NOT FOR PROFIT PARTNERSHIPS AND MERGERS: CONCEPTS AND CHECKLISTS

Practical insight into partnerships and mergers from an experienced Adviser and Not for Profit Board member

2020

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GETTING TOGETHER

There are many reasons for NFPs to come together. While environmental drivers can often exert pressure at various levels, change is usually sparked by a catalyst – that is, an event significant enough for the governance structure of the agency to review its structure. Drivers may include increased demand, changing funding and regulatory requirements, the lack of scale required to attract development partners, or the need to manage escalating costs. Catalysts, on the other hand, may include the departure of the Chair, the resignation of the CEO, unsuccessful projects, approaches about mergers, the introduction of changes in regulation or changes in funding that demand a larger scale or scope of operation.

Typically the benefits of the partnership or merger will include:

- Overhead costs spread over larger programs.
- Better services to existing service recipients.
- A more robust and efficient organisational structure.
- An increased capacity to undertake developments.

In a changed funding or regulatory environment, growth may be required simply to survive.

> *"Our quarterly strategic discussions at the Board always include a discussion about potential mergers and partnerships. While we do not actively pursue them, it does mean when a possibility emerges, the Board has a good understanding of the strategic framework in which the opportunity is to be judged." - CEO of a large NFP*

LARGER AND SMALLER PARTNER PERSPECTIVES

Larger and smaller agencies may have different reasons for coming together and, as such, may have differing perspectives, concerns and risks to manage. The smaller agencies will often be seeking a more sustainable structure, while the larger partners will be pursuing growth.

Smaller partners may seek to:

- Access growth funding.
- Relieve a Board that finds governance too onerous.
- Overcome cashflow or stock quality problems.
- Resolve difficulty meeting regulatory requirements.

Larger agencies may be seeking to:

- Extend their geographic reach or service diversity.
- Reach the next level of efficiency.
- Secure political support in a particular area or type of service.
- Strengthen their income stream or asset base.
- Gain access to assets (cash and property).
- Assume management of an agency posing a reputational risk to the industry.

> *"When invited to respond to an Expression of Interest (EOI), we want to know if we are seriously being considered or are just there to make up the numbers." - CEO of an NFP*

TYPES OF GETTING TOGETHER:

OPTIONS FOR ENGAGEMENT

The options for engagement between organisations can be placed along a continuum ranging from independence to full engagement, with a corresponding reduction in autonomy. Only some are mergers. Often mergers will require constitutional changes where partnerships will not. A partnership refers to two agencies working together to secure a particular outcome. It may be for a one-off event or a continuing service. Partnerships can be created by a formal contract or can simply be an agreement for two agencies to work towards a common objective.

Of the types of engagements identified below, only the last three can always be classified as mergers. Where a group structure places control centrally with a parent organisation, it can also be classified as a merger.

Table: Levels of Engagement

Level of Engagement		Example	Potential impact
Partnerships	Event	Contract to build houses.	Partnerships require clear and robust arrangements to ensure that they positively impact on agency performance
		Partnership to run conference	
		Contract to run a client satisfaction survey	
	Program	Outsourcing case management	More complex to manage than single events due to its ongoing nature. Requires regular reviews against agreed performance measure
		Outsourcing property maintenance	
		Subscribing to shared services organisation	
Mergers	Organisation	Transferring services assets, staff and/or properties into one entity	Will impact on agency performance and have regulatory impacts
		The merger of one agency into another	
		Merger through the creation of a new parent body	

There are a number of examples of successful partnerships and mergers that have already occurred involving NFP agencies.

Examples include:

- Contracting out of client management - an affordable housing association contracted out to a local provider.
- Contracting out of purchasing – one agency purchased cars on behalf of another agency.
- Transfer of Trustee – an agency assumed control of a specific purpose trust by becoming the Trustee.
- Transfer of Management – the provision of service was transferred to a regulated agency from one that wished to discontinue due to regulatory load.
- Creation of a subsidiary – an aged care provider created a subsidiary to enter the affordable housing sector and to maintain the separation of its non-housing operation and assets.
- Transfer of Ownership – a Local Government Authority, seeking to maintain its contribution to the provision of services to disadvantaged groups, transferred program assets into the ownership of another agency.
- Creation of Parent Structure – three agencies share Boards and officeholders as a way of coming together without merging assets.

> *"Our most successful partnerships are those underpinned by a tight contract that incorporates significant sanctions." - CEO of an NFP*

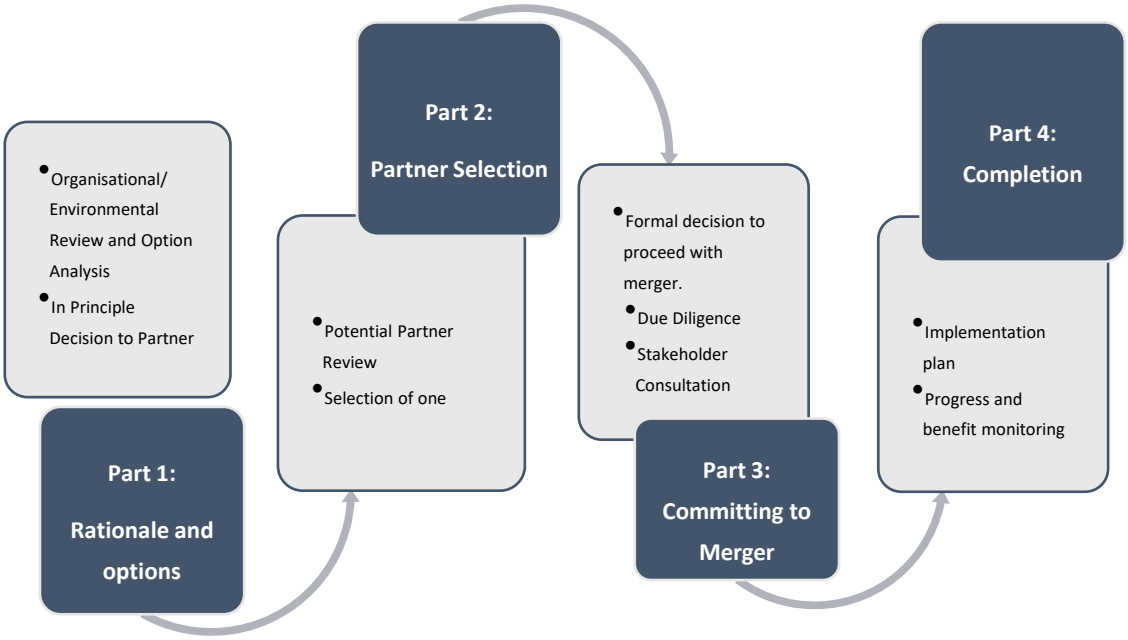
HOW TO MERGE

Mergers are permanent and therefore affect the constitutional arrangements, governance and operations of an agency. Early and detailed engagement with regulators and funders is consequently likely to be required at most stages.

The merger process can be divided into a number of stages, each with their issues, options, challenges, risk and key decision points. Unlike almost any other activity conducted by the agency (except perhaps the appointment of the CEO), merger discussions are the province of the Board. They often require intense engagement by Board members for a sustained period. A key tool commonly used is a Board Task Group, which, because of its importance, is often led by the Chair.

The merger process has four parts, with progress to the next stage dependent on a Board decision:

Diagram: Stages of Merger



"Face to face Board commitments are critical. We had an enthusiastic endorsement from their CEO and a copy of a Board minute supporting our merger. We only discovered their Board was not committed after we had written to the funder and regulators informing them of our merger intentions." - A wiser NFP CEO

THE PROCESS

Agencies should have transparent, open and outcome-focused processes to consider all options and implement the best one. It is expected that the benefits initially identified will be delivered.

Any proposed partnerships and mergers – and the methods used to achieve them – should be based on the following principles:

- The agencies will conduct comprehensive environmental and options analysis before selecting a particular strategy. This analysis will be considered at the Board level and will include consultation with key stakeholders.
- The subsequent decision by the Boards to explore partnerships or mergers will incorporate both an articulation of the desired strategic outcome and the criteria by which success is to be judged.
- The Boards of the agencies will be fully informed and briefed on proposals and their implications. Before an in-principle decision is reached, it is expected that both strategic and political implications should be considered in full.

> *"A critical point in any successful partnership is the 'Lifting the Kimono'. By that, I mean each partner fully disclosing their true circumstances…" - A Director with international experience*

The agencies will have a clear business case that describes:

- Benefits of the merger, including a clear quantification of operating synergies and value additions in terms of cross-functional activities and shared services. Usually, it is expected that there will be greater output in terms of capacity and the ability of the merged entity to deliver enhanced services while strengthening its balance sheet and operating cash flows.
- The strategic fit between the two agencies, including their attitudes towards key issues such as asset management and risk management.
- The critical success factors for the merger (this can be a gamut of aspects and parameters, both qualitative and quantitative).
- The delivery of improved services to clients.
- Improvements in the agency's financial circumstance which may, in the long run, strengthen the balance sheet and generation of recurrent operating cash flows.
- An increased scale of developments.
- Operational efficiency savings, including economies of scale.

- Strengthening of the Board.
- Improved capacity of staff.
- Simple and effective governance arrangements.
- Anticipated impact on performance standards.

A due diligence process that identifies matters of concern that need to be addressed before a formal commitment is made. These concerns may be large or small and extend beyond financial issues. The due diligence process relates to legal, financial, staff and property issues. A developed due diligence process will include:

- The appointment of a leader with sufficient skill and authority.
- The development of a detailed plan with all parties.
- The provision of adequate time.
- A focus on key risks.
- The utilisation of external specialists when needed.

> *Due diligence is the process of testing and verifying the assumptions (both stated and unstated) on which the in-principle decision was made.* ***- a Regulatory Officer***

The agencies will have a well-documented **risk management strategy** for each stage of the process. This will include risk identification and the proposed response and may be integrated with the organisation's ongoing risk management processes. The risk management strategy should also be analysed in terms of sensitivities, especially for operating risks.

A well-developed **communication strategy** will be in place that will include early notification to stakeholders.

An **implementation plan** that includes details of objectives, timeframes and required resources, including details such as:

- Required members' meeting to vote on the proposal.
- Changed funding agreements.
- New staff structure.
- Changed employment arrangements.
- New tenancy arrangements.
- New strategic plans.
- New business plans.
- Revised policies and procedures.

"It is like a switch being flicked. You go from working on getting to "Yes" and identifying every risk and cost to then dealing with the risks and delivering the merger. Problems need to be solved, not just identified." ***- CEO of an NFP***

Before Boards make the final decision to proceed, each Board will have considered a **detailed report** that includes:

- A formal assessment of the proposal against originally developed criteria.
- The due diligence report.
- A full financial analysis and feasibility.
- Risk Management report.
- The outcome of consultation with stakeholders.
- The outcome of consultation with service users.
- A detailed implementation plan.

"It is never about day one post-merger. It doesn't happen overnight and does not happen by itself. There is a lot of tidying up to do at the back end. It can take 12 – 18 months." ***- CEO of a merged entity***

Agencies will be required to deal with a diverse range of information and issues during a merger and, to a lesser extent, partnership. The extent to which analysis and action are required will depend on the nature of the partnership and the role of the agency. It is expected that larger partners, mainly where they assume longer-term liabilities, will need to undertake much more extensive analysis and planning. The regulatory impact of this analysis is largely measured in its impact on performance standards.

The issues can be dealt with in four major groupings (which overlap, meaning that the process is not linear): Culture, Operations, Finance and Legal.

CULTURE

Culture is, in some ways, the hardest to define and the most important. It is expected that agency Boards and senior management will explore it in detail at an early stage. While consultants may be used to facilitate the process, it should not be delegated either internally or externally. It can be informed by an examination of structure of the agency, including:

- A description of the **mission, aims and strategic objectives** of the business(es). The analysis will be informed by a history of the agency's development and documentation of the organisation's operation, management and governance structures. Statistical information such as unit, client and staff number will underpin this description.
- An **analysis** of the agency's focus on customer need and service, including the balance between commercial and philanthropic/charitable activities, will add to an understanding of the agency's culture. The balance of service provision will also need to be documented.
- In assessing an agency's **relationship with Government,** it is critical that the relationship with both the funder and regulator be reviewed and analysed.
- A review of the **governance** of the agency will need to be completed, incorporating a description of the Board composition and its structure, including committees. This should be followed by an analysis of Board performance. Other issues to be examined will include Board skill gaps, succession planning and risk management. The role of clients in the Governance structure is also a key issue.
- The relationship between the **Board and management,** including backgrounds, skills, relationships between and performance of the CEO and senior team. This will include an assessment of the management style (open, democratic, or closed autocratic) and its effectiveness.

> *"This is like adopting out a child. Our heart and soul is in this organisation. This not about just some clients…"*
>
> *- Chair of an agency handing over a program.*

OPERATIONAL ISSUES

Operational issues that should be reviewed relate to service supply and demand as well as funding priorities of the agencies.

A detailed description of the current portfolio needs to be developed, including:

- A review of the existing program condition in the context of a fully developed and costed long-term plan that is integrated with the agency's business plans. Where the program is managed on behalf of Government or other agencies, an assessment of the asset potential will be expected.
- An analysis of demand, incorporating a review of the waiting lists, a broader analysis of need in the catchment area, an assessment of the impact of access and allocation policies particularly in comparison to competitors and the broader market. The reporting of program demand, turnover and vacancies should also be reviewed.
- A comparative analysis of the agency's competitor, incorporating an assessment of the implications for the agency's strategic ambitions. In particular, it should include an analysis of the effectiveness of an agency's marketing strategies over time.
- A review of the business systems, commencing with the computer system(s) used for accounting and client record keeping. The inter-connectedness of these systems will be a critical issue. The analysis should be supplemented by an analysis of documentation and staff engagement, including monitoring of performance and training. This should be assessed against the skills and experience of the staff. Additional reviews should be undertaken of the investment and procurement practices, as well as disaster recovery plans.
- A review of human resource (HR) structure and management commencing with the documentation of current staffing structures (including job descriptions and salary levels) and performance. Additional or unusual staff benefits relating to superannuation, bonuses, staff transfers, redundancies and notice period should be documented. Worker compensation costs and arrangement should also be identified. Recruitment processes and effectiveness, as well as the involvement of staff association and unions, are material issues.
- A review of the effectiveness of the property development strategy, including an analysis of recently concluded projects and those in the pipeline, will also be required. An examination of projects that were rejected is particularly useful. The reporting of how risks were identified and addressed will need to be included.

FINANCIAL ISSUES

The assessment of financial issues will include scrutiny of available financial reports and an evaluation of the control environment. Business plans should also be examined to assess the robustness of the reporting against key performance indicators. The review is expected to include an examination of:

- The business planning processes, with particular focus on the Corporate/Financial Plan. The details of the plans to be assessed will include length, documentation of assumptions and sensitivity analysis. The approval and reporting processes (such as links to management accounts) will also need to be examined. Particular attention should be paid to covenants and forecasted deficits. In terms of business and financial planning, a very long term view (5 to 25 years) should be taken.
- Treasury functions such as loan profiles and lender relationships as well as identification of exposure to interest rate moves and requirements for security. The identification and review of past or potential breaches is critical. The monitoring and management of liquidity and cash flow are key issues. The use of outside advisors in complex financial issues is useful. A high priority should be given to cash flow analysis.
- Accounting policies, including compliance with accountant standards. The treatment of depreciation, property assets and sinking funds each may be contentious issues which, at times, will have required resolution at the highest governance levels, possibly on the advice of internal or external auditors. Any fundamental differences in accounting policies, particularly relating to asset valuation, need to be resolved.
- The strategy and practice to preserve the agencies' taxation status, including both tax-exempt (including GST) and tax-deductible status. The agencies' compliance performance and reporting will need to be reviewed
- Recent audit report including management letters to review issues identified (typically over the last three years).
- Comprehensive financial analysis and modelling of the proposed entity/entities with particular attention to the key ratios and any issues that may be identified during the development of these reports. Examples of financial viability templates may be a useful resource, but will not replace those developed by the agency itself.
- Internal controls to identify and manage risk, with a focus on more significant and more unusual risks. This will include an analysis of how risk management is embedded in the culture of the agencies, with system weaknesses and breakdowns (such as fraud) also identified.
- Insurance cover and cost including exclusion and excesses as well as claims in the recent past (last three years) and the process for monitoring these.
- Superannuation funding and liabilities that agencies may have with a particular focus on unfunded liabilities.

LEGAL ISSUES

Legal issues are, in some ways, the simplest area to address as they are relatively standard and can be outsourced to specialist law firms. Legal arrangements that should be reviewed include constitutional, regulatory and contractual (including both financial and property) with a particular focus on risk identification. In order to develop an informed view, the following material will need to be reviewed:

- Constitutional details including incorporation structure and status, as well as recent changes to the constitution or structure. Shareholder and membership details are important to examine. Board composition, appointment and review processes should also be reviewed. There are number of details that should be established, including details of Directors and officeholders as well as regulatory details. Regulation details and correspondence with the both the Australian Tax Office (ATO) and Australian and Securities Investment Commission (ASIC) should be reviewed for the previous three years.
- Regulatory engagement, including the regulator's view of the agency as articulated in the annual report and any compliance issues that have been raised, including breaches. The relationship with the funder and program managers within Government is also relevant.
- Property-related matters, including ownership and encumbrances on the title of properties, managed, as well as portfolio details of properties managed on behalf of other agencies, including Government. The examination of leases and contracts should identify any particularly onerous obligations.
- Finance and funding (including loan) arrangements. Particular attention should be paid to grant and trust arrangements.
- Major contracts (including those under negotiation) that may incorporate significant or unusual conditions such as guarantees, indemnities, or contingent liabilities. Registrations, license or consents also need to be examined as do exclusive supply arrangements.
- Environmental issues such as the potential cost clean ups required in projects in development or underway
- Disputes including litigation or arbitration proceedings that may be in VCAT of other parts of the judicial system. This also includes complaints of investigations by regulators, watchdogs or ombudsmen in the recent past (last three years) and any compliance failures.
- Recent significant capital transactions, including acquisition and disposals of assets or capital expenditure commitments and the loss of major suppliers/partners. Outstanding tender bids should also be examined.
- Hardware and software agreements and software licenses that relate to ownership supply and disaster recovery.

REGULATORY ISSUES WITH VARIOUS STRUCTURES

Regulators often have a role that is to both ensure compliance with performance standards and approve changes to constitutional arrangements. The performance standards often require that agencies establish and maintain effective governance and management arrangements. While regulators often neither encourage nor discourage mergers or have a preference for particular types of relationships between agencies, the following set of principles are an informative example of the expectations of a regulator.

- The delegation of a function to another will not limit the responsibility for the agency to demonstrate compliance with performance standards in relation to that function
- Parent agencies should exercise control and oversight of subsidiaries.
- There should be a strategic rationale and business case for any proposed new structure seeking approval.
- Where agencies have associated entities, governance and management arrangements must be clear and transparent.
- Dealings between associated entities must be free from conflict of interest and dealings at arm's length.
- Transfer of assets (including both property and cash) should occur transparently.
- The securing of liabilities, particularly where cross securitisation is used, should be clear and considered by the Boards of all entities involved.
- Where an agency becomes a trustee, the constraints imposed by the trust arrangements need to be demonstrated not to impede the capacity for the agency to meet its regulatory requirements.
- Where staff, particularly senior staff, operate across a number of entities, their roles and responsibilities should be clear and transparent.
- The identity of each agency and its role with the associated entities should be communicated to clients, funders and the wider community.
- A clearly articulated relationship between parent and subsidiary bodies.

POINTS OF ENGAGEMENT

Partnerships and mergers are highly likely to have a material impact on the performance of agencies and may require constitutional change. As such, agencies will often require the advice and/or approval by the regulators or funders in advance of a partnership or merger. The level of engagement will vary depending on the stage of the process, the size and complexity of the agencies involved and the role of the agency.

The regulator is likely to expect:

- Early advice that a partnership or merger is being explored.
- Formal and clear articulation of selection criteria to be used.
- Advance notice of key issues that are to be addressed, including:
    - Constitutional changes.
    - Maintenance of registration.
    - Transfer of business.
    - Transfer/novation of leases or contracts.
    - Service agreements.
    - Transfer of property titles.
    - Communication to stakeholders.
- Notification that regulatory approval may be required for the types of structure being considered, such as trusts and subsidiaries.
- Timely copies of key documents such as Environmental and Options analysis, the Business Case, Risk Management Strategy, Communication Plan, Financial Feasibility, Consultation Reports and Implementation Plan.

> *"Why consult with a funder who cannot approve or disallow a merger? Because they do approve the funding, function and property transfer that provide the rationale for the merger."* ***- NFP CEO***

RESOURCES AND ASSISTANCE

Boards and staff of NFP agencies have a broad range of sources of assistance available to them. As well as the corporate experience held within individual agencies, there is often much experience within the networks of individual Directors and CEOs. Even where that expertise and experience does not directly relate to the not-for-profit sector, it is still useful in navigating what can be a complex process. There is also much-written material both in Australia and from overseas markets such as the UK and the USA.

There is also extensive expertise available from legal and financial advisors. This can be supplemented by advice from peak bodies and consultants working in the not-for-profit sector who can assist with matters relating to organisational development and strategic decision-making. Funders and regulators are also keen to be reassured that each agency's decision-makers are fully informed and capable of making reasoned decisions that will deliver the best possible outcome.

ABOUT THE AUTHOR

MC Two Pty Ltd, the consulting firm operated by Joseph Connellan, provides strategic and operational advice to create better housing and services for people with disability around Australia. MC Two Pty Ltd has a diverse spread of clients across not for profits, the private sector, three tiers of Government and the non Government sector as well as peak bodies and education providers.

Recent projects include:

- Exploring the housing options for people with complex care needs
- Contributing to the development of an information resource
- Delivering education around Australia
- Assessment of NDIS Opportunities
- Exploration of potential housing roles for a disability support provider

Joseph Connellan has a successful career spanning more than thirty years in leadership positions in the affordable housing and disability in not for profit, mutual and Government organisations. For the last twelve years, he has worked as a consultant more recently with a focus predominantly on the National Disability Insurance Scheme (NDIS). Joseph published “Two Hands: More and Better Housing for Australia's NDIS Participants" in 2018.

Joseph has been CEO for a number of not for profit organisations including Supported Housing Limited, a large housing association focused exclusively on housing people with disability who required support, and Headway Victoria, a leading advocacy agency focussed on improving services to people with an acquired brain injury (ABI).

Joseph has held positions on government advisory bodies including the Victorian Disability Advisory Council (VDAC) and a sub-committee of the Victorian Government National Disability Insurance Scheme (NDIS) Implementation Taskforce.

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