, these studies also find that firm and industry characteristics can affect acquirer returns. The noteworthy firm characteristic impacting returns is the number of transactions in which a firm is engaged; the noteworthy industry characteristic is the munificence of the industry in which the deals are transacted (McNamara, 2008, p. 117). This latter observation would at first glance seem to suggest that acquiring firms in the low margin human services industry could expect null or negative returns. Yet counterintuitively, the *nonprofit* human services industry is uniquely munificent from a nonprofit consolidator's perspective because affiliations typically do not entail any purchase price, and consequently there is an unparalleled ROIC comprised of the new affiliate's net assets consolidated at closing, plus the present value of the affiliate's future returns, *without any investment of capital*.

Of additional interest is the theory that firms moving early in an acquisition wave benefit from a first mover advantage. These first mover advantages are enabled by the presence of barriers to entry resulting from, for example, (1) the consolidator's superior capital access, (2) the difficulties of imitating complex transaction and integration processes, or (3) by market preemption, referring to the consolidator's ability to develop relationships with Target Companies<sup>11</sup> before others enter the market. Nonprofit consolidators that are early entrants in acquisition waves can anticipate a first mover's benefit from the early identification of superior Target Companies in the absence of competition. These benefits are offset, in part, by the significant costs imposed upon first movers related to educating Target Companies to the benefits of affiliation. Firms moving later in acquisition waves not only forfeit first mover advantages but also confront the bandwagon effect that increases competition once the wave is underway.

Nonprofit consolidators are engaged in two distinct business lines, the delivery of direct services to clients through affiliated providers, and the execution of affiliations. These two business lines involve different customers, capabilities, capital requirements, profitability, strategies and business models, and so this discussion of nonprofit consolidators' strategic considerations begins with an assessment of the affiliated providers' direct services businesses.

*Strategic Considerations of Nonprofit Providers:* Nonprofit providers deliver services directly to consumers. The strategic logic guiding nonprofit providers has been a product of the industry's stable operating environment. Contrary to the familiar narrative, human services enjoyed two generations of sustained growth between 1970 and 2010 while avoiding the forces that transformed many other industries (e.g., banking). Throughout this period, the nonprofit provider segment of human services experienced exceptionally low levels of bankruptcy and minimal technological disruption. In stable operating environments with subdued competitive rivalry, provider performance tends to be compared to their historical performance, and satisfactory comparisons are accepted as presumptive evidence of organizational health and prima facie evidence that future challenges can be successfully navigated (Thompson, 1967, p. 89). This conceptualization eschews any need for performance comparisons to competing organizations customary in more turbulent industries, and indeed, many nonprofits do not view themselves as participants in a competitive marketplace. While certain human services segments including autism services and addictions have experienced significant incursions by for-profit competitors, and the basis for billing payors has shifted from cost-based to fee-for service to value-

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<sup>11</sup> "Target Company" refers to firms that for-profit consolidators seek to acquire, or with whom nonprofit consolidators seek to affiliate.

based approaches, the provision of human services remains a highly fragmented industry yielding very modest returns on invested capital.

Few nonprofit human services providers assert their strategy delivers the low cost or differentiation necessary for the creation and maintenance of competitive advantage, and so they instead rely upon the marketplace's isomorphism and inertia to thwart erosion of their position in the service system. This absence of any clear competitive advantage may become a source of increasing concern as the adoption of evidence-based practices and value-based payment mechanisms shift the market to one in which generally accepted standards exist for comparing the value of services rendered. In this scenario, nonprofits will no longer be able to assert their uniqueness or effectiveness without compelling evidence, and so the provider's operating risk can be expected to increase materially.

For nonprofit provider managements, whose compensation is correlated with organizational revenues, the prospect of stagnating top line revenues as eldercare consumes growing portions of public funding has prompted increased entrepreneurial focus. In some instances, these growth aspirations are constrained by directors' preference to conserve scarce resources for current service beneficiaries, especially if current beneficiaries include directors' family members as is commonplace for nonprofit providers of services to people with disabilities. In other instances, management's growth aspirations are limited by concerns that increasingly competitive tactics may be perceived as empire building by other nonprofits and their boards. For the rare entrepreneurial nonprofit managements with capacity and entrepreneurial inclination, a balance sheet that can support expanded revenues, and a supportive board, the consolidator role offers a path to sustainability that no alternative strategy can match.

*Strategic Considerations of Nonprofit Consolidators:* Research indicates that fragmented industries consolidate as they mature, progressing predictably through a four-stage consolidation life cycle<sup>12</sup>. The nonprofit provider sector of human services remains in the early phase of stage one, when no one or several providers have more than a de minimis share of the market, while the for-profit sector is further advanced. Following a well-worn path, certain competitors in the fragmented, low profit, provider segment have adopted a consolidation strategy that, based upon observations of the process as it has evolved in other industries, may take as long as twenty-five years to complete (Deans, *The consolidation curve*, 2002, p. 2). To date, for-profit human services consolidators have focused almost exclusively on acquiring other for-profit providers, while nonprofit consolidators have focused on affiliations with other nonprofits. In each case, these practices have been driven by presumptions about similarities in culture and by the unique legal, economic, and procedural considerations associated with nonprofit change of control transactions.

Capital structure, which refers to the sum of a firm's debt and equity, is a critical consideration for organizations pursuing consolidation strategies. The primary objective of capital structure management is to ensure that the firm has sufficient capital to pursue its strategic objectives and to protect itself in the event of unanticipated cash flow shortfalls (Koller, T., & Dobbs, R., & Huyett, B., 2011, p. 197). Building a capital structure to support an enterprise of scale in the human services industry is a major challenge for nonprofits because they cannot issue equity. This inability to issue equity has historically left nonprofit managements without any avenue to increase net assets other than by generating annual

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<sup>12</sup> Industries have similar life cycles, characterized by Deans et al as opening, scale, focus, and balance and alliance; understanding the industry's place in the cycle should be the cornerstone of a company's business model and strategy.

operating profits (a formidable challenge given the low-margin businesses in which nonprofits are typically engaged) and by securing contributions. Affiliations provide a new path by which nonprofit consolidators can grow consolidated net assets and construct a suitable capital structure for a high growth enterprise because they combine the balance sheets of formerly independent entities.

***Effectively, affiliations are a source of capital for nonprofit consolidators, in contrast to acquisitions which are always a use of capital.***

The optimal size of any enterprise measured by revenues is a function of its available capital and the capital requirements of its product or service offerings. Consequently, capital access is a source of differentiation among nonprofit organizations and a key variable impacting corporate strategy. When the organization's volume of services, measured by annual revenues, is substantially less than optimal in relation to the available capital, a nonprofit's strategic plan should incorporate growth objectives of sufficient ambition. While de novo expansion has been the customary nonprofit approach to business development, industry fragmentations make affiliations a better alternative in many instances.

The differing economics of for-profit acquisitions and nonprofit affiliations has important strategic implications, including:

- The ability of nonprofit consolidators to generate incremental wealth from affiliations effectively makes affiliations the equivalent of fundraising. For this reason, M&A is exclusively a tactic of for-profit consolidators, but can be a strategy for nonprofit consolidators;
- Acquisitions are a use of capital and therefore constrain the consolidator's ability to execute subsequent transactions; affiliations expand the consolidated balance sheet of the nonprofit consolidator and hence are a source (not use) of capital that bolsters (rather than diminishes) the consolidator's capacity to pursue subsequent deals;
- Nonprofit affiliations are instantly accretive so long as the Target Company has positive net assets on a fair value basis, so unlike their for-profit counterparts, nonprofit consolidators escape pressures to produce enhanced returns immediately to justify a premium price. For this reason, nonprofits typically forego comparably stressful integration processes and the customary for-profit "rightsizing" in favor of policies targeting harmony and long-term benefits for Targets. This approach has the secondary benefit of advancing the prospects of closing subsequent deals, which invariably include requests from prospects to speak with the leadership of affiliates who preceded them;
- While for-profit consolidators would avoid capital intense, low margin target companies (e.g., residential services providers), it is these very targets that potentially add the greatest value to nonprofit consolidators due to the appreciated value of the Target's real estate.

### **Part III: Multi-Company Business Models**

**Background:** Nonprofit consolidators mimic business models of large commercial enterprises, and so it is useful to review pertinent aspects of three different business models and related organizational structures adopted by multi-business commercial enterprises (Baker, 2009).

Commercial enterprises in the United States have evolved from machine age to information age to knowledge age accompanied by shifts in organizational structures intended to facilitate the transition from mass standardization to efficient customization (Miles, 1997, p. 7). While small, hierarchical, single corporations organized by function (e.g., program, human resources, accounting) continue to typify the human services industry, major economic sectors of national economies are increasingly comprised of multi-business enterprises proceeding from “firm-as-portfolio” business models. This firm-as-portfolio is both a business model (i.e., conglomerate, private equity partnership, network) and an organizational form (Davis G. F., 1994, p. 552). The evolution of these business models and their various organizational manifestations offers insights and cautions for the design of a multi-company nonprofit enterprise.

During the 1920s, firms including Standard Oil, Exxon, DuPont, and General Motors pioneered the use of the multi-divisional form (or M-form) to compete in *related markets* through separate divisions. The M-form structure introduced a parent-subsidary hierarchical corporate structure in which the parent controlled strategic and decision-making processes and the subsidiaries functioned as semi-autonomous divisions whose valuation could be readily determined, thus facilitating capital allocation. The M-form also facilitated easy integration of acquisitions, enabling firms to accelerate growth. The M-form remained the dominant corporate structure of large enterprises in the United States until 1950 when the enactment of fortified anti-trust legislation limited horizontal and vertical business combinations. Thereafter, firms seeking to grow through acquisition were forced to diversify into *unrelated markets*, giving rise to the conglomerate era and the organizational structure adaptation known as the holding company, or H-form organization.

**Conglomerates - The Firm as Colossus:** The business model historically identified with unrelated diversification is the conglomerate, and the holding company is the organizational structure commonly associated with it. Conglomerates are comprised of a group of independent companies spanning several unrelated industries under common management. The enterprise is organized as a holding company and so includes a parent corporation and multiple subsidiaries that may be majority-owner or wholly owned. *The business logic of conglomerates is that risk adjusted performance is maximized by centralizing the management of businesses in unrelated industries and markets whose cash flows are negatively correlated.*

Academics have proposed a variety of taxonomies of conglomerates (Achleitner, 2008), with the strategic conglomerate being the focus of this discussion because of its similarity to the most commonly encountered business model of human services’ consolidators. Strategic conglomerates are distinguished by the greater degree of independence afforded subsidiaries, which are responsible for the day-to-day operations of their business. In the strategic version of the conglomerate model corporate directors and officers focus on a long-term, global conglomerate strategy, capital allocation, acquisitions and divestitures, performance monitoring, and the selection and coaching of subsidiary leadership (Achleitner, 2008, p. 12). As additions to the conglomerate portfolio are selected for strategic fit and intended as long-term investments, conglomerates focus on income from operations as the source of their return on investment (Achleitner, 2008, p. 17); consequently, the focus of valuation of conglomerates is the performance of the consolidated enterprise rather than the value of each subsidiary.

Parent companies typically have no operations, and so centralized corporate control functions of the enterprise (e.g., strategic planning, capital allocation, legal, tax filing, financial reporting) are performed

by a subsidiary management corporation. The execution of the enterprise strategy requires intra-company links between parent and subsidiaries, and also between subsidiaries and other subsidiaries, and so many conglomerates also have an intermediate management layer (i.e., group executives) between the corporate officers and the subsidiary's operating executives. This intermediate layer of executives oversees broadly related business lines and serves as the focal points for synergistic interactions between the operating companies. These group executives also play a role in the acquisition process because of their industry knowledge and relationships.

Internal capital markets are integral to conglomerates, and the parent company provides its subsidiaries with equity, effectively placing subsidiaries in competition with one another. The parent also issues obligated group debt to support both the subsidiaries and new ventures with promising growth prospects, and this debt is serviced by cash flows generated by the subsidiaries. The obligated group structure means that each subsidiary has access to the pool of borrowed capital that can be allocated as the parent determines. A related function of the management company is cash management, which both allows management to make available the excess cash of one subsidiary to another and also serves as a short-term financial control instrument in a conglomerate (Achleitner, 2008, p. 27).

In summary, the expected benefits of the conglomerate business model include (1) *accelerated profitable growth*, achieved through execution of an enterprise-wide strategy centered on efficient acquisition and integration of new subsidiaries, resulting in economies of scale and scope; (2) *risk reduction*, achieved by establishing a corporate veil to diminish the possibility that a bankruptcy filing by one subsidiary will result in claims against the parent company or other subsidiaries; (3) *improved capital allocation*, achieved by clarifying the value of each subsidiary and thereby facilitating the conduct of an internal capital market; (4) *lower cost of capital*, achieved by convincing lenders that the diversified enterprise presents reduced risk relative to debt placements directly to subsidiaries, and (5) *increased tax efficiencies*, achieved via transfer pricing mechanisms that associate earnings with low tax venues.

While conglomerates reduce the business risks of parent and subsidiaries, they may increase the risks of creditors and co-investors as a result of the parent's ability to control its subsidiaries. This control can be employed to impose other than market-price exchanges between parent and subsidiary or between subsidiary and subsidiary and thereby impacting the claims of minority shareholders or lenders. To overcome agency problems and to align management and investor interests, the managements of both parent and subsidiary companies receive variable compensation incentives tied in part to key performance indicators at the subsidiary level, and in part to the conglomerate's consolidated performance (the latter typically taking the form of stock options in public companies or a synthetic equivalent in private firms).

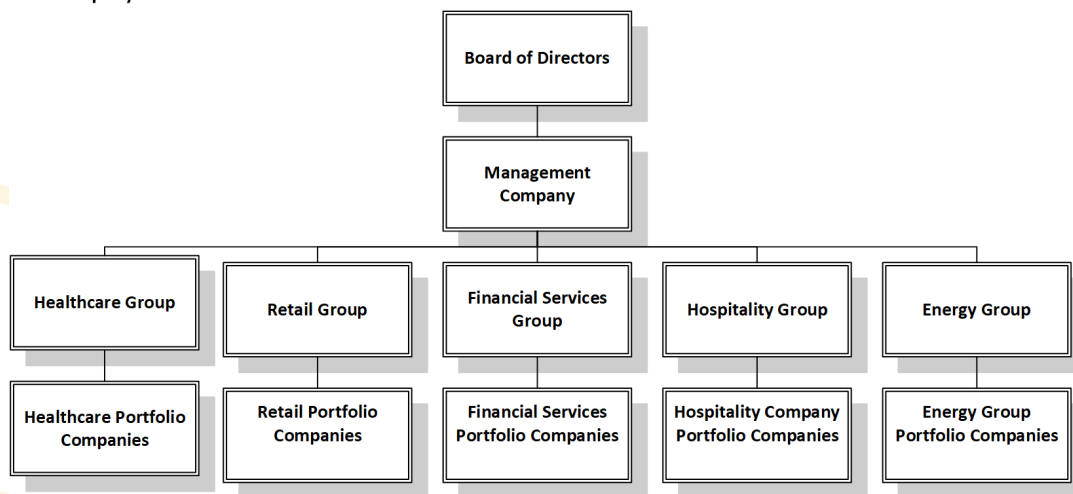
Conglomerates join under common management firms that could be operated independently, and so are justifiable only if they add greater value than any alternative (Campbell, 1995, p. 121). Conglomerates fell out of favor in the 1970s because they performed poorly when interest rates exploded, resulting in several high-profile bankruptcies. The primary disadvantage attributed to them was that their complexity hindered – some suggest precluded – directors and officers of the parent from adding value to the diversified businesses in which they invested. In the absence of clear evidence of value added by the corporate headquarters, the business logic of conglomerates collapses as shareholders can diversify their portfolios by simply holding multiple corporate securities whose returns



are uncorrelated. Wall Street subsequently has imposed a “conglomerate discount” on conglomerate equity valuations ranging from 6% to 12%.

Following the discrediting of the conglomerate business model, the “core competency” concept, which argued that multi-company businesses should be constructed around shared technical or operating competencies, gained widespread acceptance (Hamel, 1990). Still, variations of the conglomerate model are found in the United States (with Berkshire Hathaway being most prominent), and conglomerates remain a dominant business model in Asia (Ramachandran, 2013, p. 3). Warren Buffet, Berkshire’s Chairman, has argued that conglomerates offer sellers of large enterprises an advantage relative to private equity buyers because conglomerates are long-term investors that rely less on debt with its attendant risk.

The Conglomerate Holding Company Structure



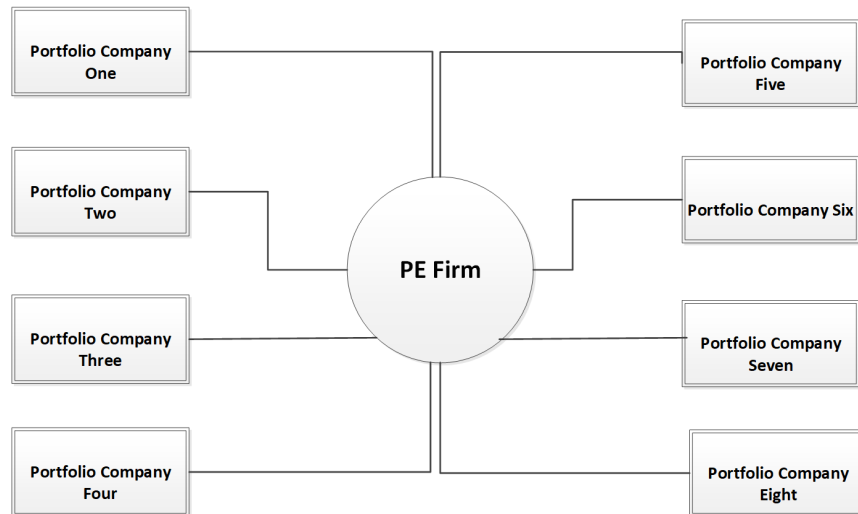
At roughly the same time that the conglomerate era in the United States was coming to a close, innovations in takeover financing, notably the emergence of high yield debt as an asset class, made underperforming or noncore subsidiaries of conglomerates potential targets for “bust-up takeovers” by corporate raiders and leveraged buyout firms, later rebranded as private equity partnerships.

**Private Equity – The Firm as Portfolio:** Private equity (“PE”), a term that includes venture capital as well as leveraged buyout firms, are professional intermediaries typically organized as partnerships, that employ capital provided by outside (typically institutional) investors, together with significant leverage, to acquire a diversified portfolio of companies. The goal of PE firms is wealth creation achieved by generating superior internal rates of return on a substantial amount of invested capital for an extended period. (Private equity partners often oversee multiple funds, and investors typically commit capital to funds for ten years, with two optional one-year extensions). The limited partnership organizational structure is chosen as a means of avoiding double taxation of income and capital gains. Limited partners (LPs) of private equity partnerships typically own ninety-nine percent (99%) of shares in a fund and enjoy limited liability, while general partners (GPs), who manage the affairs of the partnership, own one percent (1%) of shares and have full liability (and so they are organized as limited liability companies). The GPs are responsible for the selection, control, and support of the portfolio companies, which are typically limited in number and size (e.g., no single investment may consume more than 10% of the fund’s total capital available for investment).

Unlike their conglomerate counterparts, PE funds make no effort to deliver value through enterprise-wide strategies or economies of scale or scope, and their portfolio companies instead operate independently<sup>13</sup>. This is not to say that PE firms are passive investors, as they seek to add value to each of their portfolio firms by structuring deals, (including generating projections, securing financing and putting in place budgets and associated compensation arrangements), advising portfolio firms on competitive positioning, offering guidance on critical business decisions, and providing connections to the PE firms’ valuable network of contacts (Ramachandran, 2013, p. 34). **Unlike conglomerates, which focus on current income, the primary source of investment returns to PE firms is capital gains recognized upon the sale of each portfolio holding, which must be exited during the limited life of the investment partnerships, which is usually seven to ten years.**

PE funds have no internal capital market or centralized cash management function, and so debt and any additional equity financing required is arranged by each portfolio company. Indeed, the investor agreement customarily prohibits the fund from raising additional equity or debt at the fund level, as well as requiring that any profits be returned to investors rather than reinvested. The purpose of these prohibitions is to prevent fund managers from cross subsidizing firms in the portfolio. Typically, there are few if any transactions that occur between PE portfolio firms, and those that occur are transacted at market rates without the involvement of the GP.

The Private Equity Firm Structure



In contrast to conglomerates, private equity firms have flat organization charts comprised of partners, associates, and support staff. Like many law firms, there are few if any vertical reporting relationships among partners and non-partner professionals report to all the partners as a group. Further, there is no group executive management layer pursuing synergistic benefits among portfolio holdings. Instead, partners and associates tend to develop expertise in certain industries, unearth deals in that space, and subsequently serve on the board of those portfolio companies.

Portfolio firms are not wholly owned by the PE fund, which instead invests along with portfolio company executives to ensure that the interests of the two are aligned. GPs typically receive an annual management fee equal to two percent (2%) of assets under management, and a twenty percent (20%)

<sup>13</sup> As the private equity industry has matured, some participants have begun to incorporate elements of “buy and build” into their portfolios as asset prices have increased in today’s low interest rate environment.

performance fee with respect to earnings in excess of a negotiated threshold. Beyond the influence resulting from the compensation structure, PE funds also negotiate for special participation and decision rights (e.g., board seats, veto rights over specified portfolio company actions, CEO dismissal rights) deemed vital to the fund's success<sup>14</sup>.

Of note is the tendency of private equity firms to produce negative returns initially, due in part to the differing performances of fund holdings, some of which are successful, and some which underperform. This tendency, referred to as the J-curve, reflects the fact that poor performers tend to be identified early and then written down or off, while the development and execution of value-creation strategies at superior portfolio companies can require time before outsized returns are produced (Diller, 2006).

Similarities and differences between the conglomerate and private equity models are summarized below. The key issue in assessing the value added by these commercial multi-enterprise business models relates to the role of corporate management and whether and how it creates and captures value. Management must prove to investors and lenders that several diverse companies are better off under common control than they would be if they continued to act as separate entities.

CONGLOMERATE - PRIVATE EQUITY BUSINESS MODEL COMPARISON		
CRITERIA	CONGLOMERATE	PRIVATE EQUITY
Capital Structure:	Publicly-traded corporation without any requirement to return shareholder's invested capital	Limited partnership typically required to repay LP's invested capital by the 10th anniversary of formation
Acquisition Strategy:	Multiple, unrelated acquisitions seeking value creation primarily via economies of scale and scope	Multiple, unrelated acquisitions by tax efficient, limited life investment fund that treats each holding as a separate investment
Governance Structure:	Board of Directors	General Partner
Compensation Structure:	Substantial pay-for-performance	Substantial pay-for-performance; ownership of leveraged equity in the operating unit
Divestment Policy:	Infrequent (and even then, typically only of poor performers) for tax and other reasons, with agency costs often a factor	Routine and necessary as required by partnership agreements, usually within 7-10 years
Timing of Value Created:	Primarily during the Holding Phase	Primarily during the acquisition and divestment phases
Management and Control Approach:	Centralized management of continuously adjusted, enterprise-wide systems of control	Highly decentralized with substantial control systems effectively incorporated into debt instruments (i.e., covenants) via repayment requirements, reinforced by management equity participation

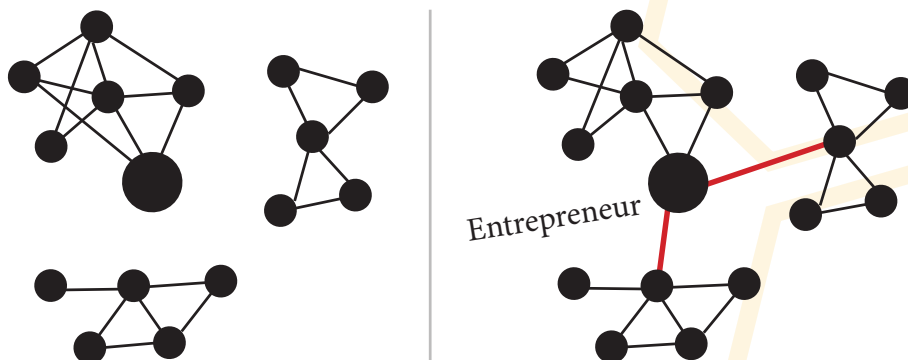
<sup>14</sup> This is not dissimilar from the reserve powers of the sole member incorporated into affiliation agreements.

**Network – The Firm as Orchestrator:** Scholars interested in strategy are fundamentally concerned with explaining differences in firm performance, but both the positioning and resource-based theories struggle to explain the phenomenon of corporate value networks that have emerged since the turn of the century. Their difficulties result from their emphasis on the individual firm and competitive dynamics, and their neglect of interconnected firms and cooperation as mechanisms for value creation (Lavie, 2006, p. 644). Firm-centric organizations that use their resources to create and keep all the value for themselves are slowly being replaced by network organizations connected by digital technologies that share value creation with network participants (Libert, 2016, p. 8).

Value networks proceed from the premise that the competitive arena has a social structure and postulate that value is co-created at the network level by reconfiguring companies’ resources, roles, and relationships. Network participants include both people and organizations in their capacities as customers, prospects, employees, alumni, suppliers, capital suppliers, peers and competitors, and so span firm boundaries. Network participants bring at least three kinds of capital - financial, human and social – to the competitive arena, and so network resources may include network participants’ intellectual property, marketing channels, facilities, personnel or other resources that are accessible because of participation in the network. Enabled by developments in information and communications technologies, interconnected firms with interdependent corporate strategies have created sustainable competitive advantage in many industries because of the “network effect.” The network effect is a phenomenon whereby a product or service gains additional value as more people use it; this contrasts with traditional businesses in which growth beyond some point leads to diminishing returns. Network partners create network effects through direct and indirect interactions with each other leading to investments in relation-specific assets, capabilities, or knowledge-sharing routines and by adopting effective governance mechanisms (Corsaro, 2012, p. 23). Governance is key because trust impacts transaction costs and the willingness of network partners to engage in value-creating initiatives.

Borrowing from social network studies, value networks (sometimes called “value constellations”) are typically described by reference to nodes (referring to the participants in the network) and the “ties” (connections between the nodes, which may be strong or weak). Receiving special attention from academics are the benefits that accrue to nodes occupying a central position between nonredundant nodes, termed “structural holes.” The structural holes hypothesis speculates that opinion and behavior are more homogenous within than between groups, so people connected across groups (at the “structural holes”) are more familiar with alternative ways of thinking and behaving (Burt, Structural holes The social structure of competition, 1992). This positioning results in people at the structural holes being more likely to have useful insights and relationships and to translate and broker these across groups, thereby offering a vision of options otherwise unseen, and new relationships otherwise inaccessible.

Structural Holes



Orchestrators functioning as brokers create value via information arbitrage in four ways: (1) the orchestrator can educate those on each side of the structural hole to the interests and difficulties of the other group, (2) the orchestrator can facilitate the transfer of best practices, (3) the orchestrator can draw analogies between groups thereby alerting each to the potential implications for their own actions, and (4) orchestrators can suggest syntheses combining distinct elements of practices of both groups. People whose networks span structural holes have early access to diverse information and interpretations that provide them with a competitive advantage in seeing good ideas. For their integrative efforts, brokers frequently receive disproportionate returns for their contributions.

While social ties are entwined with business relationships, the content and nature of interpersonal ties differ from *intra*-organizational and *inter*-organizational ties. While individual behavior impacts organizational performance, and social network science offers useful insights related to value creation in networks, it remains true that organizations with equivalent network structures differ with respect to the resources available to them and their ability to leverage those resources. Networks do not themselves act but are merely a context for action (Burt, Structural holes and good ideas, 2004, p. 354). Reach, richness, and receptivity have been offered as the characteristics that differentiate how network resources contribute to organizational performance (Gulati, 2011). Reach refers to the extent to which an organization's network connects it to others that are distant, different and diverse, while richness refers to the quantitative and qualitative value of the resources available to the organization through its ties to others, and receptivity describes the degree to which the organization can access and channel resources across the network. The interplay of these three mechanisms determines the benefits an organization obtains from its network; reach and richness together determine the *potential value* of the network, while receptivity determines the degree to which that potential value is ultimately realized. Orchestration is the capability that integrates the resources of different network participants with each other and with the orchestrator's resources, configuring and combining them to create synergies (Dyer, 1998).

The value in networks is found in the nodes. Each additional node increases network value exponentially, so as the network expands, the benefit provided to each node accelerates radically upward and fuels additional growth. Effectively, networks tap into assets – often intangible assets - previously not recognized nor accounted for by established financial reporting systems and so not leveraged for value creation. Developing and expanding the network is the core of network orchestration (Libert, 2016, p. 12). Orchestrators seek to occupy the central position in a network because network position can facilitate (or hinder) access to valuable resources, especially information, that impacts firm performance.

Building an optimal portfolio of network assets can be accelerated through business combinations, yet oddly, network literature largely overlooks how acquisitions can enrich organizational networks, and M&A literature rarely references changes in network structure as a source of synergies (Hernandez. E., 2018). When the network orchestrator is a nonprofit consolidator that affiliates with or acquires a Target Company, the consolidator's and Target's nodes collapse and the consolidator gains control of the Target's external relationships in a single transaction. Such transactions potentially benefit the consolidator's position in the expanded network (Hernandez. E., 2018, p. 1). Specifically, among other benefits, new network relationships arising from affiliations and acquisitions can be a significant factor in subsequent target selection and may lead to subsequent transactions that would not have occurred otherwise.

Affiliations and acquisitions in networks are particularly useful when resources are widely distributed across firms (as in industries such as biotech and semiconductors) or for multi-nationals (where connections to local resource providers can be essential). The latter circumstance is in many ways analogous to the circumstance of nonprofit consolidators, who must operate in multiple states and deliver diversified services to achieve scale while contending with the reality that states license and administer their health and social service system under differing state laws and regulations. Further, because multi-national companies are physically dispersed and operating in very different economic, social and cultural milieus, it has been suggested that they can be best conceptualized as a network rather than an enterprise under common control (Ghoshal, 1990, p. 604). Indeed, several authors have suggested that *the link between ownership and power in complex organizations is much weaker than often supposed, in part because, as in multinational firms, subsidiaries control critical linkages with key actors in the local environment* (Granovetter, 1985, p. 494). This same reality prevails in nonprofit networks with far reaching implications<sup>15</sup>.

Value networks can be a combination of intrafirm (relating to the relationships and processes of the controlled entities of a single enterprise) or interfirm (referring to interactions with firms not controlled by the enterprise and often referred to as “alliances”), and many value networks incorporate both intrafirm and interfirm participants. The proliferation of value networks over the past twenty years provides compelling evidence that neither ownership nor control of resources is a necessary condition for creating competitive advantage (Lavie, 2006, p. 641).

Interconnected firms create tangible benefits by increasing revenues or reducing costs in complex and varied ways. In addition to sharing costs and risks, networks can offer access to new technologies and markets, and enable the pooling of complementary skills or other resources. Intangible benefits include knowledge sharing and favors, with the former playing a critically important role in stimulating innovation (Corsaro, 2012). The value created is impacted by the structure of the network, and by the strength or weaknesses of the relationships between firms in the network, which in turn depends upon the behaviors of individuals. The important role played by individuals explains why scholars studying interorganizational relationships have focused much attention on the science of social networks and especially on structural holes and its relationship to brokerage and innovation.

The value created by a network is not captured equally by network participants. As a result, assessments of the benefits of network participation are typically described from three perspectives: the single actor (referred to as the focal company) and its interaction partners (referred to as the dyadic level), and with other companies in the system (the network level). The allocation of network benefits is largely a function of contributions made by each to creating and sustaining a network competitive advantage. The source of competitive advantage in networks may be relation-specific assets, knowledge-sharing routines, complimentary resources or capabilities, or effective governance (Dyer, 1998, p. 660).

Consolidators functioning as orchestrators seeking to maximize their value network adopt strategies intended to attract those organizations that will build competitive advantage. One framework for assessing the suitability of prospects categorized them as doubters, seekers, and believers (Corsaro,

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<sup>15</sup> Essentially, the de jure control conveyed to nonprofit consolidators as a result of their affiliate’s adoption of amended by-laws does not always equate to de facto control. This reality is sometimes discovered only after much value has been destroyed.

2012). Doubters operate virtually independently of the consolidator and its network and do not require nor plan to contribute system resources. Their interest in network participation is primarily driven by expectations of cost reduction, convenience, or reputational benefits. Seekers have closer links to the consolidator's network than doubters while maintaining ties to organizations not associated with the consolidator's network. They intend to exchange crucial resources to the consolidator or other network participants while linking the consolidator's network to their pre-established relationships. Believers are committed to the consolidator's network. They have limited activities or links to actors outside the network and expect to deliver to (and to obtain from) the network resources crucial to their future. Often, their activities compliment and resemble those of the consolidator as network manager.

Doubters add little value to the network apart from contributions associated with scaling infrastructure. Seekers add considerable value to other network participants because of the new resources they mobilize, the increased volume of business they conduct through the network, and the influence they exert over others to join the network. Believers are entrenched in the network because of the value they perceive that they receive, and consequently, the consolidator's transaction costs associated with believers is far lower than those incurred with other network participants. Further, believers are far more likely than doubters or seekers to extol the virtues of network participation with potentially significant impact on network growth and value creation. Few networks are homogeneous groupings of doubters, seekers, and believers and consequently consolidators must adopt a portfolio approach that endeavors to minimize or convert doubters and establish an optimal mix of seekers and believers, while continuously monitoring how the participants and the actors within change their status over time (Corsaro, 2012, p. 37).

Ultimately, consolidators do not automatically gain network resources merely by investing in network ties, and in fact, they incur substantial costs because the network relationships entail substantial maintenance costs. Rather, networks succeed or fail compared to firms with more traditional business models because their leadership team thinks differently about the sources of value and how that value is created and captured. To illustrate, the resource-based view would advocate protecting, rather than sharing, proprietary know-how that might contribute to sustainable competitive advantage, while network management presumes such information should be shared across the network. Similarly, managers adopting the industry structure view would seek to maximize the number of its suppliers to increase the firm's bargaining power and profits, while the network perspective would instead adopt the norm of limited supplier relationships with the goal of increasing the incentives for suppliers to share knowledge and make specific network-enhancing investments. The benefits actually created by network business models for consolidators are a function of the resources that network participants can furnish and the consolidator's ability to absorb and leverage them (Gulati, 2011, p. 219).

**Prototypical Nonprofit Consolidator's Business Model:** Business models have an important impact on a firm's profitability, growth, and value, and consequently, a routine assessment of the performance of a consolidator's business model is critical. Nonprofit consolidators create value in substantially different ways than commercial consolidators because the bulk of nonprofit value creation often occurs on the closing date when affiliate net assets are conveyed to the parent, and not thereafter as a result of post-transaction improvements to operating cash flow. This different economics would suggest that the prototypical nonprofit consolidators' business models would differ materially from their commercial counterparts, but that has not been the case historically. Instead, nonprofit consolidators' business

models have mimicked that of commercial firms and so have failed to leverage nonprofits' unique business combination economics.

With few exceptions, nonprofit consolidators have adopted the holding company organizational structures typical of conglomerates. Holding companies facilitate the delegation of operational control while allowing centralized strategic control and back office integration across business lines and geographic markets. This structure facilitated the domination of large industrial enterprises in the era when the value chain entailed a sequential production process to maximize efficient production of a uniform output, and management's task was to build scale to maximize profits and create barriers to entry. In addition, holding companies in commercial settings benefit from important tax advantages in that profits and losses of subsidiaries can be offset when filing consolidated tax returns.

The holding company business model of nonprofit consolidators includes a parent company that controls multiple, separately incorporated affiliates. Control is typically established through the designation of the parent company as the sole member of the affiliate in the affiliate's amended corporate by-laws. Typically, these by-laws grant the sole member the power to nominate, elect and remove the officers and directors of affiliates, which is necessary and sufficient to establish control under GAAP, and therefore, consolidated financial reporting. A hierarchical administrative structure centralizes power and authority at the parent level. The governance of nonprofit human services consolidators typically includes a single inside director (the CEO) and often, two sets of elected volunteer directors: (1) those that pre-date the implementation of the consolidation strategy, some of whom may have a relationship to service consumers, and (2) directors elected to the board subsequent to adoption of the consolidation strategy, in some instances pursuant to the provisions of agreements with affiliates.

A summary description of the prototypical nonprofit business model is presented below.

**Value Proposition:** The prototypical nonprofit consolidator's offering to Target Companies focuses on delivering more and better services to the Target's consumers, while reducing the Target's risks and operational burdens, in exchange for corporate control. The offering impacts service delivery through improvements to Target Company's processes, enhanced information systems, access to marketing resources, and expanded sources of consumer referrals. Risk reduction is accomplished by providing enhanced access to credit facilities, consolidation of administrative services, and by offering revenue diversification opportunities in connection with the Target's integration into the consolidator's continuum of care. Operational burdens are eased by affording new affiliates access to the consolidator's superior technology and infrastructure that enhance the quality and reduce the cost of client services. Cash transfers in these affiliations are still uncommon, in part because parent company directors and officers prefer to conserve resources for the affiliate with which they have historically been associated. Employment agreements with the Target CEOs are common, and frequently incorporate compensation, retirement, and severance benefits substantially superior to those in place pre-closing.

**Customer Segments:** The market focus of the prototypical nonprofit consolidator includes retiring chief executives of local or regional nonprofits, and to a lesser degree, CEOs of nonprofit providers experiencing financial distress. Targeted Companies' revenues are typically not more than 30% of the consolidator's revenues, and the Target's service lines usually include a core service of the consolidator. Target Companies with unionized workforces are invariably excluded. To a large degree, the acquisition



criteria of the prototypical nonprofit consolidator are designed to conform to conservative versions of their commercial counterparts and are assessed on a similar basis to allay concerns of those directors perceived by the consolidator's CEO to be most risk averse.

**Customer Relationships:** Consumers of the Target Company's services are the strategic focus of the prototypical nonprofit consolidator, and not the Target Company itself, so nonprofit consolidators would prefer merger to affiliation absent other considerations that preclude it<sup>16</sup>. Consumers are the focus because nonprofit consolidators have aspired to create a comprehensive continuum of care offering better coordinated services to consumers. This aspiration has caused nonprofit consolidators to view Target Companies as intermediaries - and ideally, temporary ones - between the Parent Company and the Target's consumers. This conceptual framework proceeds from premises that include: (1) all services will ultimately benefit from common branding, (2) operating multiple, separately branded (and possibly, competing) services following multiple affiliations within a single regional market will be inefficient and unworkable, and (3) maintaining multiple corporations and boards is complex, costly and unwieldy.

**Channels:** In the nascent market for nonprofit control there are no standard channels through which aspiring consolidators can inform Target Companies of their interest in affiliation; consequently, transactions are typically initiated by the consolidator's officers or directors via established relationships with their counterparts at the Target Company. Secondary channels include professional services firms (especially law and accounting firms who focus on nonprofit human services providers) and public agencies (especially concerning Target Companies experiencing financial distress). More traditional deal sourcing resources are unavailable as nonprofit transactions are typically too small to elicit the interest of investment banks or other intermediaries routinely involved in for-profit transactions. Several foundations or foundation-supported "facilitators" have emerged to fill this role, but the limited availability of specialized brokers and of the brokerage fees that fuel commercial M&A has impeded the evolution of a market for nonprofit control.

**Key Activities:** The prototypical nonprofit consolidator focuses on four activities: (1) Target Company identification, (2) transaction execution, (3) Target Company integration, and (4) post-closing strategic planning. Transaction execution entails the completion of a due diligence process, deal structuring, and preparation of legal documents. Integration of the Target's information, accounting, and human resources systems are key activities post-closing as the consolidator crafts a process by which the new affiliate's services can be incorporated into the consolidator's strategy and service continuum.

**Key Resources:** Nonprofit consolidators are typically long-established organizations (or outgrowths of such) that have accumulated net assets in excess of current requirements and have substantial unused debt capacity. Not infrequently, they are led by a recently engaged and entrepreneurial chief executive officer mindful of the correlation between CEO compensation and annual revenues. Effective pursuit of consolidation strategies requires both capital and execution capability, and larger nonprofits typically can claim to have at least one of these, while smaller nonprofits rarely possess either.

**Key Partners:** Due diligence is typically conducted by in-house personnel augmented by outside counsel, and occasionally, by contractors who specialize in financial due diligence. A special board committee

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<sup>16</sup> In many instances, other considerations do preclude merger as the means by which control is acquired, but merger remains a longer-term objective.

often monitors the process. The role of outside counsel is of critical importance. They are often selected for their commercial M&A experience, but their limited familiarity with nonprofit law, economics, and transaction processes can delay the closing of transactions, thus making experience with nonprofit transactions highly valued by clients.

**Revenue Streams:** Growth and diversification of top line revenues is a major driver of consolidator's strategy, and executive compensation is an additional consideration, as nonprofit executive compensation is correlated with gross revenues (Steven Hall & Partners, 2018, p. 5). The consolidation of the Target's net assets is a secondary consideration for the prototypical nonprofit consolidator if a consideration at all. Growth targets of consolidators are typically conservative, with annual growth rate targets of 10%-20% and balanced between affiliations and organic expansion; consequently, it is unusual for nonprofit consolidators to close more than two deals in a twelve-month period.

**Cost Structure:** The transaction costs of nonprofit consolidators are typically minimal compared to the net assets contributed to them by the Target Company on the closing date. While additional integration costs are incurred by consolidators post-closing, these marginal expenses may be offset in part by the annual reduction in the fixed costs allocated to existing affiliates as the Target's operations absorb their proportionate share of the overhead burden.

**Critique:** By focusing on revenue growth and diversification rather than increasing net assets, the business model of the prototypical nonprofit consolidator fails to redress nonprofits' single greatest structural impediment, inadequate capital access, while its strategy fails to overcome the nonprofits' single greatest competitive challenge, low margins. As a result, nonprofit consolidators have failed to create any source of sustainable competitive advantage. Further, the modest annual revenue growth rates and deal volumes targeted by consolidators fail to recognize that industry consolidation offers opportunities during the current phase of the industry's life cycle that are, by definition, transitory. This plodding pace of transactions impedes management's development of distinctive competencies in deal execution that might serve as a foundation for competitive advantage. Lastly, the incorporation of de minimis performance-based compensation for executive teams is incongruent with a growth strategy focused on business combinations because absent such incentives, growth offers nonprofit executives added risk and more work without commensurate reward. Consequently, key elements of the prototypical consolidator's business model and strategy are incongruent with both the internal and external environments in which consolidators operate.

To a considerable degree, the shortcomings of nonprofit consolidators' prototypical business model are an outgrowth of the mistaken assumption that the future of the human services industry will resemble its past, and therefore, an incremental strategy focused on service beneficiaries rather than target companies is appropriate. The obvious, pervasive impact of evolving information and communications technologies ("ICT") on the business models of enterprises in other segments of the economy makes this assumption bewildering, and suggest that in the nonprofit human services industry segment, business model innovation must precede the adoption of ICT, rather than the reverse.

Nonprofit consolidators have mimicked the conglomerate business model and holding company organization structure of commercial firms because conglomerates' greater experience is presumed to convey superior information about the optimal multi-business corporate structure. Yet unlike their commercial counterparts, nonprofit consolidators targeting affiliations with human services providers almost always focus exclusively on domestic markets, and operate on a vastly different scale, with tax

considerations playing little or no role in decision-making. Further, the holding company structure conducive to change of ownership transactions concluded at the highest price contributes no added value to change of control transactions concluded on an entirely different basis. Indeed, it can be assumed that the prospect of becoming one of several semi-autonomous business units whose strategy and financing are controlled by a parent appeals primarily to Target Companies for whom no alternative course is available. Perhaps most damning is the acknowledged difficulties experienced by hierarchical organizational structures with coordination and communication between businesses under common control, and their lack of flexibility and innovation. These very shortcomings have contributed to the evolution of network-based business model alternatives that are replacing hierarchical organizations in many segments of the commercial economy.

While the fragmented structure of the human services industry has provided a stable operating environment for nonprofit providers and perpetuated the interests of their boards and executives, there have been growing demands for systemic change from industry stakeholders. These critics point to the industry's unsustainable cost curve, slow adoption of technologies broadly available in other industries, and a dearth of innovation in the face of these shortcomings as the basis for their dissatisfaction. Business model innovation (BMI) differs from product or process innovation in that it relies upon an entrepreneurial spark (rather than research or scientific breakthroughs) and its adoption always entails radical (rather than incremental) change in the fundamental characteristics of a business (Bereznoy, 2015). Industry transformation resulting from business model innovation, and the difficulties it portends, is key to why BMI can serve as a basis for sustained competitive advantage.

Business model innovation for nonprofit consolidators requires a rethinking of who the customer is, how the customer is identified and solicited, how value is created and captured, and by whom. Ideally, the new formulation yields a defensible competitive advantage while generating virtuous cycles that strengthen elements of the business model at each iteration.

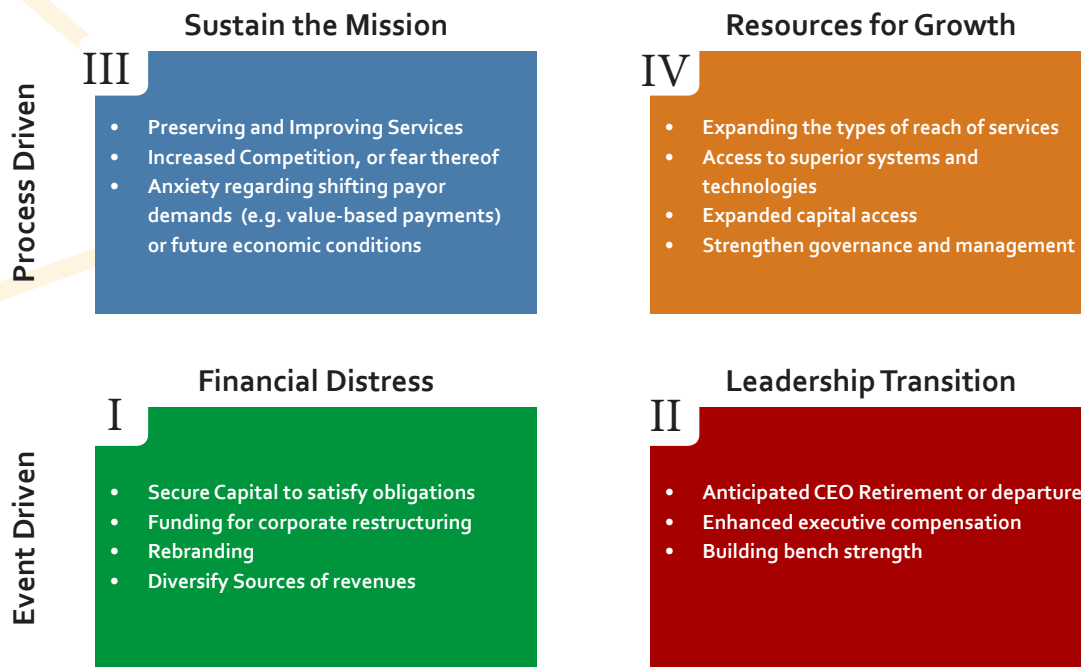
#### **PART IV: Constellation: A Business Model Innovation**

**Background:** Business model innovation is the elusive path to outperformance in industries in which product or process innovations and competitive strategies are easily imitated, and sustained competitive advantage is elusive (Lindgardt, Z., & Reeves, M., & Stalk, G., & Deimier, M., 2009, p. 2). The strategic insight that an acquisition wave is on the horizon for providers of human services is useful for business model innovation only insofar as it is accompanied by a new logic addressing how the firm will operate to create and capture value under new competitive pressures. This business model innovation must redefine some combination of the industry's prevailing definitions of who is the customer, what challenges they face, what product or service offering they need and want, how will the firm generate revenues and profits, and consequently, how capital will be redeployed. Only once these new parameters are defined can attention be productively focused on strategic and tactical issues related to how the firm will be governed and managed, what market segments will be targeted, which policies adopted and in which assets the firm will invest.

For nonprofit consolidators, frustrated by the snail-like pace of industry consolidation, the design of a breakthrough business model innovation begins by reexamining who the customer is, why they would choose affiliation, and how satisfying these customer's needs can be profitably accomplished. Further,

the design must recognize that the timing of affiliations may be driven by events or by a deliberative process, as summarized below:

**Target Segmentation:**



The vertical axis differentiates between transactions driven by events and those that occur in the normal course as a consequence of a deliberative process. While consolidators approaching transactions of the sort described in Quadrants I and II might best adopt an agency theory perspective, stewardship theory may be a better guide to understanding the dynamics of deals in Quadrants III and IV (Davis J. S., 1997). In contrast to agency theory which attributes opportunistic and self-serving behavior to managers (and consequently, a predilection for advancing their individual interests at the expense of their principal), stewardship theory attributes collectivist and cooperative behavior to managers (and consequently, a predilection for advancing organizational interests to the benefit of their principals). Clearly neither theory provides a reliable, comprehensive basis for assessing agents' conduct, and so it is useful to adopt a framework through which the personal characteristics of the manager and the situational characteristics of the firm and its industry are weighed.

Financial distress is the driver of transactions included in Quadrant I, and so *from the perspective of the Target*, value is captured if a cash transfer is made by the consolidator to the Target at closing to alleviate the distress. Additionally, the consolidator may introduce improved governance and management capabilities essential to formulating and executing a timely restructuring program. Given the unpredictable outcome and the investment of time and effort required to successfully conclude an affiliation with a distressed nonprofit, better capitalized nonprofits have historically been reluctant to pursue distressed transactions. As a result, Targets in Quadrant I are in a highly disadvantageous negotiating position, with one consequence being that pre-closing Target directors and officers may not continue in their roles post-closing.

Unlike commercial enterprises, distressed nonprofits cannot be placed in bankruptcy involuntarily by creditors, and officers and directors of Quadrant I routinely avoid consideration of a Chapter 7 or 11 petition to avoid reputational damage to themselves and the Target, even when reorganization might preserve the nonprofit's mission and a portion of its net assets. *From the perspective of consolidators*, value is captured and potentially created as a result of the consolidator's greater freedom to reassess previously foreclosed strategic alternatives, including bankruptcy. Given the increased uncertainties associated with distressed situations, cash transfers by consolidators to distressed nonprofit Targets may take the form of restricted contributions to exclude them from the bankruptcy estate should a voluntary Chapter 7 or 11 filing ultimately prove necessary or desirable from an economic point of view.

Event driven transactions like those included in Quadrant II typically involve CEO retirements (or anticipation thereof), though they also can arise under circumstances such as CEO departures during a crisis, or in the normal course. When the departing CEO is also the nonprofit's founder – or in some instances, a CEO of long tenure – these transactions are often motivated by a desire to construct a lucrative transitional or termination employment arrangement for the departing CEO. *From the perspective of the Target*, value in Quadrant II transactions is captured during the acquisition phase and takes the form of a cash transfer from the consolidator or a generous employment agreement for the CEO effective on the closing date. Typically, at least some Target organization trustees involved in Quadrant II transactions retain an active interest in the post-closing affairs of the Target, and so transactions are often structured to allow pre-closing directors and officers to retain board seats for an interval post-closing. Additionally, in some instances, the amended by-laws of the Target sometimes effectively reserve certain powers to these legacy members for a specified period. In anticipation of a leadership transition of the sort envisioned by Quadrant II transactions, consolidators may preemptively present a nonbinding letter of intent to discourage the Target's leadership from pursuing an auction process. *From the perspective of the Consolidator*, Quadrant II transactions are highly attractive because an external circumstance is fueling action by the Target board, with value captured at closing via the consolidation of Target's net assets at fair value, and additional value created to the extent that post-closing Target profits continue and grow.

Generally, consolidators find Target Companies more alluring as the fair value of the Target's net assets increase, but in this circumstance, Target directors and officers are less motivated to consider affiliation. Research suggests that the directors and officers of Quadrant III and Quadrant IV nonprofits may be most inclined to consider strategic alternatives when three factors are present: (1) the nonprofit is facing multiple strategic hurdles, (2) personal considerations are motivating the nonprofit's directors and officers, and (3) an attractive buyer is pursuing them. In the absence of all three of these considerations, Quadrant III and IV firms rarely even consider change of control transactions (Graebner, 2004, p. 394).

When strategic hurdles are present, directors and officers of Quadrants III and IV nonprofits are typically motivated to engage in a strategic planning process focused on how to sustain or extend their nonprofit's mission. If this process concludes with a determination to explore strategic alternatives, the directors and officers proceed from a strong negotiating position and can choose when and with whom an affiliation will be explored. Consequently, affiliations with Quadrant III and Quadrant IV nonprofits typically resemble a courtship in which Target Companies evaluate consolidators based upon long-term strategic, cultural, and interpersonal fit. Ultimately, *from the perspective of Target*, value creation in these situations takes multiple forms that include capital infusions from the consolidator invested in

enhancing the quality of existing services (Quadrant III), or the development of new or expanded services and markets (Quadrant IV). Target directors and officers can be expected to continue in their pre-closing roles and retain significant influence over future target strategy while gaining meaningful representation on the governance body of the consolidator. *From the perspective of consolidators*, value is both captured and created in transactions with Quadrant III and IV Targets because of the net assets conveyed to the consolidator at closing, and because of the new affiliate's annual post-closing cash flow. These benefits must be weighed against the significant opportunity cost of engaging in what is often an excruciatingly prolonged and highly uncertain process in a consolidating market. During the initial phase of industry consolidation, it may be that a focus on nonprofit transactions with Quadrant I and II Targets offers consolidators the superior path to maximizing wealth accumulation.

While the drivers of affiliations are presented in the above discussion as discrete, in practice transactions are driven by multiple considerations. Leadership transitions, for example, may be a factor influencing transactions primarily driven by considerations referenced in other quadrants. The consistent expectation of Targets across quadrants in assessing affiliation is that the prospective consolidator offers evidence of financial stability, the willingness and capacity to improve or extend operations or make them more efficient, or a willingness and capacity to deliver private benefits to officers and directors. With each additional affiliation, the consolidator's ability to make this case is fortified, and a virtuous cycle with increasing returns to scale is prolonged.

**The Inperium Constellation:** Firms perform very differently even in low growth, low margin industries like human services. The value of a firm depends on who is managing it, and the business model, strategy, and tactics they adopt. The uncommon performance of Pennsylvania-based nonprofit Inperium, Inc. serves as a useful illustration of the wealth creation opportunities achievable by a nonprofit consolidator fueled by a business model innovation. Inperium's offering, branded the Inperium Constellation, is a network platform consisting of geographically dispersed and goal-disparate organizations, including infrastructure nodes, established to create value for affiliates and capture value for Inperium by maximizing network effects, without abrogating the separate identities and cultures of constellation affiliates. Inperium has a long-term perspective and, as a nonprofit, pursues non-financial as well as financial goals.

Not dissimilar from multinational firms, Inperium's constellation model can be conceptualized as an intra-organizational network embedded in an ecosystem consisting of consumers, funders, employees, suppliers, and regulators with which the various affiliates of the network must interact (Ghoshal, 1990, p. 603). Inperium's complexity dictates that certain attributes of the enterprise and its business model, including resource allocation decisions (i.e., capital, technology, management capabilities, etc.) and the internal distribution of power, be continuously adapted to the dynamism of this ecosystem. The obscurity surrounding how Inperium has deployed its limited resources to achieve exceptional performance (sometimes referred to as "causal ambiguity") and the involvement of multiple actors and multifaceted processes (sometimes referred to as "social complexity") constitute conditions by which Inperium can confound imitators and build a sustainable competitive advantage.

Inperium's progenitor was a Quadrant IV nonprofit provider of services to adults with developmental disabilities. The progenitor initially explored affiliation with both nonprofit and for-profit consolidators, finding all their offerings unsuitable. Rather than proceed with a deal that failed to satisfy its transaction criteria, the progenitor incorporated Inperium and became its initial affiliate. Inperium thereafter

commenced execution of a consolidation strategy employing an innovative business model incorporating a network-based offering unavailable elsewhere. Inperium was incorporated as a separate entity because research indicates that business model innovations entail timely improvisations, and established firms have difficulty sensing and seizing opportunities and reconfiguring resources to capture value from innovations due to their historic identities (Stanske, 2018).

Affiliations are at the heart of the constellation business model because they result in consolidated financial reporting, enable Inperium to centralize system financing, create economies of scale and scope, and facilitate the recruitment and retention of an exceptional management team. Utilizing master trust indenture structures, obligated groups comprised of various Inperium affiliates enter taxable and tax-exempt financings that would not be available to affiliates as independent firms. Further, obligated group financings enable affiliates with growth opportunities to access capital they could not obtain otherwise, thereby benefiting from the combined financial strength of other network participants. Importantly, this is accomplished without running afoul of prohibitions on nonprofit reallocations of capital to purposes inconsistent with their mission statements.

The Inperium Constellation includes affiliates that deliver shared services to network participants<sup>17</sup>. These shared services pertain to governance and compliance activities, and activities that add significant economic value. The value-added activities are *narrowly defined*<sup>18</sup> financial, human resources, information systems, and risk management tasks that deliver the bulk of the scale economies available to the network. Notably, one Inperium shared services affiliate functions as a professional employer organization and employs all Inperium affiliates' staff, exclusive of the small number of Inperium employees covered by collective bargaining agreements. (Unionized employees are served by affiliate human resources professionals utilizing systems made available by Inperium). Shared services are offered to Constellation affiliates pursuant to a contract that provides for a cost-based fee. They enable valuable network effects because existing Inperium affiliates benefit as a portion of fixed shared services costs are allocated to each new affiliate joining the Constellation.

The importance of selecting and retaining top managers whose prior experience fits with corporate strategy is supported by academic research, and so Inperium's leadership team is comprised of executives with experience involving buy and sell side M&A, and with building and sustaining corporate networks (Yang, 2016, p. 30). Inperium's governance invests substantial time, effort, and resources in the design and maintenance of a structure of executive compensation that complies with regulatory and best practice standards while incentivizing top tier performance.

The success of Inperium's Constellation business model is evidenced by the impressive pace of its revenue and net asset growth since its founding in January 2015, as illustrated below. Inperium's performance during this period is a consequence of its business model, strategy, and organizational structure, which collectively address Target's needs, fears, and aspirations.

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<sup>17</sup> The value added by centralized corporate services is a primary justification for the existence of conglomerates (Campbell, 1995). Shared services play an important but lesser role for nonprofit consolidators due to the limited value creation achievable in low margin industries and the potentially adverse impact that affiliate integration activities might have on closing subsequent transactions.

<sup>18</sup> A study by Boston Consulting Group concluded that the more ways in which a corporate headquarters attempted to add value, the higher the level of value destruction (The Boston Consulting Group, 2012, p. 11).

	Per Audit (in \$000)				Unaudited
	Fiscal 2015 (1)	Fiscal 2016	Fiscal 2017	Fiscal 2018	Fiscal 2019
Revenues	\$ 40,581	\$ 50,721	\$ 63,486	\$ 90,998	118,449 (2)
Net Income from Existing Business	\$ 670	\$ 834	\$ 2,409	\$ 195	2,316
Net Assets contributed by New Affiliates	\$ -	\$ 204	\$ 1,337	\$ 22,814	7,624
Increase in Net Assets	\$ 670	\$ 1,038	\$ 3,746	\$ 23,009	9,940
<b>Net Assets End of Period</b>	<b>\$ 1,814</b>	<b>\$ 2,852</b>	<b>\$ 6,598</b>	<b>\$ 29,607</b>	<b>\$ 39,547</b>

#### Business Combinations Closed

1 1 6 4

(1) For the six months from Inperium's founding to June 30th

(2) The revenue run rate at June 30, 2019 approximated \$140 million.

In the first quarter of Fiscal 2020 Inperium will announce four additional new business combinations.

**Business Model:** Inperium's Constellation business model incorporates the following elements:

**Value Proposition:** Inperium enables human services providers to achieve profitable growth and enhanced sustainability at reduced risk through affiliation in a unique network. The network encourages affiliates to maintain their separate corporate identity and local control over strategic direction exercised by the existing board and management. These benefits are enabled by Inperium's ability to (1) continuously expand in a highly fragmented market, thereby creating indirect network benefits for all Constellation affiliates with respect to capital access, shared services economies, and innovation and (2) add industry leading, flexible management expertise and improved governance practices to the existing capabilities of Constellation affiliates.

**Customer Segments:** Inperium's market is comprised of the directors and officers of human services providers. Initially, the segments of primary interest are directors and officers of nonprofit providers that operate on the East Coast and are experiencing disruption, typically related to either financial distress (i.e., Quadrant I firms) or CEO transition (i.e., Quadrant II firms). These segments are attractive because external circumstances are drivers of change perceived as crucial by directors and officers, and consequently, inertia is less an obstacle than with firms seeking to sustain existing healthy operations (i.e., Quadrant III firms) or pursuing profitable growth (i.e., Quadrant IV firms). Nonprofits with appreciated real estate may be attractive, even if cash flow is marginal or negative. For-profit acquisitions may be considered in instances where specialized assets, capabilities, or licenses can be acquired that are not readily available via affiliation. Inperium is open to affiliation with providers whose employees are unionized. While membership substitution agreements (with customized reserved powers) are the most common form of business combination, a merger<sup>19</sup> is also available to Inperium Targets preferring this alternative. Nonprofits with strong balance sheets, long histories, and

<sup>19</sup> As used here, merger refers to a transaction whereby a nonprofit Target Company is united with a surviving nonprofit corporation that is an Inperium affiliate, concurrent with the cessation of the Target Company's separate corporate existence.



entrenched governance are not targeted because the factors motivating action (e.g., high levels of risk or capital constraints) are absent, or at least insufficient to overcome inertia.

**Customer Relationships:** Inperium’s customer relationships are focused on customer acquisition. Each Target of Inperium is pursued through a highly customized campaign, with every Target receiving dedicated personal attention from Inperium’s CEO and other senior corporate executives when and as required. This high touch approach is enabled by Inperium’s healthy profit margins and is essential given the imposing level of provider inertia, and the extensive education and communication effort required to overcome the apprehensions of Target directors and officers regarding change of control transactions.

Central to the Inperium business model is managing its reputation as a nonprofit consolidator. Reputation refers to expectations about a company’s ability to provide future value based on past performance. A good reputation yields legitimacy, business opportunities, talented managers, enhanced capital access, and is a key decision factor of prospective affiliates. Transparency, purposefulness, and collaboration are keystones of the reputation that Inperium strives to create, and each is pursued through a coordinated set of activities (Ferrer, 2013). Transparency goals are advanced by actions that include providing Target Companies with immediate access to information and documentation regarding Inperium that mirror that requested by Inperium from Targets in the due diligence process. Purposefulness is demonstrated by providing Target Company managements with Inperium’s business case for winning in the marketplace, and through Inperium’s bold approach to deal execution, which is focused on speed of execution and evidenced by timely presentation of detailed term sheets. Collaboration is evident in Inperium’s network business model and testimonials from directors and officers of organizations that have previously joined the Constellation. If Target Companies perceive Inperium’s reputation to be outstanding, then it is expected that the best organizations (i.e., those previously characterized as believers and seekers) will migrate to Inperium based upon expectations that Inperium will add value, decrease search time, and minimize post-closing integration complexities.

While affiliation entails a permanent change of control, a secondary focus of Inperium’s customer relationships is customer retention. Target Companies routinely seek opportunities to interact with existing Constellation affiliates to ascertain their level of satisfaction with their Constellation experience. In that networks rely heavily on voluntary cooperation rather than command and control, Inperium’s shared services affiliates invest heavily in building strong customer relationships centered on stimulating value co-creation with and between Constellation affiliates.

**Channels:** Channels describe how the firm will reach its targeted customer segments to inform customers of the firm’s value proposition (“awareness”), assist customers in their evaluation of the value proposition (“evaluation”), enable customers’ purchase of the offering (“purchase”), and deliver the value promised by the offering (“delivery” and “after-support”). In established markets, new entrants typically discover that customers have already adopted routine channels for searching for offerings, and these established channels are difficult and expensive to alter. The market for control of nonprofit human services organizations is a new one, however, and so entrants can explore various mixes of direct and indirect channels for reaching prospective Targets. Direct options, which would typically involve building an in-house development capacity, tend to be less expensive than partner channels, which may offer the benefit of extended reach.

Inperium's channels focused on awareness and evaluation include its website, social network presence, press releases, and conference presentations, while its channels focused on sales include (1) specialized business brokers that effectively function in a role akin to a system integrator<sup>20</sup>, (2) affiliate CEO's relationships with their counterparts at other service providers, (3) unsolicited letter of intent<sup>21</sup>, and (4) referrals from professional services firms including law, accounting, banking and insurance professionals. Its delivery and after-support channels are the provinces of its shared services affiliates.

**Key Activities:** Inperium performs two core activities that are distinct yet interdependent: transaction execution and network orchestration. Transaction execution includes (1) business development, which primarily involves network promotion, education, Target identification, and transaction negotiation, (2) due diligence and deal structuring, including drafting relevant legal documents and (3) deal and related financing activities. Network orchestration includes (4) information systems and financial management systems selection, adoption and integration, (5) affiliate monitoring which includes serving on boards and advising affiliate managements on growth strategies, and (6) other post-closing administrative support functions as may be elected by affiliates.

**Key Resources:** Capital access and deal execution capability are necessary but insufficient for successful implementation of a nonprofit consolidation strategy. Of critical importance, consolidators must also have effective governance supporting a chief executive officer who is strategic, creative, flexible, and capable of attracting, retaining, and motivating an experienced management team instilled with a sense of urgency. Network orchestration and centralized shared services functions are highly complex and knowledge-intensive, and so maintaining an experienced and deep management team is crucial to achieving superior performance. Inperium's experienced leadership enables it to effectively pursue multiple transactions concurrently while engendering a network of relationships that identifies new opportunities for Inperium before competitors learn of them.

Inperium's Constellation also leverages relationships of affiliate officers and directors to grow its network. These relationships contribute to network development in two important ways: affiliate CEOs introduce Target companies led by executives with whom they have personal or professional relationships, and they offer endorsements of the purported benefits of affiliation with Inperium.

**Key partners:** Inperium relies on a network of external experts for deal execution, including specialized business brokers, law firms, accounting firms, lenders, appraisers, and insurance experts. Affiliate CEOs and internal and external subject experts are critical to support network orchestration and centralized shared services functions. External subject matter experts include advisors on employee benefits, executive compensation, insurance, information systems, and capital financing.

**Revenue Streams:** For financial reporting purposes Inperium's business model generates revenues from three sources: (1) a one-time conveyance of the net assets of new nonprofit affiliates at fair value on the closing date, (2) the net income each reporting period of all Inperium affiliates and subsidiaries, and (3)

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<sup>20</sup> System integrator is a term most frequently encountered in discussions of channels for information systems technology but applies equally to other offerings entailing both high marketing complexity and high solution complexity.

<sup>21</sup> The presence of factors influencing Targets such as multiple strategic hurdles or personal motivations of directors and officers are rarely visible to Consolidators. Since the timing of affiliation proposals is critical in these instances, unsolicited offers play a useful role in unearthing opportunities not identifiable by any other means (Graebner, 2004).

a monthly fee assessed for mandated and elective shared services delivered to network affiliates. The markup applied to shared services is intentionally minimized because maximizing network value has priority over profitability, and fees for shared services could constitute a source of friction as Targets consider affiliation.

**Cost Structure:** While its customer acquisition process is customized and high touch and involves the intensive personal involvement of Inperium's CEO and other executives and advisors, these costs are effectively netted against the fair value of the new affiliate's net assets that are conveyed to Inperium at closing. Cost structure is also a consideration relevant to shared services functions. These costs, as a percentage of network revenues, are modest and declining due to the economies of scale and scope intrinsic to the Inperium network business model.

**Inperium Strategy:** Inperium's corporate strategy is primarily concerned with determining in which businesses the enterprise will compete, and how capital will be acquired and deployed, and is guided by Inperium's officers and directors. Business strategy addresses how affiliates will compete, and is guided by the officers and directors of each affiliate, and so varies depending upon factors unique to each affiliate.

Inperium's corporate strategy is to engage in the following segments of the human services industry: intellectual and developmental disabilities, behavioral health, child welfare, special and alternative education, vocational training and employment, juvenile and adult corrections, telepsychiatry, advocacy, and housing. Thematically, the inclusion of a broad range of human services providers in the Constellation serves two important purposes: first, it expands the universe of potential Inperium affiliates, and second, it leverages the tendency of networks to promote the diffusion of innovations within and across business and industry sectors.

Inperium has fewer financial resources than some potential competitors, and so its first mover strategy focuses on overcoming this deficit. The firm's corporate strategy targets growing its network to revenues of one billion dollars annually in ten industry segments in ten states by the end of its tenth year of operations. Achieving this goal will require it to source deals and successfully build value for itself and its affiliates, thereby constructing a virtuous cycle of value capture and creation.

Like platform business models generally in the early stages of their industry's consolidation lifecycle, the Inperium Constellation prioritizes growing its network revenues and net assets over generating operating profits. Still, the unique economics of affiliations has enabled Inperium to sustain consistent profitability from its inception. Concurrently, Inperium strives to continuously refine its acquisition skills because it recognizes these will be a source of competitive advantage as industry consolidation proceeds (Deans, *The consolidation curve*, 2002).

Inperium differentiates itself from other nonprofit consolidators by presenting an offering that is unique in its design, marketing, and execution. Of special note:

- In its dealings with both Target Companies and affiliates, Inperium acts with an unparalleled urgency, made possible by the extraordinary strategic alignment between its streamlined governance and able management. To illustrate, it is routine for Inperium to present nonbinding letters of intent and term sheets within hours of an initial meeting with Target Companies, and not infrequently, prior to such meetings.

- Inperium delivers value to affiliates through an offering that is marketed to the officers and directors of targeted nonprofit service providers. Its offering design recognizes that affiliates have unique value creation logics in response to differing community needs and affiliate competencies and values, and so the offering must be customized to satisfy individual affiliate requirements on a case-by-case basis.
- Affiliates contract with Inperium shared services affiliates, rather than the parent company itself, for those limited services that create meaningful expense savings and relieve the affiliate of burdensome responsibilities. Equally important, it does not contract to deliver services that fail to satisfy these conditions.
- Affiliates continue to operate as independent legal entities using their same name post-closing.
- Affiliate board members, executives, and other staff are retained post-closing, and the affiliate culture remains largely unchanged, save Inperium's introduction of an enhanced sense of urgency evidenced by a consistent preference for action over process.
- The role of affiliate CEOs expands post-closing and, as a result, their compensation increases commensurately, effective the closing date and pursuant to a new multi-year employment agreement.
- Affiliates receive cash transfers from Inperium pursuant to the Affiliation Agreement to further their missions.
- Affiliates entering the Inperium Constellation secure access to information and relationships that impact subsequent business development and program innovation.
- Affiliates benefit from direct and indirect network effects as the constellation expands.
- As the marketplace delivers feedback on the offering, Inperium's business model, strategy, organization, and processes are continually reconfigured.

Officers and directors of Targets weigh Inperium's offering by reference to the weaknesses and threats the offering helps them overcome, the strengths it leverages, and opportunities it introduces for their organization, its consumers and themselves, relative to the alternatives. To the extent that Inperium's offering provides added resources and relieves the Target of the burdens of performing certain tasks, productive assets can be deployed or redeployed to other purposes where the affiliate has a competitive advantage. Inperium's bargaining power results from the limited number of consolidators in the private nonprofit takeover market, its superior deal making expertise, and its experience in a highly specialized market that presents numerous complex financial, tax, legal and regulatory issues that must be resolved by a team of specialist advisors<sup>22</sup>.

Once Target companies become affiliates, the officers and directors of each Inperium affiliate continue to guide the Affiliate's business strategy without operational or programmatic interference from Inperium. Inperium's involvement post-closing is limited to the participation of its representatives on

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<sup>22</sup> Research indicates that the top management team's experience with acquisitions provides a competitive advantage in acquisition decision making and positively affects the performance of future acquisitions (Yang, 2016).

the affiliate board. Inperium’s board representatives endeavor to assure that whatever strategy is adopted by affiliates are internally consistent (i.e., not incongruous with corporate goals or policies), consonant (i.e., not inconsistent with the external environment as it is evolving), advantageous (i.e., directed at the creation or maintenance of competitive advantage), and fit (i.e., assessed with reference to the suitability of the financial and managerial resources available to execute it)<sup>23</sup>. Collectively, these evaluation criteria seek to provide a basis for determining whether the affiliate’s strategy will achieve the goal of creating sustainable value for the affiliate.

In the short and intermediate term coinciding with the consolidation phase of the industry’s life cycle, the Constellation business model seeks to enable Imperium to maximize market share and accumulate wealth. In the long term, the Constellation model aspires to shield Imperium and its affiliates from the existential threat that radical technological change, and the growing role of private equity in human services, portend for incumbent nonprofit firms. While it is often supposed that new entrants deploy radical technological change to dominate and replace incumbent firms, incumbents with the requisite financial, marketing and management resources, along with complementary assets and interfirm collaboration experience, frequently succeed in commercializing the new technologies and ultimately integrating the innovator (Rothaermel, 2000, p. 1237). This is the outcome the Constellation business model is designed to achieve: a diverse and sustainable nonprofit human services network of innovative believers and seekers, employing emerging technologies to compete successfully in the marketplace, to the benefit of consumers.



## OPERATIONAL CONSTELLATION



<sup>23</sup> See (Tilles, 1963) and (Rumelt, 1980).

## About The Authors

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*Kevin is the President of Angler West Consultants, Inc., an advisory firm focused exclusively on mergers and acquisitions of human services organizations. Founded in 1996, clients of the firm have included many of the industry's largest and fastest growing public, private and nonprofit corporations.*

*Prior to founding Angler West, Kevin had more than twenty-five years of experience serving as a senior executive of large nonprofit health and human services organizations.*

*Kevin has published articles on topics including business combinations, financial restructuring, valuation, and governance of nonprofit organizations and has presented at conferences on these and other topics.*

### *Ryan D. Smith Board President, Founder and Chief Executive Officer, Inperium, Inc.*

Ryan founded Inperium, one of the nation's fastest growing and most profitable nonprofit human services organizations, in January 2015 and continues to serve as Board President and CEO. Inperium is a nonprofit consolidator established to support and oversee a network of affiliated companies to ensure quality services and continuity of care, and efficient use of public funding. Since its inception, Inperium has closed more than a dozen business combinations involving both nonprofit and for-profit firms.

Prior to founding Inperium Ryan served as CEO of a Pennsylvania nonprofit provider of services to people with intellectual and developmental disabilities.

Ryan is a frequent presenter at professional conferences on nonprofit issues, mergers and acquisitions, strategy, and other business development topics.

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