

CED Incubator Policy Brief

The Incubator Marketplace in Pittsburgh

The CED has identified 25+ incubation programs in the Pittsburgh region. Approximately twenty of these initiatives have started within the past three years. This includes three new incubation programs, four venture-related efforts, eight projects that are focused on Information Technology firms and nine traditional incubators. One facility, the McKeesport incubator is in the process of closing, but new incubator plans are hatching almost monthly.

It is NOT about the space

The importance of physical location has decreased in the mix of elements required to start a business. In the past, the defining features of incubators were low-cost space, shared facilities and administrative services, and access to general business expertise.

In today's economy, it is not primarily the money or the space, but the business know-how and services. Speed to market has become the key for success. Incubators only affect speed to market when they can provide *been there/done that* experience, access to a network of qualified service providers, other companies, and strategic advisors. Today, incubators help businesses succeed not by lowering costs, but by improving the business model and adding critical expertise to the management team.

It is about the Expertise and Networks

Management skills, technology savvy, and a network of contacts emerge as the critical factors in today's economy. Start-ups require a broad array of services - from strategy development to venture capital, to contacts in the industry – and the incubators that can provide those will succeed.

Based on their research, the National Commission on Entrepreneurship (NCOE) has reported that: "Generic business advice and access to professional services may be helpful for new firms, but these services are widely available. Thus, entrepreneurs need not use an incubator for this purpose" (NCOE Update 8/29/00).

"... incubators can offer real added value when they focus on a specific market niche where they have special connections or expertise. Success will depend on deep pockets, deep connections, and focused industry expertise" (NCOE update 8/29/00).

Both the Harvard study and NCOE confirm that formal networking that goes beyond matchmaking provides value to entrepreneurs (NCOE update 8/29/00, State of the Incubator Marketplace, Harvard Business School, June 2000). "Such networking goes beyond simple schmoozing at the water cooler; it involves direct and formal links such as sales and marketing partnerships between incubates" (NCOE Update 8/29/00).

Summary

With the number of incubators in the region expanding at a rapid pace, and with many initiatives still in the early stages, there is sure to be a shakeout among the incubators. The CED cautions that public support ideally should be directed only to those facilities that demonstrate one or more of the following:

1. provide deep and focused industry expertise (but then they may not need the public money!)
 - a. provide a high-degree of access to industry contacts and advisors;
 - b. provide significant access to staff and advisors with appropriate industry expertise;
2. provide superior quality services;
3. target a strategic niche, or
4. target a special population

Given all of the venture money flowing in the region and the nation – the issue is no longer a lack of capital, but getting access to it. The larger amounts of money actually exacerbate the problem of getting access to the venture capitalists because they are swamped with requests. Incubators can help by offering the entrepreneur time to build relationships with a potential investor, especially where that investor can offer management talent and strategic industry advice.

At the high end, the region's incubators offer access to as many as 70 full-time staff. In the middle are incubators that provide about 10 FTE, while at the low end, are incubators with only 2 FTE – this means that clients won't get much time and that the incubator probably doesn't offer much more than space or matchmaking opportunities.

In Pittsburgh, most of the region's incubators are nominally focused on the information technology market space. However, the accuracy of market space definition is really determined by the degree of the incubator's management expertise in a given industry or practice. Most of the new incubators have technical and business advisory boards that advise startups in addition to the incubator staff and managers. If the expertise comes from advisors, then it is critical to know how much access the entrepreneur will have to these advisors and what stake the advisors will have in the success of the incubator and its clients?

There are tradeoffs between diversified- and single-industry models. The single industry models are more popular due to the benefits an entrepreneur receives from clustering with similar firms. Incubators with a diversified market or industry focus will face the challenge of providing quality expertise across a broad range of industries – general business expertise is not enough. On the plus side, more diverse incubators will be protected against crashes (or investor paranoia) in segments that are too specialized.

There are three basic ways by which clients pay for the services of the incubator: Fees-only, Equity-only or a combination of both. The traditional incubators tend to use the fees-only model, charging according to the space or the services provided to them.

The equity-only compensation model characterizes the new for-profit incubators. In exchange for the space, seed capital, managerial and technical advice and network of contacts, the incubator gets an equity stake in the startup. How much equity the incubator takes depends on the services and value it provides, the stage of development of the startup and, usually, the bargaining capacity of both parties. For this reason the equity deals vary not only among incubators, but also among startups in the same incubator.

In a traditional incubator, exit options focused on the physical relocation of the enterprise to market-rate space. The difference with the new incubators is that the exit options involves both location and financial considerations.

Criteria for supporting an Incubator

- What is the expertise of the staff providing services?
- Do the staff and advisors have appropriate industry expertise, contacts, and depth of experience, given their area(s) of focus?
- How do the business objectives of the incubator align with the economic development objectives of the community?
- What is the risk profile of the private investors?
- How much risk is involved for the public investment?
- Does the incubator follow the market – or is it trying to create a market (more risk)?
- What services are available to the entrepreneur?
- If mentors or advisors are used, what is their availability and how much support will they really provide?
- What is the process for choosing who is accepted in the incubator – how selective, etc.?
- If space is provided, will the space serve the needs of the tenants – does it have loading docks, communications infrastructure, lab space, etc?