

Is Diversification of Revenue Good for Nonprofit Financial Health?

by Mark A. Hager and ChiaKo Hung

In two words, *it depends*. As the authors explain, “Strategy, expertise, history, commitment, cause, and revenue mix differ from case to case, with a million different permutations.” Thus, “Study your own case, think through the ramifications, talk to everyone involved, and make your best calls without paying undue attention to an overly simplified prescription.”

AS IN ANY FIELD, NONPROFIT MANAGEMENT has its little truisms: Boards make policy and staff members carry it out. Hire an independent facilitator for strategic planning. Always thank your volunteers. One of the most often-quoted truisms is that *nonprofits should seek as much diversity in their revenue streams as possible*. Turns out that some truisms are truer than others, and anybody handing out absolute rules is probably trying to sell you something. There’s no substitute for understanding the ins and outs of an issue and then smartly applying them to your own situation. What blossoms in one situation might crater in the next.

The basic principle sounds good: depending on one primary source of income can be risky, especially if that source begins to head south, so it makes sense to hedge your bets—right? Indeed, the decree that more types of revenue—or more *revenue streams*—is always good has been around for a long time. Each revenue type (and source) comes with its own levels of reliability, constraints, and costs, and all may not align appropriately with the organization or its

stakeholders or other revenue sources. Many types of revenue streams may need a runway where they may cost more than they bring in for a period of time. Some need a different kind of organizational capacity than what exists. Some may draw you off course or create reputational issues. Some revenue streams might soften with the economy, while others do not.

Examples of this kind of complexity are everywhere. Picture a thrift shop that lives and dies purely on individual contributions, which we might call a *concentrated* portfolio. In contrast, the homeless shelter across the street may also rely substantially on individual contributions but also benefit from a foundation grant, county government sponsorship, and earnings from a social enterprise (a café staffed by shelter residents). We might say that the shelter has a *diversified* portfolio. And that’s always good, right?

Not always, no. Perhaps the government grant does not pay full costs of the service required to fulfill it, and therefore requires otherwise precious unrestricted money to supplement a

specific contract. And perhaps the social enterprise demands more than its fair share of staff attention—producing more angst than cash. The fact is that every revenue source requires some transaction costs: money, time, and attention. Every revenue source has its own level of restriction, from complete to none at all, and this affects autonomy and adaptability. The thrift store can do what it wishes with the money it makes within the confines of the nondistribution constraint—unless, of course, it loses money or operates on a very thin margin. Its revenue is not likely to decline with the economy—in fact, the opposite is true. All of these details about the nature and behavior of various revenue streams matter to the health of the overall operation, complicating the question of whether or not diversification is needed.

The decision to pursue additional revenue streams is a vital question of strategy for any nonprofit. So, you might not be surprised to learn that dozens of university faculty members who study nonprofit organizations have been studying the value of revenue diversification

for decades. But how useful has this been for practitioners? We reviewed all this research for a paper recently published in *Nonprofit and Voluntary Sector Quarterly*, and you might not be surprised to learn that the findings are messy and conflicting.¹ When we say that revenue diversification matters, what exactly are we saying it matters for? “Financial health” might mean revenues, or revenue growth, or volatility. It might mean assets, or asset growth. It might mean operating margin, or fundraising spending, or program spending, or even survival. Different researchers study different outcomes among different types of nonprofits in different places with different research methods, and **boom** they get different results and draw different conclusions. Sometimes revenue diversification is helpful to financial health, sometimes it makes no difference, and sometimes it is harmful. Given these conflicting results, it falls to you to figure out your situation for yourself.

Luckily, this rich thread of research has spawned a number of arguments about why revenue diversification might be helpful or harmful. That’s what we want to present for you here, so that you have what you need to make your own strategic decisions in your nonprofit organization. An important starting point is to dispel the notion that revenue diversification is uniformly (always, every time) a good thing. Sometimes it’s not. Turns out the pros and cons are about even on the revenue diversification question. Let’s dig in.

Pro: Flexibility

If you know anything about the revenue diversification arguments, you might call this the standard textbook declaration on the pro side. Maybe the future is going to be stable and predictable, and your one revenue stream will provide

the resources you need to pursue your mission. But the future is unknown! Two kinds of uncertainty threaten to upset the applecart at any time. One is large-scale environmental change: a hurricane, or a recession, or civil unrest could radically shift what you need or what you have coming in. The other is more personal: your revenue line could just dry up. Shifts in tax policy make people think twice about their charitable gifts, foundations change their giving priorities, governments move their contracts to your competitors, and social enterprises fail. We know these things happen, and it’s not hard to imagine them happening to us.

The argument, then, is that more (and ideally unrelated) revenue streams give us the *flexibility* to weather shifts of all kinds. If you get all your money from government contracts and that contract is terminated, you may be sunk. If you get half your money from government contracts and half from private grants, loss of the contracts is serious but not necessarily fatal. Revenue diversification can give you options when the ground shifts beneath you. We say it allows you to “hedge against uncertainty.”

Con: Risk and Vulnerability

Hager saves a little money each month: It grows in his savings account—not much, but it grows. Hung saves a little money each month: He invests it in mutual funds—sometimes the market produces big returns, and sometimes it cuts into his principal. Maybe Hung will end up with more savings than Hager after a few years, but Hager sleeps better at night.

Modern portfolio theory helps us think about how to balance our tolerance for *risk* with our desire for greater returns. The investment choices with the greatest potential for gains are the same ones with the greatest potential for loss. These same ideas apply pretty well

when making decisions about whether to pursue new revenue streams or not. Some revenue streams are more volatile or harder to maintain than others. Every time we pursue a new revenue option, we increase the complexity of our portfolio. We introduce risks that might cost us money in the long run—or at least a few nights of sleep.

Single-revenue streams, especially when the future is going to look much like the past, are safe and stable, just like savings accounts. However, the future is looking less and less like the past. Most of us now understand that we have to be prepared to adapt. Many read reliance on one revenue source as *vulnerability*, and, therefore, risk, and that makes good sense. But adding revenue streams adds complexity and new risks—ones that we often cannot fully calculate or appreciate as we enter into them.

Thus, diversifying requires at the very least a sober look at all the pros and cons of that particular income stream, including assessments of start-up costs, capital needs, and risks and consequences of worst possible scenarios. You may also need a special dashboard—or additions to your dashboard—so that the board can measure the costs-versus-benefits proposition. Without this forethought, you might end up in a worse financial position than if you chose not to diversify. The competence of your management team plays a big role here, and only you can gauge the likelihood that you will end up ahead.

Pro: Autonomy

The great advantage here is the freedom to call your own shots. *Having* money above what is needed for subsistence provides a lot of freedom, and *needing* money is a source of “constraint.” You have certainly seen examples of this: Private foundations do what they want, while their grantees have to toe the line.

Read any of the scholarship on revenue diversification, and there's a fair chance you will see references to "resource dependence," which means that money (or the ways to procure it) influences how organizations behave. Nonprofits that get all their money from government contracts—say, to provide mental health services for some part of their state—do not have much *autonomy*. The American Civil Liberties Union, with its recent huge influx of donor dollars, has a great deal of autonomy. The difference, again, is in the type of restrictions written into the type of revenue.

Revenue diversification has the potential to provide autonomy and all the advantages that come with that, since the nonprofit is not beholden to a single master. Whether many masters is better than one master is an open question, but diversification can provide freedom when one or another revenue stream places constraints on operations. The ability to call your own shots is essential; otherwise, nonprofits just vend services for the people holding the purse strings, and might stop representing their missions, boards, and broader stakeholder communities.

Con: Crowd-out of Private Donations

Crowd-out is one of those unanticipated problems that might come with—or might complicate—diversification of income streams. Put simply, *crowd-out* means that donors or purchasers might adjust their decisions due to their views on your other resource acquisition efforts. An example is the art museum attendee who declines to respond to a fundraising appeal because he believes his support obligation was met when he purchased the coffee-table book as he passed through the gift shop. Consequence: the museum cleared \$15 profit on the book purchase, but lost out on a \$150 donation.

Most of the research on crowd-out

focuses on the statistical relationship between government contracts and private donations. A mental health agency might strategize that a public fundraising campaign would provide it more latitude and autonomy, and even the ability to innovate. However, people may not be willing to contribute because they perceive the agency to be amply funded (by the government contracts) and therefore not in need of their contribution. Right or wrong, you can't blame the donor for making that leap.

Blind revenue diversification carries these kinds of unanticipated problems. Because the revenue streams are part of a portfolio, they can interact with and influence each other. In isolation, a given revenue stream has a certain potential for revenue gains. Taken together, those potentials may be lowered. If they are lowered enough, they may well not be worth pursuing or will need to be pursued in a more limited, experimental way.

Pro: Community Embeddedness

Community embeddedness refers to your street credibility. Do potential clients or patrons know about you? Do they see you as legitimate? Do potential collaborators think about you when opportunities arise? Embeddedness is one part visibility, one part credibility, and one part networking. Some people call it *social capital*—the more that key stakeholders see you as a player, the more embedded you are in the community. Not every nonprofit needs this kind of embeddedness in order to serve its mission, but many crave it nonetheless.

One important way that organizations interface with community is through their efforts to acquire resources. An organization with a prominent fundraising campaign might be well known among the part of the public that cares about its mission but invisible to foundations, other nonprofits, government, local

businesses, or the more general public. While diversifying revenue streams can have unanticipated downsides, a potential "extra" upside is exposure to new dimensions of the community. An organization well known to local grant makers might gain unique connections and increased reputation through the development of a social enterprise. Community connectedness might increase your penetration of mission, but community embeddedness might pay other benefits as well. For one, nonprofits with greater community embeddedness tend to live longer than more isolated nonprofits. Social capital pays, and revenue diversification can be a pathway to such embeddedness.

Con: Increased Administrative Costs

We mention risk and the potentials for crowd-out above, but the costs associated with (and capital required for) competently pursuing new revenue streams is too often overlooked by decision makers. If your organization has put time and effort into really good fundraising, that doesn't instantly translate into expertise in grantwriting, or investments, or sales. Expertise is one thing, but sunk and ongoing *administrative costs* in management systems are another. Contracting often carries the highest such costs, with administrative time required for application, monitoring, and reporting. A good fundraising program requires pricy software and a sustained effort. Earned-income ventures require products and physical spaces and bear the risk of market failure.

A nonprofit with a concentrated revenue portfolio can streamline its spending and maximize the resources it passes to programs. In contrast, diversification requires specializations and different administrative apparatuses across the various approaches. If administrative costs stray onto the sensibilities of donors, those donors might even reduce

their commitments to the organization. The increase in administrative outlays and the signals this may send to stakeholders are complexities that board members and other top managers do not always fully appreciate. Don't get us wrong: *we* think nonprofits should spend more on vital administration, including information technology, human resource management, and resource development. But the problem is that your patrons may not agree with that. As always, nonprofits have to balance their progress with the demands of those who hold the purse strings.

• • •

Can decades of academic research tell you whether you should diversify your revenue streams or not? Sadly, no: the results are mixed and difficult to sort out. However, what it can do is outline the issues you and your board should

consider when the question arises. Strategy, expertise, history, commitment, cause, and revenue mix differ from case to case, with a million different permutations. *It depends.* Study your own case, think through the ramifications, talk to everyone involved, and make your best calls without paying undue attention to an overly simplified prescription. Hopefully, flexibility, autonomy, and community embeddedness are around the corner.

NOTE

1. ChiaKo Hung and Mark A. Hager, "The Impact of Revenue Diversification on Nonprofit Financial Health: A Meta-analysis," *Nonprofit and Voluntary Sector Quarterly* 48, no. 1 (February 2019).

"Is Diversification of Revenue Good for Nonprofit Financial Health?" draws on the NVSQ article, with permission.

MARK A. HAGER is an associate professor at Arizona State University, where he codirects the master's degree in nonprofit leadership and management. Hager is editor in chief of *Nonprofit Management & Leadership*, and is currently working with Martha Golensky to revise her textbook *Strategic Leadership and Management in Nonprofit Organizations*. He has to check his notes to keep those project names straight. **CHIAKO HUNG** is a doctoral and MPA student at Arizona State University. Hung's areas of interest are nonprofit finance, fundraising, nonprofit competition, social entrepreneurship, and meta-analysis. He recently accepted a faculty position at the University of Hawai'i, and is looking forward to trading in the desert for some rad waves.

To comment on this article, write to us at feedback@npqmag.org. Order reprints from <http://store.nonprofitquarterly.org>, using code 260109.



The latest news and analysis about the nonprofit sector from the *Nonprofit Newswire*

Regular feature articles

Subscription information for the print magazine

For more information from the *Nonprofit Quarterly* go to www.nonprofitquarterly.org