

Financing of UK Incubators and Incubation Programmes

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This paper examines first the financing of incubator buildings together with basic client services and secondly the financing some of the higher value added services, which are characteristic of the more pro-active or hands-on incubation programmes. Amongst these latter services the paper includes the provision of seed or early growth funding, Business Angel activity etc designed to get incubatees over their start up capital needs. The paper does not seek to address issues around funding of the business beyond this level.

(a) The Buildings

Incubator buildings are fundamentally sub-economic when considered in strict commercial terms. By contrast they can be the engine for seeding significant economic development when operated well over a significant period.

However, let us start by considering the reasons why they are generally sub economic and then briefly examining situations where they might be considered economic.

Incubators have the following characteristics:

- a. They are occupied by companies with poor covenant strength.
- b. Occupancy rates while generally good cannot be expected to sustain a level of 100%
- c. The amount of space that needs to be set aside for communal, non (or low) revenue earning space is far higher than for other commercial buildings
- d. The level of management input to provide the ongoing marketing, client selection and provision of basic services such as communications, conference rooms, reception etc. is far higher than for other commercial properties. This does not include the higher-level professional business start up and development services, which are also a hallmark of good incubators. However, these higher-level services, where they extend beyond the "golden rolladex" approach as the Americans say, generally (but not always) are designed to cover a wider client base than just the start ups in one incubator. More on this later.

Taking the above key factors alone, calculations based around typical incubator parameters results in an incubator showing the following adverse income and asset values when compared to a typical office standard building:

- Lower rental bearing space utilisation - down from 82 -85% of built space to 67 - 72% typically. Loss of rental income of 15 - 20%
- Lower building occupancy - down from 100% to 90 - 95% typically. Loss of rental income of 5 - 10%
- Increased management costs up from under £5,000 to about £40 - 80,000pa. Loss of rental income of 10 - 25% typically.

Overall effect on rent taken is 30 - 50% compared to a standard commercial premises.

This then impacts the capital valuation in two ways:

- a. A straight reduction proportional to the loss of rent, PLUS
- b. A further reduction due to the lower covenant strengths of the clients. Typically valuers will use a yield worse by some 2 to 3 percentage points and this FURTHER reduces the value of the building by some 20 - 25%.

In this situation a private sector developer will perceive a loss of value of some 40 - 60% by comparison with an investment in a more conventional property built to accommodate a single good covenant occupier.

So unless the developer / investor has another motive or there is "soft funding" available, by and large they will not enter this market. This is evidenced by what is seen in the UK, the rest of Europe and indeed the rest of the world, including the USA. There are, however, some well documented exceptions, and they are worth noting.

The Exceptions

A plethora of private Internet incubators was established in the dot.com boom designed to accelerate Internet companies to Initial Public Offering on the stock exchange (IPO) within a few months. Most are long gone, blown away when the crazy bubble that gave rise to them burst. Most of the rest are struggling and those that survive are changing their business model, reducing costs (mostly by reducing the extent and depth of management intervention by the Incubator team) and introducing more ongoing charges for services to their clients.

Another more specific example is the small incubator established by the developer of the Milton industrial and business park near Abingdon operated by Oxford Innovation. It is good to hear that there are plans to extend this project. The developer is seeing that over time the incubator is producing larger occupiers for its other buildings. They are therefore prepared to subsidize the incubator to gain these wider benefits. They also gain an economy of scale by using the services of Oxford Innovation rather than having their own full-time management to operate the building. By keeping the building small for the first few years they have reduced their investment and its risk and at the same time ensured that there has been virtually 100% occupancy. There are other isolated examples but that is the entire point - they are isolated incidents.

Building Economic Analyses

Since Incubators do not have valuations which attract private investment capital, the vast majority are financed simply on a cash flow basis and are designed so that an injection of an initial grant will allow income generated by the project to cover outgoings once a reasonable level of occupancy has been achieved, while others depend on ongoing subventions from their owners to maintain a sustainable cash flow.

Most incubators work on the principle of an initial grant plus loans to finance the project, where the level of the initial grant also takes into account the negative cash flows of the first 2 to 3 years as occupation of the incubator rises to its design level. The extent of the grant needed to achieve cash flow breakeven on a cumulative basis within say 5 - 7 years can typically be about 25 - 50% of costs depending on variables such as:

- Whether or not the land is owned by a partner who is prepared accept a reduced or limited return on it for a period;

- The level of rents that can be sustained
- The specification of the incubator and hence its build costs

The Figures 1 and 2 show typical annual and cumulative cash flows for a purpose built incubator over its start up years. Where there is no capital grant aid, the heavy negative cash flow will have to be sustained from other sources such as annual subventions from founding partners. For the opposite extreme where the project is 100% grant aided for its development costs, the project rapidly builds a significant cash surplus, which might be deployed towards resourcing a full sub-regional or regional incubation business support services for the clients of the incubator and other similar growth oriented start ups. With grant aid of about 50% the example illustrated moves into breakeven on a cumulative cash flow basis after about 7 years and does not develop either heavy negative or positive cash flows at any point in time, while it is still servicing the capital debt used to finance the building.

There are other novel ways of funding an incubator, but they are not generally applicable. If in the UK we are to move towards a higher proportion of private sector funding of incubators the Chancellor might like to think about some novel forms of tax incentive that would encourage business angels or corporate venturing organizations to become serious active participants in the capital structure of incubators. While there are instances of this happening, 1990s Internet incubators apart, the investments have seldom been of a substantive nature.

(b) Financing the Business Support Aspects of Incubation

The above analysis allowed for business support to the incubator's clients to the level of the provision of common services, some of which are self sustaining in cost terms, and the provision of a management that can perform the marketing and selection processes and that can also provide some assistance to the businesses on site, at least to the level of intelligent signposting to appropriate private and public sector providers of business support services. Preferably, the network of contacts that the Incubator Managers refers their clients to should be personally developed on the basis of tried and tested experiences.

However, while this approach is common and is certainly better than no business support at all, many of the service providers are unlikely too have services tailored to the specific needs of the incubator client group. Most incubator clients will not be destined to become the next Microsoft even if they do show growth potential and are unlikely to excite the interest of most private sector organizations. There are usually too many flaws in the business, despite the potential. Similarly, until recently, Business Links did not consider micro-businesses to be their natural province and so many do not have the in-depth skills to handle this type of company. This situation is changing and Business Link + Incubator initiatives are an obvious way forward to create more intensive incubation programmes. What then constitutes a rounded incubation programme and what does it cost and how might it be financed?

The broad components of a comprehensive incubation programme might cover:

- (a) Pre-Incubation including: entrepreneur training and business model development
- (b) Incubation with: business planning, investment readiness, access to seed funding and business angels, sales development, team building, Intellectual Property protection.

- (c) Early Growth services with: Investment readiness, access to capital and business angels, international marketing and team building.

Costs for a programme, employing professional resources, whether part time or full time is unlikely to be less than £250,000 pa and could be over £750,000 pa. The implication of this level of cost is that it can be justified only if:

- The clients are very selectively identified for the incubator (i.e very high growth / high potential) OR
- The programme is extended to companies beyond the walls of the incubator OR
- The incubator is 100% grant funded

Or, possibly a combination of the above might be employed. Some of the better known examples such as Oxford Innovation, St John's Innovation Centre and Warwick Science Park have adopted the role of providing their services outside the incubator building, but in the case of Oxford and Warwick they have also increased the number of incubators they have under their management to retain the advantage of being in day to day contact with the clients the majority of their incubation services are directed at.

Given that for most incubators these resources are beyond their normal property budget how can the programmes best be resourced? There are two distinctly separate ways.

The first is for the incubator management to become involved in the initiatives of other relevant organizations, assist in the programme design but leave the implementation to others. By having some involvement in programme design, the incubator management can be more assured that the programme meets the needs of their particular client base. This makes a lot of sense economically. The second approach is to seek funding to put programmes in place based on the incubator management team, with the team then working within and beyond their brick walls. Either way, the primary sources of funding for these higher level business start up/ development / acceleration / incubation activities are likely to be:

- Business Link / SBS
- Regional Development Agencies (RDAs)
- European Union funding - primarily ERDF and some ESF
- Local Authorities
- Incomes and fees earned from clients
- Realizations of investment from clients - although this is only relevant in the long term and is largely irrelevant for the first 5 to 7 years.
- Funding from the incubator's founding partners.
- Services from selected private sector professionals (accountants, banks and lawyers etc.) where there is at least some pro-bono component.

The most appropriate funding solution will depend on the extent, or otherwise, of existing relevant programmes already running in the locality / region of the incubator. However, in the context of England there is probably much to be said for Business Links, RDAs and Incubators marshalling resources in a concerted effort to develop regional programmes with local delivery capability.

In the West Midlands the Incubators run by Warwick Science Park have taken the lead in the region in two aspects of incubation - TeamStart high growth pre-incubation start up programmes which are run under the West Midlands "Mustard" banner and a seed fund and investment

readiness service being conducted jointly with Coventry and Warwickshire Business Link and Birmingham and Solihull Business Link to provide services to growth potential start ups in the Coventry Warwickshire and Solihull areas of the West Midlands. It is hoped that, in part this will provide a pilot for the rest of the region. Funding is being derived from: Advantage West Midlands (the RDA), Mustard, ERDF, the two Business Links and Warwick Science Park itself. The two programmes are funded at a level of about £3,500,000 over 3 years including nearly £1,000,000 for a Pre-seed fund that can invest no more than £50,000 per company as part of an “investment readiness” strategy for the client.

To put this into perspective in terms of clients assisted - these programmes will assist to varying levels about 250 formative and early stage businesses over three years, while Warwick’s four incubators only accommodate about 100 businesses. It is only once the number of businesses assisted reaches these higher numbers that intensive specialized programmes become economically justifiable in terms of the cost per client assisted / developed.

Some Concluding Messages

The above analysis has been primarily focused on high growth business incubators, but similar arguments would apply to incubators whose remit is to prise open the enterprise agenda in a social minority or deprived geographical area. What will change in different classes of incubator are:

- The nature, specification and locational attributes of the building
- The detailed nature of the assistance programmes
- The attainable output targets for a given level of inputs.

Incubators are seldom economic in conventional property terms. Therefore, without some form of soft “resourcing”, by and large they do not get built and would not be sustainable if they were. Assuming that the income derived from the property has to cover at least some basic professional signposting and support services, soft / grant funding to somewhere in the order of 50% of capital costs might ordinarily be expected.

A full professional incubation programme is not affordable by most incubators unless the property is given to the incubator activity free and unencumbered, and even then only larger incubators could sustain a high level programme. A reality check suggests that a region or sub region’s best interests are served by coordinating business start up activities around their incubators drawing in (or being led by) experienced staff from the incubator(s). The key here is that:

- The leadership in programme design and development comes from those with the practical experience of assisting the particular class of business that the incubator is charged with developing.
- There is a recognition by the incubators of the need to link with others to build a critical mass of clients within a region / sub-region to make the provision of many of the higher value added services they want to offer clients worth-while in economic development terms. (For example, It is the author’s opinion, that except in very rare circumstances, it is not viable for an incubator to have a seed-fund dedicated to the clients of a single average incubator building)

Where incubation programmes are developed with this philosophy in mind, resourcing the activities should not be a problem. The resources will take time to assemble, but by engaging with regional agencies and Business Links, by participating in the ongoing development of regional economic strategies and action plans and by being involved with the economic development activities of Local Authorities, incubators should be able to agree the outputs they can contribute and then share in the resources to deliver those outputs alongside others. There is sufficient evidence in the UK now to show that this is a realistic and workable model.

Figure 1

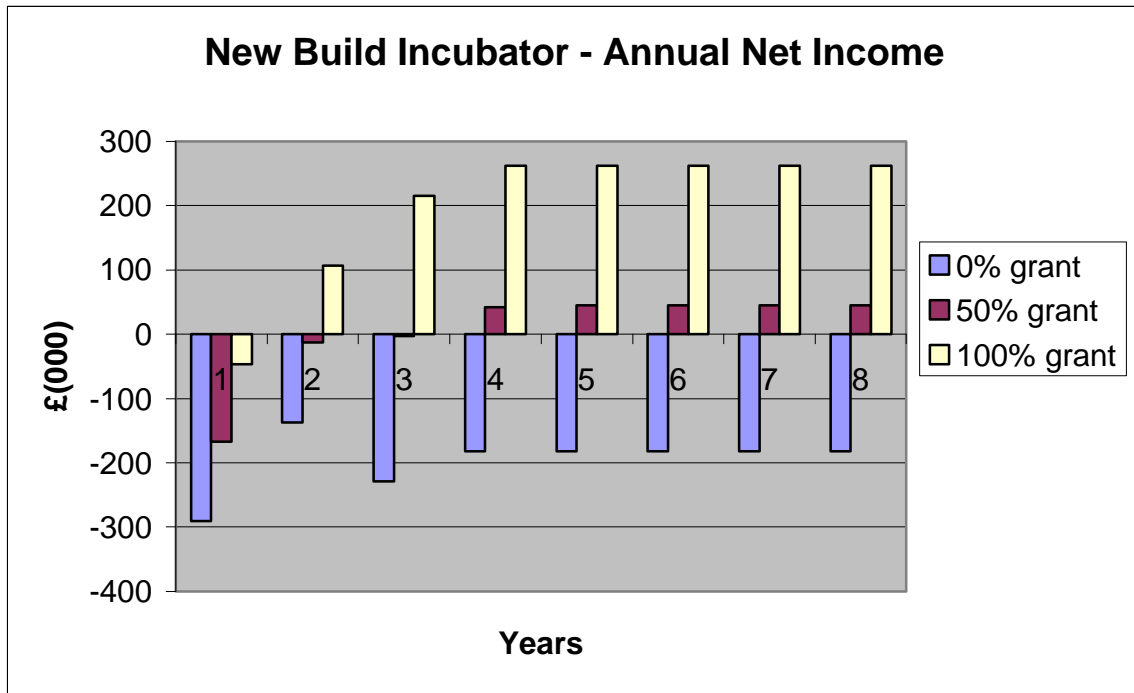


Figure 2

