RULES COMMITTEE: 8/17/11
ITEM:

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: RULES COMMITTEE

FROM: Councilmember Sam Liccardo

SUBJECT: INCUBATOR PROGRAM

DATE: August 11, 2011

Approved

Date 8-11-11

RECOMMENDATION

Direct the City Auditor to add to her work plan an audit of the Redevelopment Agency's participation in the incubator program, to enable the Council to assess:

a) Whether the performance of the incubators justifies the City's continued investment, namely:
   a. Whether there are continued lease obligations in future years (which currently exceed $850,000 in the current fiscal year); and
   b. Whether the City should be negotiating to extract itself from any RDA commitments for those future rental payments;

b) Whether any problematic conflicts of interest arise as a result of the business dealings of the incubator managers, including:
   a. whether incubator managers' work as independent consultants to assess the creation of incubators in other cities-- such as South San Francisco, Seattle, and San Diego—creates conflicts in retaining companies and encouraging growth in San José; and
   b. whether any members of the incubator management teams have earned stock, salary, or other remuneration directly from tenant companies.

c) What measurable outcomes should the Council use to assess the performance of incubators like this? That is, as we consider pending ventures employing similar or different models—such as the San Jose Environmental Innovation Center--what lessons should guide us in our monitoring and ensuring the efficacy of our public dollars?

BACKGROUND

Over the 17 years of its involvement in the Environmental Business Cluster (EBC), the Market Access Center (US MAC), the Biocenter, and the former Software Business Cluster (SBC), the Redevelopment Agency has invested some $30 million in establishing, sustaining, and expanding these incubators. Along with my colleagues on the Community and Economic Development Committee, I heard several presentations from RDA staff and contractors about the extraordinary success of our past and current incubators. We would hear glowing reports of the centers' full occupancy, long waiting lists, awards by national organizations, large venture capital investments, and favorable national media stories.

When I talked with friends and associates in venture capital firms or local technology companies, I typically heard little about these centers, however. People I spoke with seemed either unknowledgeable or indifferent about whatever the incubators were doing. We also didn't see much evidence of companies graduating from the centers to add hundreds of employees within the City of San José.

The conflicting data led me to ask many questions in recent years, privately and publicly. Most recently, at a June 17, 2011 Redevelopment Board hearing, we considered the expenditure of almost $400,000 of Redevelopment funding for the Biocenter rent. I raised several questions about the extent to which the Redevelopment Agency's extensive investment in the incubator program has resulted in the creation of jobs for San José residents. Mary Sidney, the head of San Jose State University Research Foundation (SJSURF), candidly admitted that the 836 jobs that Redevelopment claimed that the Biocenter had "created" actually included many of the company founders and other employees who pre-dated the company's tenure in the Biocenter.

I also questioned whether external business relationships of the management teams that the SJSURF contracted with to run the incubators might create conflicts of interest vis-à-vis the City of San José. For example, one management team, Prescience, prepared feasibility studies to help other cities--like San Francisco, Seattle, and San Diego--create bioscience incubators of their own.

Agency board members nonetheless praised the performance of the incubators, and approved the funding. My public questioning that day did raise the antennae of others, however, who came forward quietly to acknowledge the fire beneath this smoke. From various sources, I heard several troubling accounts about operations at the centers. I also learned that the RDA had an outside consultant perform a formal assessment in 2009, producing less-than-flattering results.

Since that time, the RDA has come under new management, and in response to my request, Managing Director Richard Keit dug through RDA files to locate a copy of that 2009 study, by Chabin Concepts, Inc., Applied Economics, and F.J. McLaughlin and Associates.

Unfortunately, that report had never previously been provided to the Council, nor to any member of the public. The report's conclusions speak for themselves:

- Only a very small number of companies "graduating" from the incubators ever remain in San José—less than 11% of the 285 graduate companies that were reported by the incubator managers as still being in business. For example, of all of the graduating companies in each of the incubators, only 5 of 67 companies at the SBC, and 2 of the 71 companies in the EBC, and 1 of the 19 companies at the Biocenter actually remained in San José.
- The Redevelopment Agency reported some $12 million in annual sales tax revenue to the General Fund, an estimate that the consultant deemed "highly unlikely," and lacking evidentiary basis. Rather, the consultants estimated a total annual revenue impact of $280,980 for the City--much of which appears attributable to a company (see below) that moved *out of San José* since the release of the report—leaving the City with something less than $200,000 in annual tax revenue to show for the Agency's $30 million investment.

- Although large figures are reported for the "economic impact" of the incubators—some $515 million in total--about four-fifths (79%) of the total appeared attributable to a single company, Callidus Software, as of the date of the 2009 report. Since the completion of the report, however, Callidus moved out of San José to Pleasanton.
- Subtracting Callidus' impact upon their departure to Pleasanton, the four incubators graduated companies with a collective total of about 150 employees in San José over the last 15 years. It appears unclear whether some or all of those 150 employees are the same people employed at the firm prior to its incubator tenure.
- Although the incubator managers claimed that 88% of the 325 graduate companies remained in business, the managers did not track those companies, and one-third of the purportedly "surviving" companies could not be located through database searches.
- The four foreign trade offices that occupied offices within the U.S. MAC may have little or nothing to stimulate job creation or investment in San José. For example, Invest Fukuoka identified its mission on the U.S. MAC website to "attract U.S. investment to Fukuoka," which obviously has little to do with our objectives in San José.
- The incubator management did little to ensure that tenant businesses complied with basic City regulations or pay required fees. Fifty-eight (58%) of the incubator companies *did not even have a business license* in the City of San José.
- As of the date of the 2009 report, only one of the four incubators had a business plan or financial sustainability plan. All of the incubators ran at an operating loss that year, and the U.S. MAC reported six consecutive quarterly losses. Large spikes in payments to independent contractors in FY2008-09 drew particular concern of the evaluators, who noted that contractors' payments exceeded salary expenses.
- The incubators' provision of physical space did not necessarily align with the needs of the tenant companies. BioCenter tenants, for example, told interviewees that they would prefer more professional expertise focused on their technical needs and industry, while other tenants found the space too expensive.
- Incubator managers ignored rules requiring companies to "move up and out" after 2 years, allowing one tenant to occupy an entire floor for 11 years. Some companies simply didn't "fledge."

In the two years since the creation of this report, I'm told, we've seen several new success stories--such as Tandem Diagnostics--and several other companies have graduated from the incubators to offices in San José. We certainly welcome that success.

Nonetheless, in light of the lack of public scrutiny of the troubling findings of the consultants, the Council needs to better understand the truth about the management and performance of these incubators, particularly before we consider any continuation of taxpayer support for the entities, or of similar such ventures.