

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

To: Members, Subcommittee on Contracting and Workforce
From: Committee Staff
Date: April 26, 2018
Re: Hearing: “No Man’s Land: Middle-Market Challenges for Small Business Graduates”

On Thursday, April 26, 2018 at 10:00 a.m., the Subcommittee on Contracting and Workforce will meet in Room 2360 of the Rayburn House Office Building to examine the challenges to growth and success for businesses as they grow out of their small size status. As the divide between small and large contractors continues to widen, successfully navigating the middle market becomes an increasingly challenging prospect for advanced small and mid-size businesses. The mid-size issue is a multi-faceted one and this hearing continues the efforts of the Committee to examine this important issue in light of the changing procurement landscape. The Committee also hopes to identify legislative solutions which may help extend a pathway to growth for these transitioning firms.

I. Defining a Small Business – Why it this Important?

Key to understanding the mid-size issue is to first understand the definition of a small business and the relevance of this definition to federal procurement. Section 3(a)(1) of the Small Business Act, 15 U.S.C. § 632(a)(1), provides, in pertinent part: “[a] small business concern ... shall be deemed to be one that is independently owned and operated and which is not dominant in its field of operation.”¹ To calculate the size of a small business, the Small Business Administration (SBA) is authorized to consider number of employees, dollar volume of business,² net worth,³ net income, other factors, or any combination of those factors. In sum, Congress has granted the Administrator substantial discretion in calculating the size of a small business, provided that the business is independently owned and operated and not dominant in its field.

The SBA size standards are important because they establish eligibility for a variety of small business assistance programs, including a panoply of government contracting programs designed

¹ Furthermore, 15 U.S.C. § 632(a)(2)(A) states that the Small Business Administration (SBA) is authorized to “specify detailed definitions or standards by which a business concern may be determined to be small for purposes of this Act or any other Act”.

² Current SBA size standards use gross revenue as a measure of dollar volume. Nothing in the Act requires reliance on dollar volume and other measures could be used.

³ The net worth standard is used, for among other purposes, to determine eligibility for investments made by small business investment companies, loans made pursuant to Title V of the Small Business Investment Act of 1958, and for participation in the program established by § 8(a) of the Small Business Act.

to assist small businesses in obtaining federal government contracts. The federal government spends trillions of dollars per year,⁴ which includes hundreds of billions of dollars spent on products and services.⁵ The volume of dollars involved in federal contracting means that every firm is looking for a competitive advantage, and the small business contracting programs are one way to obtain that advantage. In order to diversify the industrial base, create jobs, and increase competition, contracting preferences have been extended to small business participants in the 8(a) Business Development program, the HUBZone program, the Service Disabled Veteran-Owned Small Business program, and the Woman-Owned Small Business Program.⁶

II. The “Other-than-small” Conundrum

The federal government recognizes two categories of businesses – “small” and “other-than small.” While the SBA defines what a “small” business is, there is no federal definition for “other-than-small.” Therefore, this category can encompass firms that barely exceed the SBA’s small business size standards up to the multi-billion dollar household names. For example, the upper limit of the SBA’s small business size standard for information technology (IT) companies⁷ is \$27.5 million. An IT company that barely surpasses that amount, for example at \$28 million, or even significantly surpassing that amount at \$200 million, is considered “other-than-small” and therefore required to compete against each other and the dominant IT contractors. Leidos and Lockheed Martin Corp. are among the top IT government contractors and boast an average of \$6.8 billion in annual revenue each.⁸

This creates a dilemma for newly-graduated firms – they are no longer qualified for small business contracts and no longer eligible for SBA assistance, yet must compete in the open market against these titans of industry. In many cases, firms caught in this circumstance face difficult choices. They may choose to sell, often at a devalued rate than they had previously held as a small company due to the loss of that small size status.⁹ If these businesses are not acquired and subsumed into the supply chain of larger companies, they may choose to modify their business model, focusing on subcontracting opportunities with other small or large companies.¹⁰ This path prohibits the firm’s ability to gain critical project management skills needed to continue growth.¹¹ Finally, they may fail or deliberately choose to impede their own success so that they may remain small and eligible for small business set-aside contracts.¹²

⁴ The federal government spent \$3.98 trillion in fiscal year 2017. USASPENDING.GOV, <https://www.usaspending.gov/#/>.

⁵ The report states that federal agencies procured approximately \$438 billion in products and services in fiscal year 2015. GAO, CONTRACTING DATA ANALYSIS: ASSESSMENT OF GOVERNMENT-WIDE TRENDS 5 (GAO-17-244SP) (2017).

⁶ 15 U.S.C. § 631(a), 644(a).

⁷ NAICS code 541519, “Other Computer Related Services” is an often used industry code for IT services. SMALL BUS. ADMIN., https://www.sba.gov/sites/default/files/files/Size_Standards_Table.pdf.

⁸ WASHINGTON TECH., <https://washingtontechnology.com/toplists/top-100-lists/2017.aspx>.

⁹ *Leaving the Nest: Challenges Facing Advanced Small Businesses: Roundtable Before the H. Comm. on Small Bus.*, 115th Cong. (2018) (statement of multiple roundtable participants).

¹⁰ Tonya Saunders, *The mid-tier paradox: too small to compete, too large to survive*, BLOOMBERG GOV. (May 13, 2016), <https://about.bgov.com/blog/the-mid-tier-paradox-too-small-to-compete-too-large-to-survive/>.

¹¹ *Id.*

¹² *Supra* note 9.

III. Challenges Facing Mid-Size Businesses

While there are businesses that have successfully maintained their mid-size status, many firms venturing into the middle market face a heavily uncertain future and many threats to success. The Committee on Small Business examined a number of these challenges during a roundtable held on November 14, 2018¹³ which are discussed, in brief, in this memorandum.

a. Lack of empirical data examining the failure or success rate of small businesses exceeding their small size

Because there is no federally-recognized definition of “mid-size,” there is a lack of empirical data tracking the trajectory of small firms as they exceed their size standard.¹⁴ As such, potentially critical economic indicators remain uncaptured, such as: the success or failure rate of small businesses that grow out of their small status, the number of jobs created by growing small firms, industries that promote or inhibit middle-market growth, and many other factors.

Ultimately, this lack of data limits Congressional insight into how effective SBA’s contracting programs are in meeting national economic policies geared towards encouraging small business growth and job creation.¹⁵ Certain metrics that may be helpful to track, specifically regarding evaluating the impact of SBA’s contracting programs, may include: the success rate of newly-graduated firms competing in the open market, firms that deliberately scale back down to the small size standard, firms that merge or become acquired, and other metrics.

b. Newly-graduated small businesses are less able to compete against dominate large companies

The “other-than-small” category includes firms that have just graduated out of their small business size by mere dollars, through the entire middle-market spectrum, to also include the giant, billion-dollar companies. These large companies have several competitive advantages over small and mid-size firms, making true competition illusory. For instance, large companies have vast past performance qualifications, strong brand-name recognition and agency ties, as well as a multitude of professional certifications, clearances, and greater financial resources.¹⁶ Small and mid-size businesses cannot afford to maintain these resources, leaving them at a considerable disadvantage. These advantages by large firms have a chilling effect, potentially freezing out emerging advanced-small companies.¹⁷ While larger mid-size firms have a stronger foothold in the middle market, they still have limited bid and proposal budgets and many do not have specialized teams dedicated to business development or communications and marketing.¹⁸ Large companies have a solid infrastructure and can afford teams of personnel dedicated to

¹³ *Supra* note 9.

¹⁴ David J. Berteau, *Challenges Facing Advanced Small Businesses*, PROF. SERVICES COUNCIL. (Dec. 14, 2017), https://www.pscouncil.org/a/Content/2017/Challenges_Facing_Advanced_Small_Businesses.aspx.

¹⁵ *Id.*

¹⁶ *Supra* note 10.

¹⁷ *Id.*

¹⁸ BLOOMBERG GOV., *THE MID-TIER PARADOX: TOO SMALL TO COMPETE, TOO LARGE TO SURVIVE?* 4 (2016).

proposal development, graphic design, protests, pipeline development, legal teams, and other specializations.¹⁹

Additionally, large businesses, who once competed primarily for large, high-dollar contracts, are now increasingly competing for contracts across the spectrum, including those contracts that are most suitable for mid-sized and advanced-small businesses.²⁰ This puts additional pressure on mid-size firms, particularly those emergent, advanced-small businesses.

c. Going from small to other-than-small triggers certain requirements

As contracts grow in scope and size, one large contract (i.e. a high-dollar value set-aside contract) won by a small company could catapult that firm out of its small size status. This growth out of the small size triggers certain requirements that other-than-small firms must comply with, that small firms are exempt from. For example, other-than-small firms must develop detailed subcontracting plans,²¹ however small businesses are exempt from this requirement. Thus, a small firm that saw a spike in revenue due to winning a large contract may not have the infrastructure and business processes prepared and in place to take on a whole host of new requirements. This may result in small business struggling to stay viable in the open market and may be one of the contributing factors to the constant shuffling between small/other-than-small status that is evident between the upper levels of the small size bracket, and the lower levels of the mid-tier bracket.²²

d. The federal procurement landscape creates inherent challenges to growth

Due to evolving federal procurement practices, small and mid-tier companies are facing a more uncertain climate. One of the challenges small and mid-size firms face is a shrinking federal market. As budgets have shrunk,²³ the use of contract consolidation and bundling has risen – this is a procurement strategy that combines several separate, smaller contracts into one unnecessarily large and complex contract, increasing the size and scope of the contract.²⁴ These contracts become prohibitive to small or mid-size businesses, suitable mostly to larger companies. This disadvantages emergent, newly graduated firms and smaller mid-size firms from competing on these contracts which are now too complex to suit their internal capabilities.

¹⁹ *Id.*

²⁰ Mark Amtower, *Be prepared: GWACS, IDIQs will grow in this age of uncertainty*, WASH. TECHNOLOGY (Mar. 16, 2017), <https://washingtontechnology.com/articles/2017/03/16/insights-amtower-gwac-idiq-advice.aspx>.

²¹ 15 USC § 637(d)(4) and (6).

²² *Supra* note 9.

²³ The federal government has reported decreased spending yearly from fiscal year 2011 to fiscal year 2016. NATIONAL CONTRACT MANAGEMENT ASSOCIATION & DELTEK, ANNUAL REVIEW OF GOVERNMENT CONTRACTING 2016 7 (2017).

²⁴ The Committee has a long history of oversight with respect to contract bundling and consolidation, as well as the initiatives used to employ these strategies, e.g., FSSI and Category Management. Further explanation is outside of the scope of this memorandum. *Contracting and the Industrial Base II: Bundling, Goaling, and the Office of Hearings and Appeals: Hearing Before the Subcomm. on Contracting and Workforce of the H. Comm. on Small Bus.*, 114th Cong. (2015).

The Federal Strategic Sourcing Initiative (FSSI), Category Management, and other executive branch initiatives continue to promote bundling and consolidation.²⁵

Additionally, large, government-wide contract vehicles and indefinite-delivery, indefinite-quantity contracts have experienced significant growth in utilization the past several years.²⁶ Those small and mid-size businesses fortunate enough to have been awarded a spot on these highly-competitive, long-term contracts may still be locked out of key markets or forced to subcontract by large multiple-award contracts that require overly extensive past performance requirements, such as Alliant and OASIS.²⁷ The increasing use of strict past performance quantification as an evaluation tool hinders small mid-tier companies from competing as prime vendors, essentially blocking them out of critical growth markets for years.²⁸

Furthermore, due to budget constraints and other interagency pressures, contracting officers are increasingly expecting vendors to be able to do more with less, and in the face of uncertainty, the government tends to be risk-averse, preferring to contract with large, established contractors over small and mid-tier companies. Because of these and other changes in the procurement landscape, the diversity of contractors has drastically declined,²⁹ further limiting the choices contracting officers have. In sum, the shrinking federal market, increased use of large, government-wide contracting vehicles, and increasing use of strict past performance qualifications on these contracting vehicles limits the government's opportunity to realize a return on its investment in emergent small firms and mid-size businesses.

IV. Potential Legislation Extending Definition of a Small Business: Pros and Cons

The Committee engaged stakeholders in identifying potential legislation that may assist advanced-small businesses transitioning into the middle market. Proponents believe that the size standards the SBA sets for certain industries may fail to encompass many firms that are small according to statute, i.e., independently owned and not dominant in its field. Thus, the suggestion was raised to amend the Small Business Act to provide a longer time period for which a business may be qualified as small, arguing that this will improve the health of the industrial base, increase competition resulting in lower prices, and create and preserve jobs. Conversely, opponents argue that this strategy might unintentionally inhibit small business growth. Arguments are presented below.

a. Industrial Base

Proponents argue that mid-size firms are failing, as small firms that outgrow the size standards either go out of business or are acquired by large firms. An earlier study by Bloomberg Government, examining data from fiscal years 2012-16, predicted a dire outlook with

²⁵ *Id.*

²⁶ *Supra* note 20.

²⁷ Description of these MACs and IDIQs such as Alliant are beyond the scope of this memorandum. BLOOMBERG GOV., *THE MID-TIER PARADOX: 2018 COMPANY REPORT* 6 (2018).

²⁸ *Id.*, at 6, 11.

²⁹ SECTION 809 PANEL, *REPORT OF THE ADVISORY PANEL ON STREAMLINING AND CODIFYING ACQUISITION REGULATIONS* 171 (1 vol. 2018).

weaker mid-size prospects, finding that “average annual prime contract revenue for this segment of the federal market has declined substantially... midsize contractors are losing market share year after year... pressures from both large and small companies have squeezed the mid-tier market share, and this trend doesn’t show signs of slowing down in the long-term future.”³⁰

However, the latest study by Bloomberg Government examining mid-tier data up to fiscal year 2017 revealed evidence showing seemingly strong performance data and mid-tier success; for instance, Bloomberg found “a recent uptick in spending with mid-tier companies, [and] modest growth in the mid-tier share of [the] government’s industrial base.”³¹ Bloomberg further found, in its latest study, that mid-tier firms with small business divisions are a “significant driver of recent mid-tier growth,”³² attributing this to the use of small business set-asides.³³ While the report seems to indicate optimism in the middle market, it is worth noting that Bloomberg’s definitions of small, mid-size, and large are not equivalent to the Small Business Administration’s definition of small and “other-than-small,” leaving the report somewhat open to interpretation as it relates to the current procurement landscape.

b. Competition and Price

Proponents further argue that an increase in mid-size business presence in the market will increase competition against the larger competitors, thereby decreasing price. Given the trend towards increased use of larger, consolidated, multi-award contracts and the decline of small businesses willing to work with the federal government as described earlier in this memorandum, there is a concern that contracts will become increasingly available for the largest contractors and less so for smaller contractors. A strong middle market consisting of emergent, newly-graduated firms up to larger mid-size companies might increase competition against the biggest federal contractors and could indeed bring down prices. However, no concrete data exists in support or opposition to this argument.

c. Creation/Preservation of Jobs

When mid-size businesses are acquired by large firms, the large firm normally sheds the administrative side of the businesses – the human resources, accounting, marketing, legal, and other functions which are often duplicated at the acquiring company’s office. Thus, these jobs are lost. Proponents argue that maintaining and growing these businesses would preserve these jobs. Further, they argue that if the mid-size business continues to grow, it will also continue to add jobs, pointing out that these firms are credited with high job creation.³⁴ However, extending

³⁰ BLOOMBERG GOV., THE MID-TIER CHALLENGE 2 (2017).

³¹ *Supra* note 27, at 18.

³² *Supra* note 27, at 2.

³³ *Id.*

³⁴ For example, the National Center for the Middle Market found that five years of middle-market data show that the middle market produces jobs 1.5 to 2 times faster than either big or small businesses, producing 3 out of 5 net new private-sector jobs. Michael Evans, *Job Creation in the New Political Economy: Small Companies, Not Big Companies, Create Jobs*, FORBES (Feb. 8, 2017), <https://www.forbes.com/sites/allbusiness/2017/02/08/job-creation-in-the-new-political-economy-small-companies-not-big-companies-create-jobs/#82a24949e6ec>.

the definition of a small business to include firms on the lower end of the mid-size bracket does not prevent mergers nor guarantee job creation.

d. Inhibiting Growth of Small Businesses

If legislation were proposed extending the period of time a business can be considered small, proponents argue that a longer transitional period would benefit small firms who experience sudden, rapid growth in revenue, typically by winning a large contract or task order. A change in the calculation of size would help these firms sustain revenue levels under the small size threshold, allowing them the ability to develop their business plan and infrastructure to transition to mid-size more successfully, because of the increased lead-time. Opponents argue that extending the definition of small business to encompass firms that are, by current definition, other-than-small, would increase competition for those firms that are truly small, taking those contract awards and dollars away from truly small firms. This may further inhibit the growth of start-ups and very small businesses that are just entering the federal marketplace. Any legislation that is proposed should take into account a strategy to combat the potential for depressing competition among smaller firms.

V. Conclusion

Advanced-small and mid-size businesses play important roles in the federal procurement ecosystem. Understanding whether the Small Business Administration's government programs are working to ensure sustained growth for a small business once it graduates out of its small size status is important to maintain a healthy and competitive industrial base. As the Committee gains a better understanding of the challenges facing successful transition from small to other-than-small, and weighs the potential costs and benefits of legislation benefitting advanced-small businesses, the first and foremost goal must be to not harm small firms that currently qualify for the small business contracting programs.