

SMALL BUSINESS INCUBATORS

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The Challenge:

The community wishes to help those of its innovative small businesses that have good ideas but lack the resources to start operations on their own. A good tool for such business support is a small business incubator that is carefully designed and very well managed.

What is a Small Business Incubator?

Small business incubators have a long history as economic development tools beginning in the United Kingdom in the early 1970s as artist cooperatives, often located in historic buildings. In the United States incubators have been used to help redevelop blighted inner city neighborhoods, to foster scientific innovation (e.g., the National Science Foundation's grant programs for promoting University/entrepreneurial partnerships), and to provide a proving ground to groups of entrepreneurs attempting to extend their expertise to other small business owners (Campbell and Allen, 1987). While incubators began on a small scale in the US – about 40 registered business incubators in 1985 – their numbers grew to at least 600 in 1995, in large part spurred by the many attractions of incubators as a sustainable development tool (NBIA, 1996). Currently, there are over 1,400 incubators in North America: 1,115 in the US, 191 in Mexico, and 120 in Canada (www.nbia.org). Business incubation programs have been developed around the globe and are in operation in a host of countries ranging from Eastern Europe (www.wtec.org), to the Middle and Far East (www.ssl.gov.cn; www.infodev.org), and to Australia (www.businessincubation.com).

The interest in incubators lies partially in the role small business plays in most local economies. For example, in 1993, 53.7% of US employment was in firms with less than 500 employees. Small firms have been credited with 55% of all innovations in products and services (Sherman and Chappell, 1998). Thus, small locally owned businesses appear more innovative and can be developed in greater numbers more quickly than larger, often non-local businesses. And, because the small businesses typically aided by incubators are owned and operated by local entrepreneurs, they build the local economic base and are more likely to remain in place than are foot-loose multi-national firms. In addition, support for local business creation can aid in keeping young entrepreneurs in place, helping to avoid the loss of skills and education experienced in some more isolated regions.

There is one cautionary note about focusing on local small businesses for economic development, however. This is that 52.7% of all small businesses fail within their first

four years of operation (Sherman and Chappell, 1998). These realities have several implications for local economic development:

- Small businesses are desirable because they can employ local residents and foster indigenous entrepreneurs;
- Small businesses often operate in areas of technological innovation or in artistic or creative areas where relatively few resources are required for business operation;
- Small business development creates new local and regional economic capital; *but,*
- Significant efforts must be made to ensure that businesses are not created only to fail.
- And because of the inherent risk of small business failure, incubators should not be seen as the keystone to an economic development strategy, but instead as a desirable addition to a number of other efforts at promoting SME development in a community.

Business incubators stimulate and support creation and growth of new small businesses while providing support that decreases the chances of business failure. The most common goals of incubation programs are “creating jobs in a community, enhancing a community’s entrepreneurial climate, retaining businesses in a community, building or accelerating growth in a local industry, and diversifying local economies” (www.nbia.org). Evaluation research has suggested that incubators have been successful in stabilizing small businesses, creating limited job generation, and increasing sales among incubated firms for relatively small investments of public dollars (Lyons, 1990; Tornatzky, et. al, 1995; Sherman and Chappell, 1998). Indeed it has been suggested that the cost per job created in the US for incubated jobs is about \$6,580, while the cost per job of other types of firm relocation and attraction efforts such as tax abatements ranges from \$11,000 to \$50,588 (Markley and McNamara, 1995; 277).

Description of Business Incubators

Typically a small business incubator begins with a facility/building offering a common location for new firms. Public subsidies allow below market rents for prospective firms. In addition to lower rents and co-location with other, typically similar, new businesses, the incubator includes an array of support services designed to meet the needs of small start-up firms often owned by inexperienced or first-time entrepreneurs. The most common operational form in North America is for incubators to be run by nonprofit organizations; 90% are structured in this manner. More specifically, 25% are sponsored

by academic institutions, 16% by government entities, 15% by economic development organizations, and about 10% by for-profit entities (www.nbia.org).¹

The physical facilities provided by small business incubators may take a number of different forms. Incubators catering to sole-proprietors of professional service businesses may consist of individual offices with shared common areas. Such facilities may be developed in relatively small (as little as 3,000 square feet) structures, adaptively re-using residential or commercial space. On the other hand, incubators serving manufacturing or high tech companies typically require larger spaces and may occupy buildings of more than 100,000 square feet. Multi-story industrial buildings may be suitable for this type of incubator.

Business incubators provide both tangible and intangible benefits to new start-up firms. *Tangible* services often include:

- Shared equipment such as copy machines, phones, faxes, computers and internet access;
- Shared common spaces—conference rooms and lounges—for meetings with clients, and more informal interactions with other incubator tenants;
- Shared business services such as computing secretarial, accounting, marketing, and legal support;
- Assistance in basic business activities such as marketing plans, joint promotion, business plans, financial systems, bookkeeping and the like;
- Often some greater flexibility in the timing and amounts of rent and other payments that are sensitive to the needs of tenant businesses;
- Joint purchasing of business supplies and other business components, often including backwards and forwards production linkages among firms within the same incubator.

Assistance in securing start-up capital is also a critical tangible component of incubator projects. While many incubators do not directly include this component, often because the provision of start-up capital is beyond the resource means of local governments or other incubator sponsors, assuring that incubated firms have sufficient start-up financing is a critical contributor to successful long-term operation of new firms (Fasenfest et. al., 2005). Local governments can assist in this aspect of business development in several ways. At the most essential level, the incubator must provide assistance to firms in finding start-up capital from existing sources, e.g., local commercial banks or other government programs. Incubator programs can also include public support such as underwriting or guaranteeing loans to incubated firms. Finally, the optimal way to

¹ Percentages do not add to 100 because only the most common forms are included.

support new small businesses within the incubator is to include small business loans or a revolving loan fund as part of business incubator services.

Intangible benefits accrue from the ability of business owners to act as a support system for each other, although that can also turn into tangible benefits in the form of contracting among incubator firms. Intangible benefits are most likely to accrue when incubators are designed to include relatively similar firms, in product, process, or service needs. For example, high technology business incubator entrepreneurs can share new developments in innovation, creating extended talent pools, and cross-fertilization of ideas. Entrepreneurs in incubators devoted to biotech enterprises can support each other in product development and commercialization of innovations. At the very least, even in incubators with mixed firms, new entrepreneurs can share experiences and ideas about marketing, accounting, new product development, hiring and so on.

The ultimate goal of the business incubator is for new businesses to start in the incubator and then move out when they grow too large or are stable enough to operate without the special benefits provided by the incubator. This opens up space for new firms to begin in the incubator. Thus, firm graduation rates are a critical measure of incubator success and some time limit for tenants should be included in initial incubator agreements.

Implementation

The National Business Incubator Association (NBIA) in the United States, suggests that the first step in implementation should be investment in a feasibility study to assess the market for the incubator, financial requirements and sources, and community support. After this critical step has been taken, it appears that “model” incubation programs share a set of characteristics that represent industry “best practices” as identified by the NBIA. These include the following:

- ✓ Commit to the two core principles of business incubation: aspiring to have a positive impact on community economic health by supporting the success of emerging companies; creating a sustainable and efficient business operation model for the incubator itself.
- ✓ Obtain consensus on a mission that defines the incubator’s role in the community and develop a strategic plan containing quantifiable objectives to achieve the program mission.
- ✓ Structure the incubator for financial sustainability by developing and implementing a realistic business plan.
- ✓ Recruit and appropriately compensate a management team that is capable of achieving the mission of the incubator and that has the ability to help companies grow.

- ✓ Build an effective board of directors committed to the incubator's mission and to maximizing management's role in developing successful companies.
- ✓ Prioritize management time to place the greatest emphasis on client assistance, including proactive advising and guidance that results in company success and wealth creation.
- ✓ Develop an incubator facility, resources, method and tools that contribute to the effective delivery of business assistance to client firms and that address the development needs of each company.
- ✓ Seek to integrate the incubator program and activities into the fabric of the community and its broader economic development goals and strategies.
- ✓ Develop stakeholder support, including a resource network, that helps the incubator's companies and supports the incubator's mission and operations, and
- ✓ Maintain a management information system and collect statistics and other information necessary for ongoing program evaluation, thus improving a program's effectiveness and allowing it to evolve with the needs of the clients.

Essential Issues to Consider Prior to Implementation of an Incubator Project

Recent evaluations of business incubators supported by the United States Economic Development Administration have suggested that the following conditions contribute to incubators' ability to aid to local long term economic sustainability (Fasenfest, et al, 2005). If these conditions cannot be met, then small business incubators are unlikely to be an effective long-term development strategy for a locality.

Financing: Arranging for adequate financing for the incubator is a critical first step in implementation. Most incubators (about 2/3 according to some studies) are not self-sustaining and won't become so for at least ten years (NBIA, 1992). Thus, incubators need to be viewed as a publicly supported community development technique, not as a potential revenue source. Incubators have been financed through cooperative private efforts but have tended to get most of their support from government financing at various levels. Although they are most likely implemented at the local or regional level, some or most funding is provided by higher level governments. In calculating the initial investment required for the incubator, operating expenses must be considered in addition to the more obvious costs of land, building, and infrastructure.

Nature of the Incubator: Evaluations of small business incubators indicate that the most successful incubators have developed around a particular specialization or production niche. Thus, early in the development phase, local officials should decide what types of firms will be located in particular incubators. Options are broad but specific examples would include: biotech, creative or artistic, computer or high technology, transportation-related, aeronautics and so on. Successful incubators can also be developed around

very limited purposes such as those that simply provide shared office space and services to home-based businesses. The key is to draw complementary or similar firms so that the incubator itself has a known niche and the firms within it can receive the greatest benefits from co-location.

Incubator Staff: Staff will be required to run the incubator and to provide, at least in part, attendant business services. While most incubators include in-house business advisors to provide the skill sets necessary to grow new entrepreneurs, revenue is also required to recruit external business advisors. While some of these may be on a volunteer basis, funding will be required to pay stipends for external business and technology experts.

Physical Space: Consideration should be given to the nature of the physical space within the incubator. Flexibility of internal space is essential to: allow for growth of firms occupying the incubator; create options for providing space for different types of process needs; create spaces sufficient to accommodate enough firms to provide long-term revenue; and, to allow changes in the nature of firms within the incubator over time as technology changes. In planning business incubators it should be remembered that high technology activity in particular might require expensive physical space and facilities such as laboratories, computers and other specialized equipment. The development of biotechnology incubators for example will require space to accommodate these activities and will likely cost more to create than other types of incubators.

External Expertise: Access to external high tech and business expertise in organizations such as a university is extremely helpful to support firms, to generate innovations, and to provide technical infrastructure. The lack of external local experts would make creating and sustaining the incubator extremely difficult because providing such technical support services is integral to the incubator. Also, a broader network of technology resources would help to provide support and markets for firms when they leave the incubator.

Time Limits for Tenants: Incubators can exist over the long run with the original set of small business tenants; however, this is not the optimal situation. While low tenant turnover still indicates the creation of a small set of stable new firms, the goal of the incubator is to grow firms, have them graduate into the external community, and allow new firms to be developed. For this to work well, time limits should be considered at the outset and built into the structure of the incubator. Options are available for differential time limits depending on the nature of the firm, but there must be some point at which original tenants are required to move to make space available for others.

Finally, incubator design, scale, and required resources need to be appropriate to the local host economy. In other words, in areas with a weak skill base or limited market, incubators should be more limited, perhaps focusing on office space or support for local craft entrepreneurs. Markets already containing high tech or well-developed industrial sectors can sustain more ambitious and innovative incubators.

Complementary Tools

There are several complementary economic development tools that can and should be used along with small business incubators.

Small Business Financing: Start-up or seed financing programs can take a variety of forms. Revolving loan funds are often employed in combination with the most effective business incubators. Small loans, with below-market interest rates, are provided to support creation of new firms. As initial loans are paid off, money in the fund is reinvested in subsequent businesses. Such funds typically receive their initial capital via grants from higher-level governments such as regions, states, or provinces. Other public means of providing start-up assistance include low interest loans, public loan guarantees, and research and development grants and funds. Incubators can also assist firms in acquiring start-up financing by connecting them with “angel investors,” individuals or firms that lend support for fledgling start-ups. Incubator’s staff can assist companies in applying for loans, including identifying potential lenders and support in preparing venture capital presentations, financial statements, and so on.

Industrial Parks: While not essential to effective operation of a small business incubator, there are benefits to locating them within municipal industrial parks. For the incubator this provides a location with lower site costs with necessary infrastructure, potentially in proximity to similar businesses. For the industrial park, it can guarantee a stable tenant in the early years of the park, potentially drawing other firms. Similarly, incubators can be located on former military or brownfield sites to stimulate further development.

Job Training: Job and skill development programs can enhance the local employment base, increasing the availability of skilled workers both to develop new and innovative firms but also to supply the labor for fledgling firms within the business incubator. Local job training programs, particularly those that emphasize skilled, high technology, or creative types of employment will facilitate development of small businesses.

Entrepreneurial Training: More directly complementary to small business incubators are training programs aimed at creating local entrepreneurs. These training programs emphasize skills and abilities needed to successfully create and run small businesses: financial planning, marketing, accounting, hiring, computing and other basic business functions.

Investment in Education: In addition to skill and entrepreneurial training, investment in the local education infrastructure is inherently complementary to small business development. Strong educational institutions at the primary and secondary levels provide the necessary human resource base for economic development. Emphasis on institutions of higher education can create a number of synergies that can increase the effectiveness of small business incubators. Universities generate the innovative ideas necessary to begin new high technology enterprises, faculty can provide the skill training necessary for economic growth, and can often assist new businesses by providing services to support start-ups.

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