



Testimony on behalf of Mid-Tier Advocacy (MTA)

IN SUPPORT OF H.R. 1812, The Small Business Growth Act

Before the House Small Business Committee

Tonya M. Speed

“Sustainability for Small Businesses”

September 14, 2011

For Questions Please Contact:

Tonya M. Speed

Phone: (202) 421-5100

Mister Chairman, and members of the committee, I am honored to come before you today representing Mid-Tier Advocacy (MTA) to discuss the current size standards policy environment leading to the disappearance of a group of federal businesses often termed “mid-size” firms. “Mid-size” or “mid-tier” refers to “other than small” businesses, having outgrown their NAICS revenue/employee ceilings, which, but not large enough to successfully compete against the largest integrators in the federal market place. Without any federal assistance but lacking competitive infrastructure to sustain themselves, these businesses are quite literally between a rock and a hard place and therefore some face the threat of going out of business altogether. Because mid-size firms are often an acknowledged source of innovation and jobs, this disparity affects the very health and vitality of our national economy.

The MTA directly and indirectly represents a community of small and mid-size firms that provide employment for thousands of people across the United States and across multiple industries including, but not limited to, information technology, engineering, logistics, facilities management, operations and maintenance, international development, scientific research, resource management, construction and more in support of both the public and private sectors. As an organization of the country’s top veteran-owned, service disabled, hub-zone certified, minority-owned and woman-owned businesses, we believe that most concerns are well represented as it pertains to small business.

In the last 40 years, the federal government has had a significant positive impact on the development of small businesses in our country. In particular the Small Business Administration (SBA) and its’ numerous programs’ contributions to expand the United States economic base with fundamental support to small business, in the areas of federal procurement has been a tremendous asset to small businesses across the nation.

However, Mister Chairman, thousands of small businesses, who have graduated and/or matured, have disappeared from the landscape of the federal marketplace over the last three decades. The policies that drive the management of size-standard criteria help the entry-level and emerging firms; however, the same policies that make it possible for start-up firms to succeed, also eventually stifle many of them after the businesses achieve some modest success in the federal marketplace, i.e., once they have outgrown their small-business status. As a consequence, a significant number of mid-size businesses are faced with the decision of either:

- (1) selling their companies, often on less than desirable terms, to large corporations, or
- (2) Going out of business altogether.

Most small business entrepreneurs prefer to grow their businesses in order to increase value for themselves and their families, as well as their employees and they seek the support of government to create an environment in which they can succeed.

What is the Definition of a Mid-Size Firm?

A mid-tier company may have exceeded the largest size standard that is associated with the NAICS codes governing SBA small business categories. They are seasoned businesses as a result of having been in the federal market for 10 to 30 years, or more. Their revenues may range from \$10M to \$350M and they will likely employ from 100 to 2000 people. They are no longer considered small businesses, but neither are they large enough to compete for and win contracts against the multi-billion dollar businesses that dominate the federal market place and in light of the current economic hardship pursue contracts of even the smallest size, stiffening competition for mid-tier and small businesses.

Our testimony today will focus on:

- 1) Why We Believe Small Mid-Size Businesses Save Money
- 2) Why Congress Should Protect its Investment
- 3) Why We Believe the Pilot Will Assist Small Business Growth, Create Jobs and Strengthen the Industrial Base

“Challenges”

Challenges to Small Business Growth in the Federal Marketplace

I will start with a discussion of the current and, as we believe, restrictive policies that include inadequate standards used to define all small business by the North American Industry Classification System (NAICS¹). We say “inadequate” because in most cases the NAICS codes define small business in the federal market place as a business with less than a certain threshold in annual revenues over a three year average.

Additionally, the size standards are inconsistent with what is happening in the current business environment. For instance, a business that specializes in training, only qualifies as small if it has a three-year average sales of \$7M or less, and in information technology if sales are less than \$25M. Once they surpass this average, becoming moderately successful in the federal market place, they are considered “*other than small*” and thrust into the unrestricted labor market without the infrastructure and capital to compete successfully against *significantly* larger businesses. Consequently, one of the many challenges for a ‘small business’ is to **survive beyond the size standards**.

The Small Business Administration (SBA) recently proposed updates to the NAICS standards for a substantial number of industries in Sectors 54 and 81. MTA appreciates SBA’s commitment to updating these long-over-due NAICS size standards however MTA also believes the proposed updates fell considerably short and will preclude many small businesses that should continue to qualify in an appropriate category from competing for contracting opportunities. Specifically, SBA’s proposed 2% raise in the size standards for IT-related services from \$25 million to \$25.5 million is inadequate.

Small businesses that grow beyond the limits set by the NAICS codes are in fact **punished for doing what any business aims to do and that is to grow**. At the same time, the unprecedented growth in the size and number of federal contracts restricted to small businesses is providing tremendous growth for small businesses, but is also reducing the time required to graduate from small business status.

As a negative, emerging “*mid-size firms*”, are, unfortunately, simultaneously accelerated to the point where they **are no longer able to effectively compete**.

Upon out-growing the size standards for their primary NAICS code, any business, even if it only has \$8M per year in sales in the training industry, has to directly compete with the top federal government systems integrators such as Northrop Grumman, Lockheed Martin, SAIC, EDS-Hewlett Packard, and General Dynamics with average sales of \$30B per year and 130,000 employees (**see Tables 1 & 2 below**).

Just as nobody would expect a \$250,000 start-up business to beat a \$50 million dollar firm in competition for contracts, it is unrealistic to expect matured small firms or emerging mid-size firms to successfully compete against such corporations in the long run.

Table 1

GRAPHICAL VIEW OF SMALL BUSINESSES COMPETITION AGAINST LARGE BUSINESSES					
DAVID vs. GOLIATH					
LARGE SYSTEM INTEGRATORS		SMALL/MID-SIZE FIRMS		LARGE SYSTEM INTEGRATORS	SMALL/MID-SIZE FIRMS
Company Name	Annual Revenue in BILLIONS	NAICS Ceiling on Revenue in MILLIONS		Number of EMPLOYEES	NAICS Ceiling on EMPLOYEES
Northrop Grumman	\$33.8	\$7 – 33.5M		120,000	500 - 1500
Lockheed Martin	\$45.189			136,000	
General Dynamics	\$31.981			91,200	
EDS (not part of HP)	\$22.1			136,000	
CSC	\$16.740			95,000	
Average	\$29.962				

Mister Chairman, the above table clearly demonstrates how imbalanced the federal policy on size-standard is as it relates to the ability of “small/mid-size firms to protect and further develop their businesses.

To make this point even more clearly, let us assume the above sales standards were (4x times) what they currently are: Instead of a \$7M ceiling, the NAICS small-business restriction would now be \$28M and instead of \$25M, the restriction would be capped at \$100M. The sales differential between a large corporation and a matured small or mid-size business would still be nearly \$ 29.934B and \$ 29.862B respectively – almost \$30B. With such a stark difference, how is it possible that two such businesses, in all fairness can be placed in competition with each other for federal contracts?

The fact remains, that doing business in the federal market place is very different from doing business in the commercial sector. Businesses in the federal market place are limited by government requirements on yearly submissions of General and Administrative (G&A) budgets to be approved by the Defense Contract Audit Agency (DCAA). These budgets define the amount of money a business can utilize for its growth expenses. For example, if a business with a 10 percent G&A budget and sales of \$1M will have a \$100,000 G&A with which it must cover all of its corporate management costs, including accounting and finance, HR, contracts administration, security risk management, quality assurance, internal logistics and business development (sales representatives and proposal development). To compare, a \$25M firm with a 10 percent G&A budget will have \$2.5M to cover the same functions. This, to an inexperienced business person might appear to be an abundant sum to operate such a firm. But consider the cost of qualified management personnel in the federal market place as reflected in the following estimated annual base salaries:

General & Administrative (G&A) Expenses – A Business Model

CFO	\$175,000
Director of Administration	\$125,000
Chief Technical Officer	\$150,000
Business Development Manager	\$175,000
Business Development Specialist	\$120,000
HR Director	\$120,000
Contracts Administrator	\$135,000
Quality Assurance Manager	\$120,000
*Total	\$1,120,000

**The above salaries are estimated at the lower end of the competitive range.*

***To this, we must add Health/Retirement Benefits and Overhead Costs:*

Benefits (35 percent)	\$392,000
Overhead (25 percent)	\$378,000
**Total	\$1,890,000

According to this model, just the leadership costs for a \$25M business amounts to \$1.89M, leaving only about \$600,000 of the \$2.5M budget. This sum must pay for staff support in accounting and finance, HR and project operations support, business development and proposals and of course, the owner, or CEO, who is leading the organization.

Restrictive Policies: Unintended Cap on Small Business Development

We often hear from economists and government officials that small business is the backbone of our economy. Perhaps a broader and more accurate view is that small business and “mid-size” business are the backbone of the economy. Yet, government policy often proves to be a barrier to small and mid-size business growth rather than encouraging a logical growth pattern. While there are notable examples of a small business developing into a sustainable large business within a relatively short period of time, the usual small business life cycle includes an intermediate mid-size phase. At this point in their life cycle, the business owner faces a choice, sell out, or due to the NAICS size standard impediments face reversion to small business status and disappearance from the marketplace, if, however, the choice is to grow and compete with the big companies, the small business must have a unique service or product that government customers need.

Otherwise the competition will be with \$30+ Billion multinational companies with thousands of employees that have huge business development infrastructures. Unlike small businesses, their staffs may include a variety of marketing researchers, high-powered lobbyists, business capture specialists, proposal writing experts and former high level government officials with relevant contacts in government agencies.

Imagine a \$30 Million company competing against a \$30 Billion company for the same contract. It usually turns out to be a one-sided contest with the small business spending more than it can afford to write the proposal and the large business being awarded the contract. The small business will not be able to survive very long.

One alternative is to cut its losses and agree to be acquired by a large business. More often than not, the decision is to sell rather than fight a losing battle. While this may be one solution for the owner under the circumstances, we believe there should be other alternatives. The pilot that is being considered would provide the needed growth path and transitional period for a small mid-sized firm that is growing, but still needs capacity and infrastructure to be sustained over time. In the first scenario, the economy loses a mature and proven small business which usually offers more innovation and better value to the government than many large businesses do. When this scenario is multiplied, this loss of mature small businesses (with their flexibility, quality, responsiveness, and good value) has a dampening effect on economic growth. Also, when large businesses buy small businesses, they tend to primarily hire contract direct labor personnel and release indirect labor personnel who would duplicate their existing staff. The result of these layoffs is an increase in the ranks of the unemployed.

“Opportunities”

Mid-Size Businesses Strengthen the Industrial Base, Create Jobs and Encourage Greater Competition

Large businesses often buy small businesses in order to get bigger (with higher rates) and to reduce the competition in the government marketplace. The purpose of size standards is to provide a means of setting aside a portion of government contracts for exclusive competition among small businesses within specified industrial classifications. (Mid-size businesses are NOT recognized in the present NAICS size standard system). It is within the interest of the federal government to contract with the small business and mid-size communities because these businesses bring innovation, flexibility, and lower prices than most large businesses. The fact that small and mid-size businesses expand the economy by providing more jobs at a faster rate than large business is significant.

Recognizing the value of competition at all levels of federal contracting will maximize the taxpayer's return on investment

Since the government invests in small companies, it should “protect its investment” and continue to support them – or at least monitor their progress - after they graduate. This makes perfect policy and economic sense: as a taxpayer, I want to know what sort of return I am getting on my small business investment. Secondly, protecting “small” medium-sized companies is important. Small companies are good at “invention” (coming up with new products, services and processes) but medium companies are required for “innovation” (taking new products, services and processes to a mass market). A small company does not possess the capacity to truly leverage the economic benefits of an invention – it needs to grow in order to do that. If it cannot grow, innovation is being stifled.

Currently published size standards are based upon either the most recent 3-year average revenue or 3-year average number personnel employed by a small business, depending upon the industry. For example, the size standard for information technology NAICS is \$25M and the size standard for telecommunications NAICS is 1500 employees. This means that the average revenue for companies eligible to receive small business set aside contract awards in the information technology category cannot exceed \$25M. However, the limit for contracts assigned a telecommunications NAICS can exceed \$25M as long as the company receiving the contract does not have more than 1500 employees.

SBA's most recent proposed rule on NAICS size standards closed for public comment in June 2011. With respect to SBA's proposal to reduce the number of size standards within Sector 54 to 8 anchor size standards, it appears to be a logical and sound approach provided that the sizes are large enough for small businesses to grow and still be considered small business. For example, the standard for financial management including budgeting, accounting and auditing is only \$7M. The market for such services, including high salaries for professional employees, makes this an unrealistic ceiling if such a business is to grow.

The same is true for information technology services that were increased from \$25 to \$25.5M. The value of such a small increase makes little difference in the ability of small business in this category to grow and still be considered small.

In our view, however, the answer to this problem is not to have the \$7M or \$25.5M firm to “graduate” from small business and compete in the unrestricted category. When that occurs, the mid-size small business has few choices than to remain small within the size standard or sell to a larger firm. When that happens, the federal government loses because the country will have fewer mid-size businesses that create jobs faster, and who provide quality goods and services at lower rates. Some say that graduation from small business NAICS codes is like *“falling off a cliff”*. A further indication of the current trend is a 2010 Center for Strategic and International Studies (CSIS) study which showed that government **spending on start up and small business areas was quite healthy during the past 10 years, but showed a steady decline for mid size businesses.**

We should also be mindful of the tremendous difficulty in establishing size standards that will apply equally to the private sector market and the federal market space. The differences in contract revenue and staffing levels vary so widely that efforts to force them into the same size categories would be like mixing apples and oranges and calling them the same. We are encouraged to see that the SBA draft recognizes the difference and look forward to its early analysis of the problem which, hopefully, will lead to separate size standards for the private and public sectors. Until this occurs, however, we continue to work within the constraints of the present NAICS size standards that apply to both sectors.

The current system does not recognize the reality of how a small business grows into a large business. A small business does not normally transition even from the largest NAICS size standard of \$35.5M (except for \$175M minimum assets required for banks and financial institutions) and compete against multi-billion dollar large businesses. Being a small business one day and graduating to a large business the next day is

unrealistic, although the present NAICS size standard system appears to assume otherwise. It is true that some small businesses have competed and won contracts against large businesses, but they usually lose in view of the vastly superior business capture resources that large businesses devote to winning.

Training and Infrastructure Critical to Small Businesses to Grow to the Next Sustainable Level

A small business normally grows into mid-size where additional infrastructure is added for internal strength and other resources are devoted to influencing the external political environment. The mid-size business is characterized by greater involvement in high-fee associations that facilitate access to decision-makers and increased participation in high level seminars and fund raisers where it is possible to meet prospective customers on a social basis. This mid-size phase of growth is where sufficient resources for individual and team training are available, as well as the use of consultants for better strategic planning and the development of more competitive personnel, operations, and information systems. The mid-size phase provides the foundation for competing with large business for unrestricted solicitations.

Mid-size businesses are important to government because they continue to show the innovation, lower prices and agile adjustment to the changing federal environment.

These businesses are sometimes described as “too big to be small and too small to be big.” They bring significant value to procurements that may be too large for small business but would be too expensive if performed by large business.

The point is that government could save money by developing policies that encourage the growth of mid-size businesses because they are capable of performing services that large businesses perform, but at lower rates. The government should recognize the mid-size as a necessary phase of business growth and should identify and reserve procurements for competition within the mid-size in a similar manner as small business.

Mid-size contract opportunities would come from unrestricted procurements and not come from small business set asides. Small business procurements would **not be affected** by the recognition of the mid-size category.

Another benefit would be required mentoring of small businesses by mid-size businesses which would help them grow and contribute more significantly to the economy. Mentoring would provide an opportunity for mid-size businesses to give back to smaller businesses some of the valuable lessons they have learned along the way. Helping protégés to avoid some of the pitfalls of marketing, operations, and finance would also result in faster growth so that the small small business can do their part in growing the economy earlier than would normally be expected.

Recommendations for Enhancing Small Business Growth and Immediately Creating Jobs

We recommend a five year *pilot* like the one that is being proposed in the Small Business Growth Act, H.R. 1812 by Representative Connolly and a similar amendment by Representative Rogers. The proposed Small Business Growth Act legislation allows Contracting Officers to elect to use the number of employees to determine small business status. This pilot aims to provide an even playing field by building upon the concepts already in place by using an employee size-standard that is already being used, for instance, in the telecommunications and telephone support industry, where a business is still considered small if it employs fewer than 1,500 people, regardless of its three-year average sales. Several economists have concluded that using just “average revenue” is an *inadequate measurement of business size without other considerations*. For example, many of the contracts awarded to small businesses are for provision of supplies, and value added reselling.

These contracts provide only a small profit margin, but have the potential to rapidly increase the businesses revenue stream and thereby accelerate its graduation to the unrestricted or “full and open” category.

Similarly, small businesses that serve as prime contractors on supply and value added resale contracts are credited with the total revenue expenditure for that contract. However, in reality the small business must partner, team and enter mentor protégé

relationships with other small and large businesses to successfully compete on these types of contracts and must disperse a considerable amount of revenue to subcontractors. The amount of monies dispersed to subcontractors can be as much as 80% of the total contract value which only leaves 20% for the prime, but 100% of the revenue gets added to prime contractor revenues. Using a pilot program provides the flexibility to make interim adjustments in response to changes in the business environment and to leverage lessons learned. It also provides the opportunity for more businesses to become prime contractors, thus creating greater competition and enhancement to the overall industrial base.

The small/mid-size firm has done everything they have been asked to do and often more than. Now they are penalized for their successful performance and support to the customer. The dominance of large corporations is so overwhelming because they continue to absorb the 'small/mid-size businesses' share of the market place, which they achieve not only through outcompeting the smaller businesses but also by acquiring them.

Infrastructure Capacity Affected by “Graduation”

Businesses need strong and stable infrastructure to grow. Infrastructure includes DCAA accounting systems, human resources systems, intellectual capital (especially at the executive levels) technology systems, strategic planning processes, and other industry specific standard business processes. The key word is stable, because as business size fluctuates, so does its infrastructure, and like a physical building, as the infrastructure weakens, so does the entire business, which may lead to an early death.

A study of the annual receipts of small firms shows there is a significant decline in businesses across all industries when the annual receipts go from \$1- 5M to \$5 – 10M. For example, in 2002, the Information Industry (NAICS 51) shows that in the first category (\$1 – 5M) there were 13,263 firms, but in the second category (\$5-10M) the number firms declined to 2,572, which represents an 80% drop.ⁱⁱ The Professional, scientific and technical services industry (NAICS 54) shows an 88% drop in firms.

Note: These figures are for ALL firms in an industry. Small government contractors represent a subset of these firms.

Source: U.S. SBA, Office of Advocacy, based on data provided by the U.S. Census Bureau.

We understand that this decline could be due to a number of things including the usual spasms associated with business growth and development, and that the Census data is for all businesses and not just federal government contractors. But, the drop is so significant as to lead one to believe there may be a relationship between the most common small business NAICS with a revenue ceiling of \$7M and this drop in revenue. This data lends support to our contention that just as a firm reaches a level of stabilization in its revenues and infrastructure; it is no longer eligible for the support provided to other small businesses.

MTA strongly support the Connolly bill H.R. 1812 because it goes to the heart of how the government can get a better return on its small business investment. To quote Mr Connolly's office, *"The success of these small businesses is what's helping to drive the economic recovery, and the loss of incentives threatens not only their ability to compete but also their ability to hire. Furthermore, federal agencies would lose a valuable pool of small and mid-tier firms that compete for relatively small contracts."* We could not agree more.

This pilot program within GSA would create a separate opportunity for "mid-tier" small businesses to compete for select IT contracts only after other small businesses have had an opportunity to compete for them but before the contracts would be open to broader competition. Further, The MTA agrees that small business concerns should be protected from unfair competition. Under this recommended approach the agency/department would be directed to consider other small business programs [8(a), HUB Zone, SDVOSB, and traditional SB] *before* considering the small business growth pilot, thus "protecting" smaller firms and paving the way for these companies to work on

the appropriate "medium size" contracts. This would preserve incentives for small businesses while helping to sustain opportunities for these growing mid-tier companies who bring savings and value to the government.

We recommend the passage of H.R. 1812. We further recommend that this Committee direct development of a study to determine the impact of graduation from current small business categories on small business infrastructure and revenues.

Summary and Conclusion

The federal government's small business development programs and the esteemed members of the Small Business Committee do an excellent job of supporting and overseeing the establishment and growth of small businesses. We believe that it is fair to say, however, that the record of viable small businesses after 8(a) and other small business program graduation is not nearly so good.

The federal government has invested millions in dollars in support of small business development. Therefore, it is in the best interest of the taxpayer and the government to protect its investment by ensuring that businesses that have grown to the maturity phase are allowed to continue to grow and mature. We contend that the federal government has single-mindedly focused on the start-up and growth phases of business development while ignoring the maturity phase. **We also suggest that in this time of economic challenges, the government cannot afford to let any business decline which will ultimately lead to more unemployment.**

MTA recommends the following:

- Passage of H.R. 1812, which has a five year *pilot* that promotes small business growth and increases options for subcontractors to become prime contractors.
- Development of a study to determine the impact of graduation from current small business categories on small business infrastructure and revenues.

Finally, we strongly support the chairman's recent comments challenging elected officials and constituents alike ... *"to view small business contracting as one of the best possible uses of government expenditures. This cost-saving strategy can actually help Washington address our out-of-control federal debt and help create jobs."* For all the reasons stated above, the establishment of a mid-size business category would insure that the government would get the best bang for its buck, because they deliver greater value.

Mister Chairman, we sincerely appreciate the opportunity to provide testimony before the Committee today. We are prepared to answer questions and welcome your suggestions on any further actions that could result in policy changes to support small and matured small businesses.

ⁱU.S. Census Bureau, North American Industry Classification System. <http://www.census.gov/eos/www/naics/>

ⁱⁱU.S. Small Business Administration. Employer Firms, Establishments, Employment, Annual Payroll, and Receipts by Receipts Size of Firm and Major Industry using NAICS, 2002. http://www.sba.gov/advo/research/us_rec_mi.pdf