Business Incubators: Tools for Local Enterprise Development

Local business creation is frequently identified as a priority for economic development and growth. Local firms are often targeted because they tend to remain in the community, bring revenue into the local economy, and use local resources as inputs for their business.

Consequently, cities and towns often seek to support local entrepreneurs by providing financial and practical assistance while they develop their enterprises to the point where they become self-sufficient. And incubators are among the tools that can be employed to foster local business creation.

This article, used with permission from the International City/County Management Association and originally appearing on the ICMA website, is condensed and adapted from Economic Development: Strategies for State and Local Practice, *2d Edition, by Steven G. Koven and Thomas S. Lyons (Washington, D.C.: ICMA Press, 2010).*

Traditional business incubators are buildings that house several new businesses under one roof, an arrangement that takes advantage of economies of scale and other synergies to assist firms through their perilous start-up periods.

Full-Service Incubators

Full-service incubators typically provide their clients flexible space and affordable rents, shared business services, business development training and coaching, financial assistance, and the opportunity to network with peers.

Full-service incubators offer tenants space that can be adjusted to meet their changing needs. To enable the incubator to continue to serve several clients at a time, most incubators have a policy about the maximum square footage allocated to any one tenant. In some cases where an incubator tenant has been permitted to expand to occupy the entire building, the incubator program has sold the building to the tenant business and used the proceeds to purchase another building for its activities.

Originally, below-market rents were standard practice to lower overhead costs to fledgling companies. As time went on, however, business incubator operators came to realize that the other services they offered were of such value that they could charge market or even slightly above-market rents and still attract clients. Program sponsors began to clamor for financial self-sufficiency on the part of the incubators they supported, and charging at least market rates for rent was an important development.

One of the most popular offerings of a full-service incubator is its collection of shared business services, which represent the kind of resource pooling that makes incubators a unique and effective business creation tool. They generally include reception and telephone answering; access to a copy machine, fax machine, and kitchen area; facilities for conferences and meetings; security; janitorial services; and parking facilities. Clients using incubator services who want to lower their overhead costs typically pay on a fee-for-service basis, and because these resources are shared, their cost is often less than what it would be outside the incubator.

Full-service incubators may offer seminars and workshops at little or no cost that include training in skills or core competencies necessary for successful entrepreneurship: bookkeeping, marketing, strategy, computer information systems, legal considerations, and human resources management. Some incubator programs have built alliances with business development professionals in their communities, who provide training to incubator clients at no charge in exchange for the opportunity to develop long-term relationships with the entrepreneurs and their businesses. Business development assistance is also provided via mentoring and coaching. One of the most important aspects of any incubation program manager's job is to act as a mentor and coach to client entrepreneurs.

The final service offered by a full-service incubator is, perhaps, a natural outcome of the incubator setup: the opportunity for networking.

A full-service incubator provides financial assistance, because the credibility afforded by being part of the incubator program helps the client approach traditional lending institutions. An incubation program also helps new businesses develop a business plan attractive to traditional lenders and coaches them on how to present it. Because these approaches might not be enough to help some new enterprises, many incubators set up revolving loan funds to provide access to scarce start-up or working capital. Incubators make small loans to client companies at below-market interest rates and with more relaxed collateral requirements. As clients pay off their loans, the money is recycled for use by other clients.

The final service offered by a full-service incubator is, perhaps, a natural outcome of the incubator setup: the opportunity for networking that occurs when several companies are brought together under the same roof. Some businesses in the incubator may purchase goods and services from one another. Others participate in joint ventures or establish other forms of partnership. Perhaps the simplest and most beneficial form of networking is the exchange of neighborly advice and the sharing of information and knowledge among incubator tenants.

Incubator Management

All incubator programs have to set up internal management procedures, including admittance of new clients to the program, determination of how long a client can stay, establishment of reliable financing, and decisions about whether to specialize in certain types of businesses.

Because incubators need to manage the tenure of their clients, most have clear entrance requirements. The Entrepreneur Center of Central Texas, for example, clearly specifies its qualifiers for entry (see www.tec-centex.com):

- New or early-stage business
- Executive summary and/or business plan
- Four to six months of working capital
- Sound management and/or product development team
- Service-oriented, light manufacturing, or specialized nonprofit organizations
- Good potential to produce jobs in the local area
- Potential to produce significant revenue in four to six years
- Intent to remain in the Temple [Texas] business community

Practitioners agree that a key to successful screening is looking for good matches between the incubator's mission and the prospective client and her or his business.

The issue of how long clients should be permitted to stay has evolved with increased understanding of the incubation process. In one U.S. example, the incubator established an arbitrary eighteen-month limit on the length of residence. When later research revealed that the average incubation time for a new business is thirty to thirty-six months, it became clear that forcing a business out too soon was self-defeating. When a fledgling company failed for lack of support, resources already invested by the program were lost.

But incubator tenants cannot be permitted to linger indefinitely. Many incubators collaborate with their tenants on goals for growth, and the incubator monitors their progress. When a business achieves self-sufficiency, it leaves the incubator; in other words, it "graduates."

Incubator developers and operators also need to consider financing. The majority of incubators draw their financial support from various local sources. Municipal governments, private corporations, and nonprofit organizations such as community development corporations and chambers of commerce have all supplied start-up and operating capital to incubators.

Recent years have seen the rise of incubators designed to support the development of microindustries.

Sponsors that want to make incubator programs financially self-sufficient have developed a number of innovative financing strategies. Many incubation programs have begun to take equity positions in their client firms. This can be quite lucrative, particularly for high-technology-focused incubation programs. But this practice is not a solution for all incubators; in particular, programs that work with small service businesses will find it difficult to make the practice pay. In fact, insisting on an equity position could damage some businesses and discourage entrepreneurs from availing themselves of incubation services.

Some incubators specialize in certain types of clients. Some work exclusively with light-manufacturing businesses, for example. These incubators tend to be large; they offer such services as access to loading docks and forklifts, and they are equipped to deal with the residuals, noise, and other problems created by manufacturing processes. Others cater solely to service businesses; they function physically much like office buildings and are sensitive to the image that young businesses in the service sector want to present. Historically, retail incubators have proved very difficult to sustain. Finding affordable locations that permit sufficient foot traffic or other access is not easy.

One of the most common types of incubators over the years has been the mixed-use program that houses clients from more than one economic sector. Most common is a mix of service and light-manufacturing firms. The advantage to the incubator is that it can cast its net more widely for client businesses. But mixing business types can create unforeseen conflicts. In one mixed-use incubator in the Midwest, airborne particulates from a particle-board manufacturer found their way into the product of a salsa maker, requiring the latter to stop operations until a filtering system could be installed.

Current Developments

Recent years have seen the rise of incubators designed to support the development of microindustries. They bring together companies that are in the same business but are not necessarily competitors. Some examples are import-export businesses, food processors, and ceramics manufacturers. Bringing together businesses with common needs permits the incubator greater efficiency in providing assistance. For example, food-processing incubators typically have a common kitchen that can be used by several small businesses simultaneously or scheduled in a manner that serves all incubator clients. Industry-focused incubators also enhance opportunities for networking by linking companies that are more likely to complement one another. The challenge of industry-focused incubation is acquiring and paying for the specialized equipment and systems that are often required.

Increasingly popular are virtual incubation programs—that is, incubators without walls that offer no rental space but instead coordinate the activities of community service providers that assist local entrepreneurs. Virtual incubators are especially popular and efficient in rural areas, where suitable buildings are either nonexistent or in short supply and resources are limited and spatially dispersed. Furthermore, virtual incubation can avoid the distractions of real estate management that have preoccupied residential incubators at the expense of their business development function.

Although the concept of virtual incubation has evolved very slowly, interest in it is growing, particularly for community and regional incubation systems. Regional incubator systems consisting of networks of individual residential incubation programs operating in local communities in a defined geographic region are becoming more popular in rural areas with limited resources and markets.

Keys to Success

Four major categories of resources are essential to entrepreneurial success:

- Business concept: an idea for a product or service that is innovative and can be sold. Most people view such a concept as a prerequisite to entrepreneurship, but this is not always the case. Some entrepreneurs start with weak business concepts that need substantial refining. Others have no initial business concept at all, but when they are introduced to a concept, they can turn it into a successful business.
- Physical resources: plant, equipment, inventory, human capital, and financial capital.
- Core competencies: a wide-ranging resource category that includes technical/operational, managerial, marketing/sales, financial, and administrative skills.
- Market: all those things necessary for accessing and retaining markets, including customers, distribution channels and the like.

Potential Obstacles

On the other hand, a number of obstacles may stand in the way of access to these resources or cause their use to be difficult. By identifying obstacles to local success, incubator programs can adopt strategic practices to overcome them:

- The required resource may not be available in the context in which the entrepreneur is operating.
- The resource may be available but not visible to the entrepreneur; the entrepreneur may be unaware of where to find it.
- The resource may not be affordable to the entrepreneur.
- The entrepreneur may face transaction barriers (problems with the exchange) in acquiring the resource; transaction barriers may include required government permits or licenses, racism, and/or gender bias.
- The entrepreneur may lack self-awareness and not know which resources are actually needed.
- The entrepreneur may lack accountability, or the willingness or the know-how to take responsibility at the level required of a business owner.
- The entrepreneur may face emotional obstacles to success, such as false pride, analysis paralysis, or misplaced anger.
- The entrepreneur may not have developed the capability to use the resource after it is acquired; for example, many entrepreneurs with access to financial capital squander it through mismanagement.
- The entrepreneur may lack creativity in recognizing opportunities and seizing them and in developing innovative solutions to emerging problems.

Best practices may be those that are specially designed to fulfill the unique needs of the entrepreneurs in the context within which the incubator is operating.

There has been much talk about best practices in incubation. The danger in this is that these practices may be identified and then applied in cookie-cutter fashion. In fact, best practices may be those that are specially designed to fulfill the unique needs of the entrepreneurs in the context within which the incubator is operating—be it an inner city, a rural area, or the campus of a university.