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İSGEM STRATEGY AND SUSTAINABILITY

Summary

This paper considers the potential sustainability of the three incubators assisted by the project within the context of the current İSGEM model. Sustainability has two definitions:

1. Sufficient income generated to cover expenditure
2. Delivery of a range of business support services focused on tenants, enabling incubation to take place.

First we set out the background to the project and identify weaknesses in the current model. With the project extension we are expected to help formulate a future strategy paper. We propose developing research into the other İSGEMs to confirm if the weaknesses identified below are experienced by all İSGEMs. From this we will work with KOSGEB to identify strategy adjustments to the model.

Secondly, we review the specific problems of the building and supply that have negative impacts on the sustainability of the İSGEMs.

Third, we then review the current stage of each İSGEM and the sustainability challenges each faces. Each İSGEM circumstances is different and the likelihood of sustainability different in each case.

In Malatya it is clear that they will achieve the first sustainability definition above. To meet the second definition we are recommending a number of changes to current management, employment and practice. The key concern focuses around staff skills and motivations and how external consultants can be used with KOSGEB support to deliver much of the professional services.

In Kastamonu the extensive delay in opening the İSGEM is the key challenge to achieving the first sustainability definition. The financial situation is likely to be challenging through to the middle of 2017. 11 entrepreneurs are waiting to move into the İSGEM, which will mean an occupancy rate of over 50%. A number of policies to maximise the chances of financial sustainability have been made. To ensure the delivery of focused support services a number of changes to staffing and management are recommended. Not currently included in the forecasts is the use of external consultants to deliver much of the business support services as this is not currently being considered. This will probably be necessary for business support services to be effective and this will be discussed with management.

Tokat's strategy is the clearest statement of delivering business support services with management systems designed to monitor deliver implementation. While this is the case Tokat's focus is largely on the delivery of external services to maximise positive impacts and generate sufficient income to cover costs. The staffing requirements of this external policy means it will be very difficult to deliver the internal support services envisaged. To maximise the chances of financial sustainability it will be necessary for the Board to complete the shareholding financial injection set out in their agreement with KOSGEB during 2016, the forecast external income will be achieved and a more robust attitude taken to debt collection, including rent. KOSGEB will need to cover the historic electric bills built up while the building licence is awaited and in addition provide a further cash injection of 20,000 TL in 2016 and 80,000 plus TL in 2017 unless the İSGEM is willing to immediately adopt the changes recommended by the expert.





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Background

The project has assisted in establishing three new incubators (ISGEMs) in Kastamonu, Tokat and Malatya. The three buildings were previously constructed under a separate component and there is a separate supply contract providing furniture and equipment. Launched in May 2014 the Technical Assistance contract has two components, the first of which is focused on the launch and operation of the 3 ISGEMs.

The overall objective of the project of which this is:

“Contributing to local economic development of selected regions by encouraging and strengthening start-ups and increasing the competitiveness of SMEs and entrepreneurs.”¹

The specified purpose of this activity’s first component is:

Establishing three new business incubators in the selected regions (Kastamonu, Malatya, and Tokat) in order to **develop and spread more focused, specialized, comprehensive entrepreneurship support mechanisms**

The profile of the three ISGEMs, established before the TA start, closely follow the KOSGEB model. The three boards are primarily controlled by the Chamber of Commerce (Malatya) or Chamber of Craftsmen (Kastamonu & Tokat) with small shareholdings by sector chambers. Shareholders are committed to provide shareholders’ funds amounting to 50,000 TL in each case.

Tokat and Malatya ISGEMs have 5600 sq. metres space of which 2826 is lettable space (51% of total), plus a basement 10 units intended for storage of 588 SQM. The two each have 3104 sqm of common space with the remainder allocated to meeting room, cafeteria and management room. Kastamonu ISGEM has a different slightly larger design at 5707 SQM, with lettable space at 2173 SQM (60% of total). Kastamonu office units are smaller & more usable than the oversized office units in Tokat and Malatya

All other costs of each operation are to be funded out of revenue, security, cleaning, heating, insurance, maintenance, etc. The buildings are equipped with individual electricity meters but gas (for heating), water and other services have to be covered from rent changes. A particular challenge has been paying the large deposits required for electricity and gas supplies prior to their connection.

Each of the three ISGEMs were provided finance by the project to employ a manager and a technical advisor. Their salaries were specified at 5 and 3 times Turkey’s minimum wage. This followed KOSGEB staffing recommendations.

KOSGEB runs a wide and significant range of business support programmes. However, for several of these the ISGEMs do not appear able to access them directly or be a recognised supplier for their clients. KOSGEB recognition enables the ISGEM to recommend tenants for start-up funding without the tenant undertaking KOSGEBs normally required entrepreneurship course.

The expectation KOSGEB has for ISGEMs is that after their initial funding all costs should be covered by income generated from their operations.

¹ Terms of Reference page 7



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Weaknesses in this Development Model

The central consideration is the objective of the public finance in supporting the 3 ISGEMs, namely: **encouraging and strengthening start-ups and increasing the competitiveness of SMEs and entrepreneurs.**

1. Staffing

For the ISGEMs to be considered as sustainable they need not just to generate sufficient income to cover costs, they need sufficient income to deliver this social policy objective.

Achieving this social objective requires, within the incubator walls, for the ISGEM to offer a range of business support services and to provide regular coaching to all the tenants. With only two professional staff it is unlikely that the ISGEMs can deliver this service range effectively. The European Business Network recommended minimum staffing level is 3 professional staff and the average number across their members is 14. From the work undertaken with the three incubators it is clear that the growing workload will undermine the ability to deliver a professional support service. We are recommending that each ISGEM also employ an additional business advisor and an administrator. This will enable the staff to focus on their core business support function. However, it is very unlikely that the costs of the additional staff can be fully covered from rental income given the size of the incubators. Ongoing funding may be required to maintain a professional level of support services for new entrepreneurs approved as tenants.

While the ISGEM, properly staffed, can have a demonstration impact on entrepreneurship development this can be enhanced significantly by out-wall activities such as involvement in encouraging entrepreneurship development from schools upwards, providing training for entrepreneurs who are not tenants, advising new business start-ups, running innovation programmes etc. EBNs average of 14 staff includes project based people who are involved in these and other activities. Clearly, these out-walls activities need to be financed not from tenant rents but other sources for the objective to be addressed in this way.

The salaries mandated by the project ToR are in excess of local salaries and do not reflect the core competencies of the staff employed. They will be significantly reduced following the end of project funding but this is likely to have negative motivational impacts that would have been avoided with a more sensible employment policy.

2. Board membership

The board membership is in each of our 3 ISGEMs dominated by one organisation that holds 90-95% of the shares. The central chamber representative is of central importance in decision making. In all 3 of the ISGEMs this person is very reluctant to allow the ISGEM manager to have managerial responsibility. In all 3 ISGEMs an inappropriate amount of day to day decision making is in the hands of an unpaid volunteer not always available to respond. This is an inappropriate structure, which reflects the current shareholding, and is preventing managers exercising their areas of responsibility, undermining motivation and professionalism.

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We can give a number of examples where this level of centralised decision making outside the staff group has led to inappropriate decisions concerning suppliers, tenants selected etc. Indeed the staff appointed in each ISGEM also reflects this process with further negative effects on performance. For the operating of effective support services, especially in relation to the mobilisation of external specialists, the ISGEM manager needs to be given a great deal of additional responsibility.

A broader based much more equal ownership structure involving a wider range of stakeholders including large enterprises and representatives of new entrepreneurs, public sector, universities in addition to the Chambers is strongly recommended.

Current shareholders are committed to providing share capital to a set amount. In no case has this been fully implemented. Rather smaller amounts have been made available where a pressing need required this to happen. Not enforcing the delivery of such commitments is a major weakness of the current system.

3. Revenue Funding

The project finance for the 3 ISGEMs is primarily capital (building/equipment) plus the projects revenue support for staff salaries. All other costs to be met from rent or other income. In our project reports we have identified the weaknesses of this approach. To launch successfully the ISGEMs have a range of start-up costs to meet before the revenue stream can start. Without initial finance for revenue costs incubators cannot be launched.

In the case of these 3 ISGEMs a range of damaging actions had to be taken to overcome the lack of start-up revenue. Initial tenants rent and deposits had to be used to pay immediate bills, taking not agreed extensive credit from suppliers, KOSGEB cajoled into not seeking immediate transfer of supplier contracts on handing building over, not immediately insuring the building, not initially hiring cleaners, not initially heating the building, not initially hiring security services, taking tenants immediately available rather than selecting those with most growth potential, etc..

All the above steps caused by the lack of support for revenue expenditure are damaging to the ISGEMs reputation, undermining the professional image required to focus on the projects objective. Not recognising this need will undermine all future ISGEM projects and needs to be addressed.

4. Approach to business development for new businesses

Incubators operate a pre-incubation programme where new potential entrepreneurs are assisted to research and plan their business idea and develop it to the point where they can effectively launch their business. Within KOSGEB there is the idea that new entrepreneurs should launch their business early and research their idea and build clearer plans after the business has been launched. As such the concept is clashing with the pre-incubation concept to some extent with businesses being launched early and requiring start-up type assistance after launch. This concept is to some extent undermining the focus of an incubator which should use pre-incubation to weed out poorly defined business ideas rather than discover this after they have become tenants.

5. Legal Structure

There is a great concern amongst some ISGEMs about the inadequacy of the current legal structure. In part this is a concern about tax treatment of tenants and ISGEMs but also a concern about board

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structure, enshrined objectives, access to public funds and excluded areas of ISGEM participation in KOSGEB funding programmes outside the area of their specific support.

There is a need to conduct a legal review to identify how to improve existing legal structures as well as steps to consider specific legislation

Specific Building Problems of the 3 ISGEMs

Set out below are building related problems that are impacting on the sustainability of the 3 ISGEMs. Hopefully, these problems are only applicable to the three ISGEMs being supported, but this should be checked through a survey of all ISGEMs including the 6 new projects currently being launched.

1. Building Design

The buildings are poorly designed for their function. There is an excessive amount of common space, raising running costs significantly. The building security design is based on a significant amount of security guards, again raising running costs significantly. Room sizes, especially offices are too large for start-up businesses. Some designated production units have poor access for industrial supplies. Design allows for cross pollution to easily happen between production units, restricting the types of tenants who can be housed.

The designed level of insulation does not meet Turkish standards, significantly raising heating costs and environmental impact. Placement of radiators indicates a failure to calculate heating needs. Window placements make some units almost unusable in summer sunshine. Design in Malatya and Tokat has significant cleaning problems to windows and roof lights caused by the design.

Much greater care is needed in ensuring ISGEMs are located in cost effective buildings that reflect their incubator function. Design competition should not award contract to the lowest price but to the most cost effective design. Design should be influenced by a needs analysis leading to a clear strategy for the ISGEM. Design should then clearly reflect the strategy rather than expecting strategy to be identified post construction.

The high running costs derived from the design of the 3 ISGEM buildings are a significant challenge to their sustainability.

2. Building Construction

The buildings suffered from poor construction with a significant range of problems requiring significant restoration work to be carried out by the constructors. This is a prime reason for the delayed opening of Kastamonu and is damaging to the reputation of Malatya and Tokat. Tenants have been disappointed by problems around water penetration, toilet functioning, winter heating and summer cooling problems associated with the building. In several cases it was necessary to give rent free periods etc. to reflect building related damages to the tenants businesses.

3. Supply contract

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The separate supply contract for furniture and equipment saw deliveries start in late February 2016 and will still take many months to complete. This has caused a number of problems in achieving the sustainability of the three buildings including:

- Unable to apply key aspects of the pre-incubation programme
- Unable to run training courses or hold meetings in the building
- Tenants unable to use planned building facilities i.e. meeting rooms, refreshment making etc.
- Unable to implement planned telephone systems
- Unable to properly establish the staff offices of the ISGEMs
- Unable to establish the ICT potential assumed for the buildings

All these problems caused by the supply contract delays have had a negative impact on the ISGEMs reputation, service delivery to tenants and on their sustainability through raised costs and reduced incomes.

Sustainability of the three ISGEMs

The summary table below sets out the annual end TL cash forecast position for each ISGEM. As can be seen a cash surplus is being forecast for two ISGEMs. For Tokat two forecasts are produced with the second including recommended changes to policy showing a small surplus each year.

Annual Forecast cash flow

ISGEM	2016	2017	2018	2019	2020
Malatya	59461	47880	67037	135537	205226
Tokat 1	-14476	12747	43379	10749	-31107
Tokat 2	23241	35275	108127	96134	78280
Kastamonu	76110	139519	252713	362386	492010

It should be realised that the above summary table is based on a larger number of assumptions specified for each ISGEM in the attached individual reports.

1. Malatya

By February 2016 Malatya ISGEM should have achieved 70% occupancy of the rentable space. This is expected to rise to an average of 80% during the year and achieve 95% by 2018. Given the rentable levels established and planned increases are implemented with the current collection periods maintained it is expected that the ISGEM is financially sustainable. The summary table sets out the forecast income and expenditure as calculated in the attached detailed report and forecast tables.

In addition to the rental and other income the forecast includes the requested grant finance from KOSGEB set out in the approved submitted business plan. It also includes the shareholders paying the outstanding share capital by the end of 2017.

In forecasting costs it is understood that the Board intends to reduce wages post project support. We have also recommended hiring an additional administrator and continued use of local consultants to



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provide specialist services. These changes and recommendations are also included in the financial forecasts.

INFLOW AND OUTFLOW OF CAPITAL	Total				
	2016	2017	2018	2019	2020
From receivables last year	35,000				
From Sales	204,187	296,640	400,786	479,580	521,738
For operating costs	350,246	374,622	402,624	426,386	452,049
For Investments	15,000	-	-	-	-
Redemption of debt & liabilities	-	-	-	-	-
Financial means					
- Equity from shareholders	-	25,000	-	-	-
- Liquid funds before planning	35,000	-	-	-	-
- Overdraft	-	-	-	-	-
-Rental deposit	5,040	3,320	-	-	-
- Loan	-	-	-	-	-
- EU Grant	139,230	-	-	-	-
- KOSGEB Grant for wages	6,250	18,750	-	-	-
-KOSGEB Grant for equipment & minor repair work	-	13,500	-	-	-
- KOSGEB Grant for consulting	-	5,832	20,995	15,306	-
- Other	-	-	-	-	-
Total Financial Means	185,520	66,402	20,995	15,306	-
Overdraft/ excess	59,461	-	19,157	68,500	69,689

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Cumulative	59,461	47,880	67,037	135,537	205,226
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While the financial forecasts indicate financial sustainability there are a number of concerns about the sustainability of the organisation as an incubator as opposed to a managed workspace. These include:

- Central day to day management role of the board & the restrictions this places on effective delivery of support services
- Skills of staff. Given the starting position the staff have made progress but will require to continue training for a significant period, including English language training for the Manager.
- Currently the technical advisor spends much of his time dealing with administrative work that prevents him play his central role in delivering services to tenants
- The manager is not sufficiently involved in delivering services to tenants
- There needs to be a stronger focus on pre-incubation to ensure that future tenants are new innovative businesses with growth potential

To mitigate this risk factors to the sustainability of the service delivery the report recommends that the İSGEM:

- Employ an administrator to take over the administrative activities of the technical advisor and also offer administrative support services to tenants
- Professional staff (manager as well as technical advisor) to focus on initial business planning and ongoing regular reviews of performance with tenants, using these meetings to identify opportunities and weaknesses of the individual businesses that could be tackled by specialists (trainers, consultants).
- KOSGEB should work with the İSGEM to ensure their tenants had access to KOSGEBs grant aid in hiring consultants and trainers in a timely manner.
- Manager to receive English language training.
- Both professional staff to continue to receive business skill and coaching training on a regular basis
- Manager to spend much more time working as an advisor to tenants.
- The board devolves a much higher degree of responsibility for day-to-day management to the İSGEM manager
- Establish a regular pre-incubation programme, promoting interest and selecting around 16 potential entrepreneurs for detailed work within the İSGEM in a pre-incubation area to finalise their business plans prior to selection as new tenants.

2. Tokat

Tokat has the most difficult provincial economic circumstances to respond to, located in an area of outward migration, especially of young people, with low skills and education levels of the population. The area is dominated by agriculture with little manufacturing and falling rates of company formation.

The İSGEM in response to these challenges has adopted an unusual strategy focusing, in addition to in-wall services, on the development of external services that address the provinces economic problems while generating additional income for the İSGEM.

The building continues to suffer from a range of building related problems caused by poor construction, design and maintenance. The rent established for new businesses, already low in comparison to the



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other two ISGEMs (reflecting local costs) is discounted by 60% as an assistance policy by the ISGEM. A relaxed policy towards rent collection with no deposit being taken has encouraged the early tenants to delay payments, especially considering the low building values. KOSGEB has agreed to pay the deposit required to connect the gas supply, but has not yet paid this deposit. As a consequence one tenant has been waiting 10 months to start their business. Currently the ISGEM is not planning to turn on the heating system once the gas is connected because of the high costs of heating the communal space and inability to charge tenants for heating their units.

It is recommended that the ISGEM, once the building improvements are made (fabric and maintenance/security), should instigate a policy of raising rents of existing tenants to reflect inflation and gradually raising rents for new tenants towards more commercial levels. A much stronger policy towards rent collection should be instigated. These changes will generate additional funds that will allow amongst other things for the building to be cleaned and heated. Heating the building should reduce the deterioration in the building fabric, positively impact on the ISGEMs image and enable tenants to work effectively over the winter period.

In producing the forecasts the expert has relied on the forecast income from external services supplied by the KE and also reflected the KE assumptions about how historic debts for electricity and water will be met by KOSGEB or chamber once the building license is granted. It is also assumed that the outstanding equity from shareholders will be paid in 2016, that KOSGEB will agree the financial package requested in the business plan and that staff salaries will be reduced by 40% once the project finances comes to an end. On the basis that these all happen and that the ISGEM accepts the recommendations for changes in rental and other policies it is forecast that the ISGEM will be financially sustainable. With the same assumptions but without adopting the changes recommended then the ISGEM will require further financial injections for investment and to cover a small cash deficits as specified below.

Option 1

INFLOW AND OUTFLOW OF CAPITAL	2016	2017	Total 2018	2019	2020
From receivables current year	23,302	24,750			
From receivables last year	24,029	34,360	27,318		
From Turnover & Sales	57,662	202,626	287,649	296,597	327,209
For operating costs	271,184	285,162	309,335	341,727	369,065
For Investments	80,000	52,000	-	-	-
Redemption of debt & liabilities	-	-	-	-	-
Financial means					
- Equity from shareholders	37,500	-	-	-	-
- Liquid funds before planning	1,904	-	-	-	-
- Sponsorship	-	-	-	-	-
- Surplus from Goldmining activity	25,000	-	-	-	-
- Rental deposit	-	-	-	-	-

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- EU Grant	140,061	-	-	-	-
KOSGEB grants for repair and maintenance		12,500	25,000	12,500	
KOSGEB grants for Curtains	7,000				
KOSGEB grant for air con	14,000				
KOSGEB grants for cleaning machines		35,000			
- KOSGEB Grants for wages	6,250	18,750			
KOSGEB grant for forklift	-	36,400	-	-	-
Total Financial Means	231,715	102,650	25,000	12,500	-
Overdraft/ excess	- 14,476	27,223	30,632	- 32,630	- 41,856
Cumulative	- 14,476	12,747	43,379	10,749	- 31,107

Option 2, with recommended changes

INFLOW AND OUTFLOW OF CAPITAL	2016	2017	Total 2018	2019	2020
From receivables current year	23,302	28,932			
From receivables last year	24,029	35,672	32,103		
From Turnover & Sales	58,974	240,251	367,107	403,568	465,250
For operating costs	293,779	324,072	351,358	438,060	473,105
For Investments	-	-	-	-	-
Redemption of debt & liabilities	-	-	-	-	-
Financial means					
- Equity from shareholders	37,500	-	-	-	-
- Liquid funds before planning	1,904	-	-	-	-
- Sponsorship	-	-	-	-	-
- Surplus from Goldmining activity	25,000	-	-	-	-
- Rental deposit	-	-	-	-	-
- EU Grant	140,061	-	-	-	-
KOSGEB grants for repair and maintenance		12,500	25,000	12,500	
KOSGEB grants for Curtains	-				
KOSGEB grant for air con	-				
KOSGEB grants for cleaning machines		-			
- KOSGEB Grants for wages	6,250	18,750			

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KOSGEB grant for forklift	-	-	-	-	-		
Total Financial Means	210,715	31,250	25,000	12,500	-		
Overdraft/ excess	23,241	12,033	72,852	-	21,992	-	7,855
Cumulative	23,241	35,275	108,127	86,134	78,280		

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While there are significant challenges for the financial sustainability of the ISGEM the staff skills, commitment and the service specification in the strategy indicates a clear awareness of the soft business skills support required by tenants. While the extent of the external service mix means that the staff time available for delivering these incubator services will be very constrained the clear statement of intension means that they are able to be offered to tenants.

3. Kastamonu

The significant problems experienced by the building has prevented the ISGEM opening until end February 2016. This means any sustainability forecast cannot rely on prior performance in developing estimations of financial flows. During 2015 the staff focused on awareness raising and pre-incubation support, leading to 11 potential tenants likely to move in during March.

The report distinguishes between new start clients and existing enterprises that are launching new subsidiary ventures at the ISGEM. The latter group should paid a full commercial rent from the start and be restricted to a maximum of 30% of available space in the ISGEM. It is recommended that a pre-incubation area is established and used to assist potential new SMEs to finalise their market and financial knowledge and projections prior to considering them as tenants. Future tenants are expected to primarily come through this channel.

The late start means a financially challenging period for the ISGEM until 2018. However, with the payment of outstanding share capital, the requested KOSGEB funding contained in their submitted business plan, a strong policy towards rent collection, a reduction in staff salaries post project funding and the achievement of reasonable external training and consultancy income, the ISGEM should be able to maintain a positive cash balance and be profitable from 2018.

INFLOW AND OUTFLOW OF CAPITAL	2016	2017	Total 2018	2019	2020
From receivables last year	-	-	-	-	-
From Sales	224,747	395,655	483,749	510,631	549,638
For operating costs	353,841	389,144	414,055	440,958	470,014
For Investments	20,000	-	-	-	-
Redemption of debt & liabilities	-	-	-	-	-
Financial means					
- Equity from shareholders	25,000	-	-	-	-
- Liquid funds before planning	10,000	-	-	-	-
- Sponsorship	20,000	-	30,000	40,000	50,000
-	-	-	-	-	-
- Rental deposit	18,893	6,648	-	-	-
KOSGEB grant for maintained	-	13,500	13,500	-	-

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KOSGEB grant for equipment	-	18,000			
- EU Grant	140,061	-	-	-	-
- KOSGEB Grants for wages	6,250	18,750			
Other EU Support	5,000	-	-	-	-
Total Financial Means	225,204	56,898	43,500	40,000	50,000
Overdraft/ excess	76,110	63,409	113,194	109,673	129,624
Cumulative	76,110	139,519	252,713	362,386	492,010

While the financial sustainability is achievable the key issue is the level of soft business support services to be delivered to tenants. The report raises a number of risks in this area concerning the level of managerial autonomy given by the board to the manager, the staff motivation where salaries are being reduced, the skills of current staff and the workload staff have to carry. Recommendations are made in each of these areas to reduce the risk to soft service delivery including the employment of a full-time administrator.