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Smart business incubators : the Australian context

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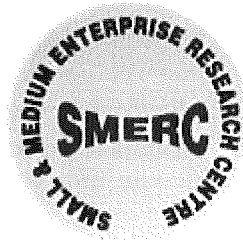
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Smart Business Incubators
The Australian Context

December 2004



Small & Medium Enterprise Research Centre
Edith Cowan University

For
the City of Joondalup

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AIMS AND OBJECTIVES OF THE STUDY

The aim of this collaborative study was to research the current status of Australian incubators and develop a benchmark based on successful business incubators, using criteria such as tenant and manager selection, operating indicators and exit criteria.

To achieve this aim the following objectives were addressed:

- identification of current business models for incubators at both a national and global level,
- analysis of the current status of business incubators in Australia including length of operation and tenant demographics,
- identification of key issues that impact on successful graduation of tenants,
- the development of a sustainable and viable business model of best practice for business incubators that the Joondalup Business Incubator can benchmark itself against.

BACKGROUND

The Joondalup business incubator was officially opened in October 2003 and has had some challenges in its early establishment. The incubator is funded from an AusIndustry grant with the City of Joondalup, Edith Cowan University, and the Joondalup Business Association as the major stakeholders. The City and the University also contributed significant financial resources and are members of the current management committee.

IMPORTANCE OF SMALL BUSINESS TO LOCAL ECONOMIES

Small and medium sized enterprises (SMEs) are an important source of innovation and of employment and SMEs globally contribute as much as 30 to 60 percent of a country's gross domestic product (GDP) (Sherman and Chappell, 1998). In Australia they contribute 30 percent of GDP and have created 70 percent of employment growth over the past 10 years (Department of Industry Tourism and Resources, n.d). The 1.1 million small businesses (businesses employing under 20 people) in Australia represent 96% of all businesses in the country (ABS, 2002b). Given their obvious importance to a nations economic wellbeing, many countries pay specific attention to the stimulation of business development. Since the 1990's the development of a number of business incubators is one such approach and business incubators are perceived to be of growing importance within Australia and the recognition of their value adding capacity to enterprise development in an economy makes this research of national significance.

A business incubator has been described as a unique way to facilitate the creation and growth of a new business idea in the community (Sherman & Chappell, 1998) and incubators are places to provide newly created small businesses with all the necessary resources to improve their chances to survive and succeed (UN-ECE, 1999). As an entity, business incubators are commercial facilities offering services that range from the provision of space, assistance in business operations to education and training (Wiggins & Gibson, 2003). Incubators have the capacity to assist their clients by the design of value-added services and the delivery of those services in a consistent and timely fashion. Business incubators may also offer strategic services, operational

services and infrastructure services to business start-ups. Most incubators have a local community focus as they are sponsored or supported by a variety of agencies including Government, Universities, Business Associations or other private groupings of business service providers.

REVIEW OF PREVIOUS INCUBATOR LITERATURE

A review of previous research into business incubators revealed that the majority of research and evaluation of incubators, prior to this study, had been undertaken overseas with little Australian research being conducted on the success or otherwise of business incubators. In 2000, the Commonwealth Department of Employment, Workplace Relations and Small Business (DEWRSB) commissioned PriceWaterhouseCoopers (PWC) to undertake a national survey of business incubators to assess the relative impacts made against the criteria for funding and to assess the return on investment for Commonwealth funds invested. Having invested more than A\$30 million since 1994, the Commonwealth used the PWC survey to review the funding guidelines and programmes. The outcome has been a greater focus on the funding criteria, but there are considerable limitations to the survey, primarily related to the limited scope of the survey and the factors used to assess the data.

According to the Australian & New Zealand Association of Business Incubators (ANZABI)¹, incubators in Australia are a hybrid type of economic development facility that combines features of entrepreneurship, business facilitation and real estate capacity. In Europe business incubators are well established and data from a 2002 European Commission report, "*Benchmarking of Business Incubators*" state that

¹ In September 2004 ANZABI changed its name to BIIA, Business Innovation & Incubation Australia to better reflect the business development aspect of incubators.

there are around 900 incubator facilities in the European Union. As well as generating new business start-ups incubators are also employment generators. In Australia, over a ten-year period the jobs created by an incubator in which \$0.5 million per incubator has been invested by government will cost less than \$1,000 per job and at the Federal level, savings in unemployment benefit and tax revenue generated by each job would be approximately \$13,000 per annum for as long as that job continues to exist (Department of Employment Workplace Relations and Small Business, 1999; Webb, 2003).

Even though business incubators are well established in Europe and the United States of America, they are a relatively new phenomenon in Australia, with the majority of Australian incubators having been established in during the past 10 years, primarily through Commonwealth Government funding programmes and with local government support. The Commonwealth Department of Industry, Tourism and Resources, where the current responsibility for incubator funding lies, defines business incubators as:

A facility designed to assist new and growing businesses to become established and profitable by providing premises, advice services and support. The incubation period is normally from one to three years, during which time fledging businesses can become established before graduation into the wider business community (Department of Employment Workplace Relations and Small Business, 1999; Webb, 2003).

Well managed incubators, should not only make small business establishment and growth more affordable and attainable, they should also assist new businesses to establish achievable 'real world' milestones through graduated rent structures and help in the creation of a polished professional image. The 'value add' of incubators is that they should provide business assistance, business services and networking

facilities (Allen & McClusky, 1990; Lalkaka, 2002, 2003; von Zedtwitz, 2003; Wiggins & Gibson, 2003).

Incubators operating effectively, can be seen as a significant vehicle to strengthening the national (or local) innovation system, thus promoting the competitiveness of an economy (Vedovello and Godinho, 2003). However there has previously been no common criteria to measure the economic success of incubators within their local community. This current study will provide the City of Joondalup with information to assist in the development of a best practice model for the Joondalup Business Incubator, based on the information gained from in-depth reviewing of current practices of successful incubators in Australia.

There are several factors to the successful operation of an incubator, which include clear selection criteria for tenants and some valued added services on the part of the incubator management, aimed at assisting in the development of the incubator tenants. This should lead to significant economic outcomes for the incubator tenant and therefore the local community. These factors are shown diagrammatically below in Figure 1.

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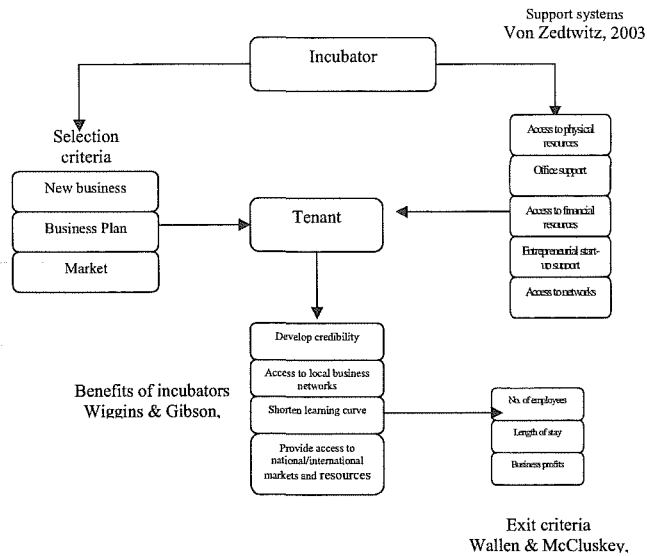


Figure 1: *Theoretical framework of business incubators*

Based on the model variables of importance in relation to successful incubation should include:

- tenant selection criteria,
- concise program milestones with clear policies and procedures,
- on-site learning,
- leveraging of resources and entrepreneurial education,
- clear exit criteria.

All of the above variables are essential, especially exit criteria and tracking of graduands, as this is a measure of the economic impact of business incubation on both the local and the wider business community. The services and supports that are provided and are available during the incubation period should be consistent with the

growth potential of the business. The model described in Figure 1 indicates potential influences of structures crucial to the success of business incubation.

The limitation within Australia of this hypothesised model is that it was not developed from local data and is based purely of descriptive or exploratory data collected from international research. The results of this study provides a picture of the current status of business incubation from an Australian perspective in addition to providing some guidelines for best practice in the incubation process in relation to selection and exit criteria, support systems and client management.

BUSINESS INCUBATORS IN AUSTRALIA

According to ANZABI² there are 3 broad types of incubators, general purpose incubators, high technology incubators and other special purpose incubators with the majority being not for profit. In April 2004 there were a total of 109 in operation and 8 under construction, their geographic locations are shown in table 1 below.

Table 1: *Australian small business incubators as of April 2004*

State	Operating	Under construction
Western Australia	17	2
South Australia	8	2
Northern Territory	4	0
Tasmania	5	0
Queensland	14	0
New South Wales	26	3
Australia Capital Territory	5	0
Victoria	30	1

² At the time of publication the association was still called ANZABI

Funding sources

The majority of incubators were funded initially by the Federal government as part of the Federal Small Business Incubator program or another government program BITS. Additional operational funding for these incubators came from several different sources including from state government (32%) and local government (36%). There were other additional sources of funding and these are provided in more detail in Table 2.

Table 2: *Additional sources of incubator funding*

Additional sources of funding	Percent
Local Government	35.5%
State Government	32.0%
Community organisations	10.0%
BITS	10.0%
University	6.5%
Business Associations	6.5%
Private sponsors	6.5%

Business Enterprise Centre co-location

Many incubators in Australia are co-located with a Business Enterprise Centre (BEC) and there is either one manager who is responsible for both the BEC and the Incubator or there is a shared management arrangement. Approximately one half (49%) of all incubators are co-located with a BEC. The advantages of this arrangement include sharing a manager and/or sharing the administration facilities.

Business Incubation and Innovation Australia (BIIA previously called ANZABI)

The peak national body for incubators in Australia, the Australian and New Zealand Association of Business Incubators (ANZABI) state that business incubators should be committed to 3 core principles.

1. Focus on nurturing and growing successful businesses
2. Offer services designed to meet the needs of their client businesses
3. Are themselves sustaining businesses

Combining the theoretical model, which has been developed from the current literature, and the ANZABI principles, produces a delivery gap in that there are no guidelines as to how to achieve these actions. Neither do they provide the procedures for these structures, and it is hypothesised that although incubators will have many different combinations of these structures, it is the procedures and guidelines that drive the structures which are missing from many incubator operations.

METHODOLOGY

As there are relatively few incubators in operation, personal interviews were conducted with managers. In total 20 managers nationally were interviewed and included 10 by telephone and 10 were visited personally to be interviewed. The personal interviews included two in Western Australia, three in Queensland, three in Victoria, one in South Australia and one from the Northern Territory. One manager of an incubator under construction was also conducted.

Data collected from the interviews included:

- the original objectives of the incubator, whether they had been achieved and overall performance,
- information on tenants included selection criteria,
- exit and graduation processes,
- type of support services available,
- perceptions of success.

The results of the in-depth interviews are presented in the following section.

RESULTS

Incubator objectives

The objectives differed for different types of incubators, however the common objectives were:

- job creation,
- reducing small business failure,
- promotion of small business and entrepreneurship,
- networking,
- localised economic development or revitalisation.

All (20) of the managers believed that these were important objectives, and whereas most of the managers (18) believed they were achieving job creation, there was less belief that their incubators were reducing small business failure (14), achieving promotion of small business in general (13), networking (12) and economic development (12).

Of less importance were the higher order objectives, those being commercialisation of research and development, technology transfer or export development. Just over half (12) of all managers interviewed had these 3 objectives as important but only 6 had any sort of commercialisation happening and even less (4) had any technology transfer or exporting happening in their incubators.

These results indicate that there is often a gap between set objectives and meeting the objectives and demonstrates a need for a set of management processes that will

provide support for incubators to achieve their objectives. In addition the lack of higher order objectives, such as commercialisation and technology transfer clearly rest with having appropriate tenants in the first instance, which were lacking in most of the incubators interviewed. These particular objectives may also be unrealistic for many incubators tenants, especially ones that are not affiliated to universities and is perhaps more appropriate to European and US models of incubators. In the long term however, these may well become obtainable objectives for some incubators if they are part of their overall business strategy and plan.

Incubator performance

The performance of the incubators in determining which were operating successfully was measured against the various aspects of the theoretical framework developed from the literature (see Figure 1) and included:

- client management practices,
- the number of graduands in relation to the years of operation,
- the jobs created by tenants and by graduands,
- the number of new tenants,
- the number of tenants who have gone out of business,
- the length of stay and the contact made with graduands,
- the services offered.

Based on these criteria, incubators were identified as operating successfully if the manager could attest that their incubator had the management systems in place that

selected appropriate tenants, monitored the tenants over their stay and offered value adding services.

Tenants

Initial Screening

Some of the managers had a more formal screening process than others. When asked who was responsible for the screening of tenants the most common response was the actual manager (15). More experienced managers made the final decisions and only consulted their board or advisory panel to ratify the decisions or to seek advice if there was a concern. Of the managers that had to consult, there was a general feeling of a time lag and that tenant selection was an operational issue and therefore the responsibility of the manager, especially incubators that had thorough selection criteria.

Selection criteria, tenure and exit criteria

It is recognised that selection criteria and exit strategies are critical to the success of business incubators. Most of the incubator managers (17) reported that they did have selection criteria however there were differences in how formal and rigorously the criteria was adhered to. Many managers mentioned the overarching issue of having to meet tenancy targets and that occasionally there was pressure on them to relax the rules so as to have the majority of their incubator occupied. Several managers also expressed exasperation at sometimes being seen as property managers rather than managing creativity and innovation and genuinely incubating new business start-ups.

Most important selection criteria are listed below however all managers acknowledged that most tenants would not meet all of the criteria but that these should be used as a guide. The selection criteria included:

- commitment and enthusiasm,
- existence and quality of the business plan (there is also the expectation that a new business would need support to refine and further develop the business plan and that assistance would come from the manager),
- secure financial viability (which requires either the manager to be able to determine this with the business owner),
- links with other tenants,
- estimated business turnover,
- growth prospects,
- ability to market the concept or idea.

Interestingly the most important criteria as stated by the managers was enthusiasm and commitment, followed by financial viability of the business, the business type or focus, the existence and quality of a business plan, growth prospects and ability to market the concept. The criteria listed above are not always part of every new start up businesses tool kit, and in terms of quality business plans and marketing ability these should be supported as part of the incubation process for business support. Based on the managers opinions, commitment and enthusiasm or 'passion' is clearly thought to be extremely important and whereas this would be an important criteria for any new business start-up irrespective of location, not having some of the other selection criteria on entry can be overcome in the relatively safe environment of an incubator.

Some caution should be used here in interpreting these criteria as even though enthusiasm can be very important, there is no substitute for a sound business idea and even a basic business plan.

In addition, length of time in business was a selection criteria for some incubators. There were businesses in all of the incubators which were existing businesses, some for a considerable length of time, anchor tenants and the occasional business that is downsizing. Very few incubators appear to be consistently taking new start ups, spin offs from new technologies or home-based businesses growing out of home. The conclusion is that the length of time in businesses as a selection criteria is more about having a good mix of businesses in an incubator and also that established businesses and also anchor tenants can play some role in the communal and networking activities within an incubator.

The idea of new start-up businesses entering an incubator is to provide the best opportunity to survive the first 3 years which in the life of all small businesses are the most tenuous. The facilities and services that are offered in an incubator should allow the new enterprises to concentrate on building up the business and establishing a good client base and a network of support. One way to enable this is to have a reduced rent structure that can alter with the length of stay to be at or above commercial rates by the time the tenant business is due to graduate out of the incubator. Thus providing a seamless transition from the supported incubator environment to the more aggressive free market environment.

As job creation and maintaining local economic growth were strategic objectives for most incubators, new enterprises should be fostered and assisted and then graduated out of the incubator into mainstream or Main Street location making way for other new businesses in a continuous cycle. The average length of stay for the tenants is a consideration in this process. The average length of tenancy for the businesses in incubators is 5 years and yet only a small proportion, (6) of incubators kept track of their graduands. Without tracking the graduands it is impossible to measure the economic and employment impacts on the local community. This is clearly an area where most incubators fail.

Incubator management should keep in contact with businesses that graduate out and where possible arrangements made for these businesses to provide support back to the incubator. This alumni situation occurs in some incubators and appears to work well. These graduated businesses can also become mentors, possibly facilitate training and professional development and they can continue to nurture the networks that have been forged during their time in the incubator.

Diverse tenancy

Many incubators are purpose built and have specific types of tenants such as technology enterprises, retail fashion or arts. These types of incubators are not always successful in the conventional sense and can take a long time to realise their potential. For young incubators an alternative option which may lead to initial greater occupancy, innovation and more productive enterprise and still achieve performance

outcomes is having a more diverse tenancy rather than a rigid criteria specific tenancy. Areas where incubators can diversify their tenancy include the following.

- Part-time tenants who may be moving out of home and ‘testing the waters’ or where it is not financially viable to move in full-time till the business expands or becomes more established.
- Shared tenancy arrangements again where the business is moving out of home and only want to be part-time in the initial stages or tenants who are located in several places and move around so do not need a full time work or office space.
- An anchor tenant which can include a BEC, a business association, a law or accounting firm, a training provider or any other business which is commercial and will add to the attraction of a consistent flow of clients into the incubator to conduct business. Some incubators have personal services as their anchor tenant, which do not necessarily value add to other incubator tenants but do provide the continuous traffic that is needed by some businesses.
- Virtual tenants such as those who are co-located in other places or who have use of hot desk arrangement.

Support services – business advice

One of the most significant findings identified from this study was that incubators associated with a Business Enterprise Centre or equivalent were amongst those that were operating most successfully and achieving their stated objectives. In relation to the ability to offer business advice having a BEC located in the incubator provided opportunities for both tenant businesses and potential tenant businesses to access the following assistance:

- development of business idea,
- business and strategic planning,
- financial and legal support,
- marketing and sales,
- management.

Those incubators who were not associated with a business enterprise centre were less likely to offer the range of business services that are seen as critical to the success of new start ups and developing enterprises. There are also other types of services and support given by some incubators, including business services and other support services.

Support services – business services

An advantage of being in an incubator for start-up and developing businesses is the availability of shared business services. Where incubators were offering the full range

of these services either for free or for a fee depending on the stage and size of the business, the overheads for developing businesses are kept to a minimum and opportunities for growth are accelerated. The services that are essential for most businesses and that can be unaffordable in the earlier stages of a business include:

- secretarial services,
- reception and telephone answering,
- office and/or workshop accommodation,
- conference and meeting rooms,
- photocopier, fax and postage services,
- book keeping and work processing.

In addition to providing much needed resources to these businesses having facilities such as reception and meeting rooms promotes the concept of professionalism and portrays for the businesses to their clients a successful operation. Again different incubators offered different levels of service with some managers offering a very comprehensive range of services and some offering only the minimum. Some of these services were provided by the managers and/or by volunteers or 'friends' of the incubator. Whereas this in principle is a way to keep down costs the quality of the services may well be questionable and is clearly very reliant on the expertise and networks of the manager and overall management committee or advisory board of the incubator.

Other support services

Mentoring has been recognised as an important factor in the success of any business. By having network facilities the incubator is well positioned to provide networking opportunities to all the tenants either with other tenant businesses or other client businesses. The incubator managers who considered it a priority to provide these opportunities were operating in incubators that are achieving outcomes and meeting objectives. Small businesses can be very isolated and the incubator environment should be one which is vibrant and innovative with lots of entrepreneurial activity giving businesses access to networks that they would not otherwise have the opportunity to synergise with.

Perception of success

Those incubators that were operating successfully as determined by the criteria outlined in the theoretical framework also had several characteristics and operations that provided a perception of success. Firstly each of these business incubators did not have the word 'incubator' in the title. Names such as 'development centre', 'business enterprise centre', 'innovation park' or 'business complex' were some of the alternative names. The rationale for not including 'incubator' in the title is to present a perception of professionalism as opposed to a collective of start-up businesses. This avoids customers and clients thinking that they are either going to get an inferior service or products due to the inexperience of the owner-manager or that they will be able to pay less again because of the inexperience.

In addition there were several other 'perception of success' variables and these included the following.

- Affiliation with key institutions such as universities, local governments or local business associations. This is especially pertinent for technology incubators as it infers both professionalism and that there is financial credibility. For general purpose incubators having affiliations is only meaningful if they are mutually beneficial for both the incubator and the partner.
- An experienced incubator manager who has a supportive board or advisory panel and has the authority to make decisions. Most of the managers interviewed had experience in the private sector and had some training or business advise background. Where the incubators were specialised the manager also had the appropriate industry background.
- A key board of management that include members from local government, business associations, key business members of the community and representation from legal or financial institutions.
- Where relevant, a noted advisory council, this was especially true in specialised incubators where 'technical' expertise was also important.
- A mix of tenants including a good anchor tenant and promising start-up companies that bring activity, entrepreneurship and innovation to the incubator.

- A waiting list of new businesses seeking to become tenants, thus creating a dynamic environment.
- Successful graduated firms who remain committed to the incubator and provide on going support and mentoring in addition to moving into the commercial business community.
- Involvement of the incubator, its tenants and staff with the local business community so that the incubator was seen as part of the business community. This also had a positive effect on encouraging tenants to graduate out of the incubator as they were already involved within their local business community. Many incubators are in central locations thus making it easier to be involved in the community.

CONCLUSION

Business incubators should be facilitating new business start-ups and fostering creativity and innovation in business ideas. The incubator managers interviewed for this study indicated the presence of all the infrastructure and services that are required for best practice in incubation, but in the main the procedures and policies were not evident to support the philosophy of incubation for small businesses, neither were they embedded in the client and incubation management practices.

The management expectations for an incubator should not be exclusively financial, nor should they be short-term, since the true potential of a successfully graduating start-up business may only be realised several years after its creation. Any model of business incubation must be designed for the long term and must be proactive in considering the following indicators of effective incubator management practices.

- Day-to-day management – this needs to be in line with the objectives of the incubator and focus on managing residual risk assisting new tenants achieve their goals, which will be in line with the goals of the incubator. At an operational level the manager should be hands-on. Strategic directions should be the domain of the board of management.
- Incubation charter, which includes the objectives of the incubator and defines the selection criteria, occupational rules, exit strategies, graduands policy and all related tenant practices.

- Optimising leverage and synergy by ensuring that new businesses benefit from the incubator's industry expertise and network access as well as more specific businesses services offered and available within the incubator. By providing graduate mentors and coaching, internal and external chains of networks and synergies are developed.

Any model of business operation is not likely to succeed if the execution of the model is inadequate. Whether for profit or not for profit, incubators for small businesses should be run like a business, which means that they have clear goals and objectives and in addition to operational policies and procedures. Business incubator managers should be facilitating the creation and growth of new start-up businesses and not simply property managers who maintain tenants purely to ensure that they have high occupancy rates.

Businesses that have past their start-up phase should be graduating to other commercial premises allowing new businesses the opportunity to 'incubate'. Indeed allowing businesses to stay in an incubator could well be detrimental to those businesses as there could be a perception from potential customers that the business is still new or still at start-up stage and therefore not as competent or experienced as businesses that are operating from genuine commercial premises.

The comfort zone that many incubators are providing to some of their tenants is in part because of a lack of a coherent set of initial objective for the incubator. The data regarding the number of start ups in any given time is not clear in the Australian context and nor are the number and destinations of the graduands. In Australia it

appears that the number of actual jobs created is not a criteria hence the inability to measure the return on invested capital for any given number of years.

The future of incubators as generators of enterprise and not just as property management models rests with the willingness of sponsors to support their incubation facilities for the long term. Finally there is a need to recognise the economic and social benefits to the wider community when the stream of start-ups graduate from the incubator move into the local business community and begin to grow and expand in terms of employment and output.

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