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"No Man's Land: Middle-Market Challenges for Small Business Graduates"

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Good morning Chair Knight and Ranking Member Murphy. I want to thank you for the opportunity to testify on this important topic. My name is Steve Ramaley, Associate Attorney in the Government Contracts Law practice group at Miles and Stockbridge, P.C. I am testifying today on behalf of the 800-member Montgomery County, Maryland, Chamber of Commerce (MCCC) and as an active member of its GovConNet Council. The Council meets monthly to tackle federal contracting issues that affect small and midsize firms. Large companies are also an important part of the Chamber membership and they support efforts to assist small and midsize companies to obtain success in federal contracting.

According to Bloomberg Government's "The Mid-Tier Paradox: 2018 Company Report," there is some good news and some not so good news.

The good news is that the number of midsize vendors to the federal government — defined by Bloomberg as firms with \$25 million to \$500 million in revenue — is the highest in five years, totaling almost 1,700. That compares to roughly 118,000 small businesses and 110 vendors who are "large" — with annual revenues in excess of \$500 million. The other good news is that in FY17, federal government spending on midsize companies went up 2.1%.

If you look closely at the data, however, there is some not so good news. First, despite the increase in numbers, midsize vendors still account for only 1.4% of all vendors to the federal government. And second, even though last year saw an increase in midsize spending, this increase came on the heels of an 8.3% decline across the previous three years.

Also, I must note a caveat: Bloomberg defines midsize companies as firms with annual revenues between \$25 million and \$500 million. Since SBA size standards top out at \$35.8 million, Bloomberg's midsize numbers include "big small businesses" as well as those who no longer qualify for set-asides. Bloomberg reports that roughly 23% of federal spending on midsize companies was made through small business set-asides. So, if we removed this spending on "bigger smalls," it would paint a considerably more pessimistic midsize picture.

This leads to our request for Congressional action. As small businesses and government contracts become larger, it is inevitable that they will face choices – grow beyond the small business programs to compete with large companies, stay small to avoid the difficulties of competing in a "full and open" environment, sell, or go out of business. Unfortunately, it appears that more and more firms are being forced to make those latter choices — stay small, sell, or go out of business.

Also, before getting into the meat of our proposals, we echo the observations in the Bloomberg report that (1) there is a need for the Government to identify highly qualified companies early in the acquisition cycle and (2) the burden rests, and should continue to rest, on midsize companies to identify strong teaming partners and productive contract vehicles. Our proposals are designed to facilitate success, but not cause it. That is up to each individual company.

Size standards play an important part in government contracting, defining eligibility for small business programs. This hearing is very timely because the SBA is about to undertake its five-year review of size standards, which vary from industry to industry. Currently, the highest revenue standard is $38.5 million, applicable to industries such as financial services and aerospace engineering. This means that a business in those industries cannot have more than $38.5 million in annual receipts, averaged over previous three years, to qualify as "small." A business with an average revenue of $39 million is expected to compete with large businesses with revenues sometimes in excess of $500 million. The numbers bear out how difficult such completion can be.

Small business programs impact the local and national economy, though the purpose of these programs is sometimes misunderstood. Small business programs are not designed to subsidize business development; the purpose is to ensure supplier diversity in the federal marketplace in order to spur innovation and guard against supplier consolidation and noncompetitive pricing. And, of course, small businesses produce the majority of American jobs. Without these firms growing to become midsize firms, who in turn grow to compete and challenge large businesses, the federal contractor ecosystem would stagnate, and jobs would likely be lost.

Government contractors experience a unique pattern in their growth which is causing this midsize crisis – or no man's land. Contractor growth can be mercurial, sometimes hovering in the single digits and then exploding over two or three years. This pattern of sudden growth is increasingly common because of the Government's more frequent use of large indefinite delivery, indefinite quantity (IDIQ) contract vehicles, under which contractors can be awarded huge task orders. It is not unusual for a contractor to win a single award or task order that, on its own, bumps the contractor out of the small business program. As referenced earlier in my testimony, the SBA uses a three year average of revenues to determine program eligibility. So a company with historic revenues of $15-$20 million might win an $80 million task order and be very quickly slingshotted out of the set-aside environment and into the full-and-open world.

This leads me to the Chamber's first recommendation: change the SBA formula for small business eligibility. Our proposal is to allow companies to look back five years and choose their lowest 3 years for purposes of calculating size standard eligibility. The Chamber's GovConNet Council, comprised of practitioners and business owners involved in government contracting, worked for months to come up with proposals that would give larger small businesses more "runway" to adjust to rapid growth, while still protecting smaller businesses under the various SBA programs. We believe this proposal strikes that balance.

The rationale behind this proposed change can be stated simply: competitiveness takes time to build. Revenue is not an indicator of present competitiveness; it is an indicator of future competitiveness. Bigger small businesses that are about to graduate from the set-aside world need time to recruit talented employees, develop their intellectual property and build infrastructure to compete at the next level. Having a good year (or even a couple good years) does not mean that the company will continue to grow. Moving from a three-year look-back, to a lowest three in the last five, would give firms more time to adjust to the full-and-open marketplace. Furthermore, firms that show consistent high revenues would still be graduated.

Who would benefit from this proposal? Not just big small businesses and midsize companies. Any small business that intends to grow will eventually benefit from these changes. Further, having more well-qualified firms under the revenue standards will increase the chance that solicitations will be set-aside, and therefore will give all small firms more opportunities to compete. Separately, large businesses benefit because it increases the pool of well-qualified subcontractors. A major complaint we hear from large primes is that by the time they find a great small partner, the work garnered from that relationship makes the partner large.

There have been suggestions that perhaps it would be better to use a straight five-year look-back, instead of the lowest three out of five that we are proposing. First of all, both are better than the status quo. But a straight five-year look-back would punish firms who may end up with decreased revenues in following years. While competitiveness takes time to build, it can be lost overnight. Losing one contract can cascade to key employees departing, the unraveling of teaming relationships, or other crises. A straight five-year look-back would require firms on the decline to continue to count peak years, even if they were four or five years ago. A three out of five-year look-back would not do that. Second, the straight five-year look-back would, in many cases, be less impactful than our proposal. Firms winning one very large task order or IDIQ can be pushed out of the small business program even in one year. A five-year look-back might not be helpful to those companies. The midsize no man's land is a big problem, and it needs a big solution.

In addition to the three out of five-year look-back proposal, the Chamber is offering another measure which, just like the look-back proposal, is a relatively simple change. We propose allowing companies to subtract Independent Research and Development ("R&D") expenses from total revenue for size determination purposes.

This change would support the government's initiative to stimulate technological and biomedical innovation and would allow companies to continue to pursue and develop new products and processes, without penalty. Firms who invest in R&D often do so at the expense of their present competitiveness. For firms at the cusp of becoming large, every revenue dollar counts and must be brought to bear to help win the next contract award, in order to maximize revenue streams that can support the company while it transitions to full-and-open competition. This dynamic effectively discourages R&D investment. Allowing a firm to subtract its R&D costs from size receipts would not only support innovation, it would also remove one barrier to small business contractors who invest in future growth.

The key to this change is simplicity. We are proposing that this subtraction piggybacks off the IRS's definition for R&D expenses, which firms already annually tabulate and report. Also, we recognize the need for a cap on the subtraction — to prevent otherwise large firms who have massive R&D expenses from qualifying as small businesses. We propose the subtraction be capped at two times the NAICS size standard. For employee-based standards, we propose a subtraction of a single employee for $50,000 in qualified R&D expenses.

Let me wrap up this testimony by emphasizing that the midsize "no man's land" is an ever-present worry for every small business contractor. Until we provide meaningful opportunities for growth beyond small, we will continue to see too few companies crossing "no man's land" to become successful large businesses. We believe that our proposals would be effective steps in the right direction, but we'll be the first to say that even more steps are needed. We look forward to working with this Subcommittee, and sincerely thank you for your time, your attention to this matter, and for your invitation to participate today.