

“Thought Paper”: The Role of Small and Medium Enterprises in Frontier Capital Markets

#4: “Business Incubators”

Rachel Yon and Daniel Evans

This paper is the fourth of a series of “thought papers” published by the Network Science Center at West Point addressing issues facing Small and Medium Enterprises (SMEs) in the developing world. As our team conducts their analyses, certain findings and insights might arise that are not directly related to the research question at hand but, we believe, are important to both the academic and policy communities. This particular series of “thought papers” will address insights concerning economic development issues.

The Network Science Center at West Point has been involved in ongoing research exploring the network topologies of Capital Markets in Frontier Capital Markets. Frontier Markets are essentially a subset of Emerging Markets with lower market capitalization and liquidity. Our team’s research has involved extensive data collection including numerous interviews with financial leaders and innovators in these emerging economies.

During the course of this data collection and the subsequent analysis, the research team has identified additional topics that we believe are ripe for analysis. We believe that addressing these research topics is vital to understanding and devising potential innovations in economic development.

Our initial visits to these Frontier Markets focused on larger firms, financial institutions, and macro-economic issues. During the course of these visits, especially in Africa, our teams observed a culture of vibrant entrepreneurship as we met with owners and founders of numerous SMEs. Because of the impact of our discussions with these entrepreneurs, we have decided to explore the importance of these businesses and their potential impact of economic development, at large, and their potential contribution to the development of these frontier capital markets. Our third paper focused on the types of private equity potentially available to SMEs in Frontier Markets. This paper will introduce the concept of “business incubators.”

Introduction

An incubator is an organization that helps entrepreneurs to realize their business dreams from creation through to commercialization. Through this process incubators hope to have a “positive impact on a community’s economic health, by maximizing the success of emerging companies.”¹ Incubators must work with a variety of different individuals and groups (such as local and national governments, the business community surrounding the business, venture capitalists etc.) in order to “produce sustainable graduate businesses, the benefits of increased income, employment, and economic development of the local community and, where appropriate, a return on shareholder investment.”² This is especially true in the developing world “where small companies are often struggling to compete in local, national, or international markets with relatively few resources and limited technical or business expertise.”³

In order to improve the economy of a country, new firms are vital. Unfortunately, firms in this early stage of development are also fragile. Many countries have enacted initiatives to protect these small firms in their beginning years as governments recognize the potential for job creation. The private sector, recognizing that many governments are interested in investing in this area, has also been willing to help these entrepreneurs. Business incubators are just “one initiative in an armory of measures designed to ensure new ventures have an easier passage into the business world.”⁴ In order to meet these goals, a business incubator provides a host of services to fledgling companies, including but not limited to: “floor-space made available on a flexible and affordable, but temporary basis; common services that include secretarial support and shared use of office equipment; hands-on business counseling; access to specialized assistance such as research and development support and venture capital; and networking activities operating as a reference point inside the premises among entrepreneurs and outside to the local community.”⁵

However, incubators do not always make a difference. Their level of success depends on a number of factors and it does appear their ability to succeed is on a case-by-case basis highly dependent upon the entrepreneur, the country, the support of the government, and the incubator. Yet, there are certain critical elements that are necessary for any incubation program to be successful. First, there needs to be a range of stakeholders who support the business and its growth. Second, incubators should be established in communities where there are a number of early stage small businesses

¹ Buys, A.J. and P.N. Mbewana. (2007). Key success factors for business incubation in South Africa: the Godisa case study. *South African Journal of Science* (103): 356.

² Barrow, Colin. (2001). *Incubators: A Realist’s Guide to the World’s New Business Accelerators*. Chichester, UK: John Wiley & Sons, Ltd., 5.

³ Mubarak Al-Mubarak, Hanadi and Michael Busler. (2010). Business Incubators: Findings from a Worldwide Survey, and Guidance for the GCC States. *Global Business Review* (11:1): 2.

⁴ Barrow, Colin. (2001). *Incubators: A Realist’s Guide to the World’s New Business Accelerators*. Chichester, UK: John Wiley & Sons, Ltd., 9.

⁵ Buys, A.J. and P.N. Mbewana. (2007). Key success factors for business incubation in South Africa: the Godisa case study. *South African Journal of Science* (103): 356.

that are looking for help with their growth. Third, incubators need to increase the chances of businesses survival and help them to enhance their growth prospects through the provision of necessary facilities and services. Fourth, the management of the incubator needs to be effective, organized, and prepared to provide these services to interested businesses. Fifth, incubators need to show that they have a number of businesses that they graduate as successful and that stay in business after they have exited the incubator. Finally, incubators need to have positive economic and community impacts in the form of job creation and/or the provision of profitable investments and/or the provision of opportunities for providers of capital etc.⁶

While incubators may focus mainly on supporting entrepreneurs and their small businesses, many believe that the more important goal should be to “foster economic development and job growth by enabling small businesses to become big enough to be significant tax payers, market makers and employers.”⁷ This larger, and more important goal, means that it will not just be the entrepreneur and the incubator involved in this relationship but also sponsors, local and national government organizations, economic organization, community groups etc. will have to be consulted in order for this ultimate plan to be realized.⁸

Types of Incubators

There are five generic forms of business incubators that have emerged:

1. Industrial incubators – often found in repurposed warehouses and dilapidated buildings. They attempt to create employers in response to unemployment in an area.
2. University-related incubators – provide access to “laboratories, computers, libraries and the expertise and assistance of its faculty and students.”⁹
3. For-profit property development incubators – provide physical workspace as well as expertise.
4. For-profit investment incubators – normally venture capitalists and/or business angels way of having investment firms in a central location.
5. Corporate venture incubators – large firms take in smaller firms and offer financial support and business expertise in return for a percentage of the business.¹⁰

⁶ Barrow, Colin. (2001). *Incubators: A Realist's Guide to the World's New Business Accelerators*. Chichester, UK: John Wiley & Sons, Ltd., 6.

⁷ Mubarak Al-Mubarak, Hanadi and Michael Busler. (2010). Business Incubators: Findings from a Worldwide Survey, and Guidance for the GCC States. *Global Business Review* (11:1): 18.

⁸ Ibid.

⁹ Barrow, Colin. (2001). *Incubators: A Realist's Guide to the World's New Business Accelerators*. Chichester, UK: John Wiley & Sons, Ltd., 30.

¹⁰ Ibid, 31.

Venture Capitalists as Incubators?

Venture capitalists, in an attempt to be more innovative, often create incubators. As they are not generally known to have a large return on most of their investments, the creation of incubators allows them to control their profits to a greater degree. Start up companies tend to have dramatic changes in their early stages and therefore having the business close at hand means that venture capitalists are able to more closely monitor the signs of success or failure. By “being on the doorstep, successes can be quickly reinforced and failures ruthlessly weeded out before too much money has been wasted...a business incubator provides a perfect environment to reduce the chances of failure.”¹¹ Larger venture capitalist firms see the creation of incubators as a way to compete against the smaller, boutique firms who “had acquired a reputation for being fleet of foot.”¹² Although they do not always label themselves as incubators, if the venture capitalist firm “go[es] beyond the provision of equity capital, they are an incubator.”¹³ However, the final outcome is still always the same – they are in business to make the largest profit possible. Unfortunately, for venture capitalist firms, they tend to move into this arena without the realization that it is a completely different type of business and therefore many of them are not able to succeed in this endeavor.

Accelerators

Consultants willingly trade their expertise for a share of the business they are supporting in service-for-equity arrangements. In order to provide the necessary services big firms often partner with smaller incubators so that the small incubator is able to help the business in the early stages and the bigger incubator accelerates its growth later on.¹⁴ However, these accelerator partnerships are actually a very small part of the business of these large firms as it has been shown that little money has been made in this manner.¹⁵

Business Angels

Business angels are “informal suppliers of risk capital to new and growing business, often taking a hand at the stage when no one else will take the chance....whilst they often lose their shirts, they sometimes make serious money.”¹⁶ They are quite similar to business incubators except that besides guidance and monetary support, they also get their hands dirty as “on average they spend 10 hours a week in dealing with each of their investments.”¹⁷ Angels, unlike the other groups discussed above, have one major difference – they invest their own money. As a result of this, they are “equipped to take

¹¹ Ibid, 87.

¹² Barrow, Colin. (2001). *Incubators: A Realist's Guide to the World's New Business Accelerators*. Chichester, UK: John Wiley & Sons, Ltd., 87.

¹³ Ibid.

¹⁴ Ibid, 112.

¹⁵ Ibid, 121.

¹⁶ Ibid, 101.

¹⁷ Ibid, 102.

decisive, even heroic, actions....angels... are still free to act on their feelings.”¹⁸ If they feel the company they are supporting has an innovative idea or they admire the integrity of the owner, they can bail it out regardless of the profit they may receive or what they may lose.¹⁹

Business angels, in general, are individuals with a background in small business or entrepreneurship who have garnered a significant amount of net worth. In general, they are looking for a financial gain but there are altruistic considerations that come into the help they provide. They choose their investments carefully and only invest in a small portion of the businesses that come before them. They tend to invest in businesses close to where they live although some have been known to stray farther if they are interested in a particular area of business. They only invest in businesses that they are familiar with so that they can ensure the best return on their money. They are also “up to five times more likely to invest in start-ups and early stage investments than venture capital providers” and are known to back people rather than propositions, i.e. they bet on the jockey and not the horse.²⁰

However, in general, angels are not highly successful as they are not as experienced in investing as venture capitalists and “it would seem from the research that the entrepreneurial and independent spirit that drives their investments and may lead them to regret their choices.”²¹ However, angels do not have to work alone as they can create partnerships with established incubators and bring their expertise and financing to the table. According to Colin Barrow:

Such relationships between entrepreneurs, business incubators, and business angels result in a new business getting funding and resources, where in other circumstances they may not have fared so well. There is little doubt that business angels have an important and growing role to play in the incubation of new and growing business throughout the world.²²

Gain from Incubators?

By being part of an incubator, businesses can expect a slightly higher chance of survival, the ability to raise money may be a little easier (but, of course, some businesses do not need to raise that much money to begin with), they do have expertise at their fingertips (although many incubators do not have enough one-on-one time to provide to these businesses so they are not getting the tailored consultations they may have expected, and finally, there is sharing involved in the big decisions to made for the company (of course, many entrepreneur’s would prefer to run their businesses their own way and money may not be their primary motivation unlike many incubators who see it

¹⁸ Ibid, 104.

¹⁹ Ibid.

²⁰ Ibid, 107.

²¹ Ibid, 109.

²² Ibid, 110.

as the one and only motivation). Therefore, if an entrepreneur wants to get involved in an incubator, he/she needs to be a team player, a good listener and learner, be willing to share ownership, meet set goals, and not mind getting instructions that they have to follow in their own businesses.²³

Incubators can give entrepreneurs a deal of a lifetime: “subsidized rent, shared office equipment and access to tax breaks and grants,” however, if the incubator is taking anywhere from 5 to 50% of the control in the firm away from the business owner, this deal might need to be reconsidered. Incubators often do not live up to their promises and “few for profit incubators actually make a profit and the rest may not deliver much in terms of job creation and extra value in the community providing their support.”²⁴ Despite the problems that incubators face, “many firms and geographic areas have benefited greatly from attracting, stimulating, and fostering an entrepreneurial community.”²⁵

The second paper in this series on incubators will explore several incubators currently operating in Africa.

²³ Ibid, 25.

²⁴ Ibid, 24.

²⁵ Ibid, 25.