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The Merger Proposal

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By Denise L. Gammal

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Before You Say "I Do"

Why nonprofits should be wary of merging by DENISE L. GAMMAL

In 1999, HOPE Services of San Jose, Calif., and Skills Center of Santa Cruz, Calif., decided to merge. Both organizations served developmentally disabled people in Santa Clara and Santa Cruz counties, and they had similar values and philosophies. HOPE Services was the larger of the two, with a budget of some $17.4 million, while Skills Center had a budget of some $5.4 million. "We felt we could deliver better services and more long-term stability by uniting the two organizations," explains Joe Campbell, president and CEO of HOPE Services.

The two leaders and their boards knew they would face one-time costs of implementing the merger, including around $40,000 in legal fees. They also anticipated that it would cost an additional $600,000 in ongoing annual costs to raise the salaries of the Skills Center's workers to those of HOPE's unionized staff. But they did not foresee what happened next: the loss of tens of thousands of dollars in grants, as nine out of 10 foundations that had previously funded both organizations dropped their levels of support – most by nearly 50 percent. HOPE had to find new funders to replace the lost support. It also took HOPE more than three years and countless hours of staff time to complete the merger.

In the end, the HOPE/Skills Center merger proved successful. But many other nonprofit marriages don't end so well. When the 1997 merger between the University of California at San Francisco and Stanford University medical centers went sour in 2000, the two organizations had to spend many millions of dollars unhitching themselves, reports the *San Francisco Business Journal*.[1] Other organizations, urged by their funders, expend a lot of resources exploring proposed unions, only to decide that merging is not a good idea. This was the case with Easter Seals Hawaii and the Special Education Center of Hawaii, which in 2003 spent some $12,000 and much time and effort ruling out the possibility of merging, reports the *Pacific Business News*.[2]

With the best of intentions, many funders and other commentators encourage nonprofits to merge, arguing that their integration will help reduce duplication of services, difficulties going to scale, and competition for scarce funding. All too often, however, no one is prepared for the costs and challenges of merging – in part because they do not have enough information about it.

The Stanford Project on the Evolution of Nonprofits (SPEN) is one of the few studies to examine the frequency and outcomes of mergers. Our findings suggest that nonprofits need to save a lot more money, budget a lot more time, and get to know each other a lot better before walking down the aisle. Otherwise, they may face the fates of many couples who rush to the altar: unhappy marriages or costly divorces.

Lots of Knots

Many believe, as *The Chronicle of Philanthropy* asserted in January 2005, that "mergers have been relatively rare" in the nonprofit sector. Yet nobody really knows how many are taking place, much less how to judge how many would be enough. Of the dozen academic articles published on nonprofit mergers, half are about the hospital industry and all are based on case studies, rather than on surveys of representative samples (which give a more accurate, comprehensive picture). One study by La Piana Associates, a consulting group that specializes in nonprofit mergers, and Chapin Hall, a research center at the University of Chicago, found that 24 percent of their sample was undertaking "strategic integration"– a broad category that included mergers, partnerships, and alliances.[3] But I could find no study with generalizable results that focused on nonprofit mergers alone.

At SPEN we interviewed 200 leaders from a randomly selected sample of operating nonprofits about mergers and other management practices. We included all kinds of nonprofits except religious congregations. Organizations in our sample had annual budgets ranging from about $5,000 to nearly $500 million, and were located in urban, suburban, and rural communities across the 10-county San Francisco Bay

One hidden cost of mergers: Many nonprofits in our study were shocked to see that foundations scaled back their funding for their newly scaled-up organizations.

region. Although regions and states vary, we found that the Bay Area nonprofit landscape closely resembles that of the nation as a whole.[4]

Despite popular wisdom, we found that mergers clearly are not rare. Seventeen of the 200 organizations (8.5 percent) in our sample had undertaken mergers and program acquisitions since the 1970s. Seven organizations had been involved in multiple mergers, adding up to 28 mergers in the sample overall. Fifteen of these mergers happened in the last 10 years. Two other nonprofits had attempted mergers that failed or were abandoned. All of the merging organizations provide direct services in the areas of education, health, or human services. Most get their funding from a mixture of philanthropic, government, and fee-based sources.

Difficult Engagements

In our interviews with these veterans of consolidation, we heard over and over again: Mergers are not for the faint of heart. How long a merger takes varies, but the process is always much more time-consuming than expected. For many of the SPEN organizations, the full integration took three or more years to complete, with delays that were usually due to unanticipated problems.

Mergers are also very expensive, starting with the costs of moving and marketing a newly consolidated organization. With careful planning, merging nonprofits anticipate many of these one-time costs. But not all of them. For example, many nonprofits in our sample, including HOPE Services, were shocked to see that foundations scaled back their funding for the newly scaled-up organizations. After all, they thought, isn't a larger organization that delivers better services to more clients a *better* investment than the former, smaller, less-effective organization?

Funders also heap additional costs upon nonprofits by urging ill-advised unions. In an extreme example, several funders pressured the Big Heart Center (not the organization's real name), a Bay Area health services provider, to take over the programs and offices of a failing peer. But neither the funders nor the Big Heart Center realized how much help the newly acquired facilities needed. The 40-year-old center – a stable, $2 million organization – had to invest nearly $1 million in major capital improvements and untold numbers of staff hours to relicense and reopen the sites.

Big Heart's executive director says that funders had committed to paying for the merger in full. Yet "in the end, [the money] didn't materialize," he says. The funders did not cover the income the center lost while it closed down its newly acquired facilities for rehabilitation. They also did not adequately fund the renovations or the staff time diverted to the merger. In one case, a funder even asked Big Heart to return its grant. As a result, Big Heart had to dig into its own assets to survive. Unlike the typical American nonprofit, which has assets of only about $100,000, Big Heart had enough reserves to cover the unforeseen costs. Yet merging without the promised support wiped out the organization's reserves, leaving it – as well as the poverty-stricken residents who depend on its services – vulnerable to future financial difficulty.

Dysfunctional Families

Another issue that blindsides many merging nonprofits is the clash of organizational cultures. The Davis Street Community Center in San Leandro, Calif., learned this in 2001 when it merged with San Leandro Community Counseling, a struggling mental health organization. Davis Street began as the food ministry of a local church in the mid-1970s. By 2000, the center had spun off on its own and grown into a $5 million operation. With its nationally recognized model,

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Davis Street offered not just food, but also clothing, child care, medical care, and other services to low-income working-poor residents.

At a strategic planning session that year, the Davis Street board decided to add mental health services to its portfolio, says Rose Padilla Johnson, executive director of the center. At about the same time, Susan Kleebauer, the board president of Community Counseling, approached Padilla Johnson to discuss the possibility of merging. Kleebauer frankly disclosed Community Counseling's crises: One of the staff members had recently embezzled tens of thousands from the nearly $500,000 organization, and the organization had lost several government contracts. But she persuasively argued that Davis Street should help Community Counseling keep serving the San Leandro community, as the organization had for 30 years.

Urged by Davis Street's board president, Mimi Wilson, Padilla Johnson explored the merger. After carefully weighing the legal and financial risks of taking on Community Counseling, as well as gaining the support of the primary government funder, Davis Street's board approved the merger. "The stars were aligned," says Padilla Johnson. "It was like a puzzle and the pieces just fit." The county immediately transferred its grant from Community Counseling to Davis Street, and the counseling group fully merged with Davis Street over the next two years.

At first, "it was like a marriage," says Padilla Johnson of the merged organization. "Everyone seemed supportive of this blended family. Everyone was hopeful. Clients were excited because they were coming to their appointments and suddenly there were all these services."

But then the honeymoon ended. "It wasn't 'The Brady Bunch'; it was more dysfunctional than that," says Padilla Johnson. She had worked hard to integrate the boards, but had not focused enough on integrating the different staff cultures. The Davis Center staff was an educationally and ethnically diverse group that subscribed to a holistic social welfare model, in which the staff member meets clients wherever necessary, directs the dialogue with difficult questions, and helps the whole family with a wide range of life challenges – not just psychological ones. In contrast, Community Counseling's staff was made up of mostly white male Ph.D.s who were used to a traditional psychotherapeutic model, in which the client comes to the clinic during standard hours and tells the therapist what area he or she personally wants to work on.

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The Davis Center staff expected the Community Counseling staff to answer phones, deliver groceries, and meet clients in places convenient to them, such as at the Laundromat or in their homes. Yet the Community Counseling staff was extremely concerned about patient privacy issues and unhappy to share equal footing with colleagues who had less education, including some with only GEDs. This culture clash proved costly: All but one of the original 13 counselors and interns left. Over several years, the merged organization spent almost $100,000 on staff training and development to address the issues.

"The things we thought would be challenges were not," says Padilla Johnson. "The things we had no idea about were the challenges. Culture has to be right up there with funding, worked from the start."

HOPE Services anticipated some of the cultural issues that the Davis Center encountered and took great pains to mitigate the consequences. "We needed to spend serious time to come up with a wider perspective and make sure that all our values were in the same place," says Campbell. The nonprofits made a point of integrating at the very top by creating a new position, vice president and chief operations officer, for Skills Center President and CEO John Christensen. They also initially preserved the Skills Center name and identity within the HOPE organization. Ultimately, however, the integrated organization needed everyone to identify with the larger entity, and so Skills Center adopted the HOPE Services name.

Rushing to the Altar

Despite the bumps along the way, HOPE Services and the Davis Street Community Center survived their mergers. The SPEN study shows, however, that many organizations are not so lucky. Funders or leaders pushed at least 10 of the nonprofits in our sample into mergers because one or both organizations were in financial distress. Letting these organizations close might have been better than jeopardizing the stronger nonprofits forced to absorb them. For example, when government funders pushed Big Heart to take on the foundering facilities of its peer, the results were nearly disastrous. The funders' motivations – preserve essential services in low-income communities – were honorable. Yet in their zeal to help four additional communities, they almost killed services to all five.

More broadly, many observers believe that consolidating organizations through mergers and acquisitions will solve problems stemming from too many, too small nonprofits in the sector. For instance, in *Begging for Change*, nonprofit leader Robert Egger argues for "fewer programs getting more of the money" (p. 46). Several big foundations, such as the James Irvine Foundation, agree and have developed grant programs to help organizations merge.

But how many nonprofits are too many? Competition, in this sector as in others, is good for consumers, providing checks and balances and protecting vulnerable populations from being exploited. Moreover, as economist Henry Hansmann points out, the point of nonprofits is to fill the gaps left by governments and markets – gaps in which many marginalized populations and causes are not being served.[5] New nonprofits are also essential for solving new prob-

lems. Grassroots organizations are often the first responders to new needs, such as the AIDS epidemic in the early 1980s, or global warming and troop support now.

Even in the business world, mergers often do not increase profits. Buyers overestimate the value of efficiencies and underestimate the costs of combining, and so pay too much for the merger. Nonprofits likewise may incorrectly price the costs of integration and doing business in a new way, especially if one organization brings good programs but financial distress to the deal. And even if they anticipate and can pay the cost of merging, do they really resolve any of the concerns voiced within the sector?

In our study, for example, not one of the merged organizations reduced its need for funding. Instead, every single one used mergers to grow its activities. And so although mergers decreased the number of organizations in the sector, they actually increased its total revenue requirements.

The problem perhaps is not that too many new nonprofits open, but that too few poorly managed or low-impact programs and organizations close. Insofar as funders and leaders use mergers to keep foundering nonprofits alive, then consolidation is not what the sector needs. Instead, we need more of what Joseph Schumpeter called "creative destruction" in his classic *Capitalism, Socialism, and Democracy*.

Uniting for the Right Reasons

Our study suggests that in the nonprofit sector, as in the world of human courtship, money is not the right reason to merge. But mission may be.

HOPE Services merged with the Skills Center to grow to a size that would better guarantee its long-term stability – and ability to deliver its mission. "Mothers and fathers of children with developmental disabilities realize that disability is going to be there when my child is an adult, when my child is 70," says Campbell. "Parents have to be able to look at organizations like HOPE and make a judgment about 'Is this organization going to be around 50 or 60 years from now?'" he says.

Greater scale helped HOPE weather the downturn when its business ventures, which employ developmentally disabled clients, were posting monthly deficits over $1 million. Scale has also made it easier for HOPE to compete for new contracts, as well as to give clients a wider array of better services. HOPE's greater geographic reach also allows its clients to stay connected to a nonprofit they know and trust as they move around and grow older in the Bay Area.

Although financial distress initially drove Community Counseling to approach Davis Street, the two ultimately merged because everyone involved – leaders, boards, and their government funder – wanted to ensure that citizens of the San Leandro area would have access to mental health services regardless of ability to pay. Before the merger, many Davis Street clients had no access to services such as counseling, parent education, and domestic violence prevention. Similarly, many Community Counseling clients did not know about Davis Street's many offerings.

By merging with Community Counseling, Davis Street gained not only a strong program at a cost far below starting one from scratch, but also valuable volunteers, board members, community contacts, and new perspectives. So although the merger was, in many ways, both harder and costlier than either group anticipated, "it has been a huge value add," says Padilla Johnson.

Yet even when nonprofits want to merge to advance their missions, they must proceed cautiously. Leaders and boards governing the two organizations must work closely together, taking time to ensure that staffs not only take ownership of the new entity, but also learn how to work together to make the most of the potential synergies.

For their part, funders must support the process and the newly merged organization, foreseeing one-time start-up costs as well as unexpected expenses. Rather than viewing merger as an opportunity to reduce grants – an exit strategy – they should instead view the newly merged entity as a better investment of their philanthropic resources, and support it accordingly.

What starts with a courtship and is followed by a wedding eventually must settle into the hard work of sustaining the relationship. Getting it right takes long-term commitment and strong communication at the staff, management, and board levels. Merged nonprofits, like spouses, also need the support of their communities – their funders, government regulators, clients, and neighbors – in order to succeed. □

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5 Henry Hansmann, "Economic Theories of Nonprofit Organization," *The Nonprofit Sector: A Research Handbook*, 1st ed., ed. Walter W. Powell (New Haven, CT: Yale University Press, 1987).