WHITE PAPER ON

FINANCIAL SUSTAINABILITY OF STARTUP INCUBATORS

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ABSTRACT

Incubators have become a key component of India's entrepreneurship and innovation ecosystem. Hence, it is important to ensure that they become financially sustainable within a reasonable period of time. A financially self-sustaining incubator is better positioned to create long-term impact, utilise resources efficiently, evoke the confidence of different stakeholders, maintain operational and strategic independence, provide high-quality services and contribute to a resilient ecosystem. The primary objective of this report is to outline various revenue streams (not to be conflated with funding sources) accessible to startup incubators and recommend a revenue mix which ensures that the incubator remains focused on its core activities related to provision of entrepreneurial support to its incubatee startups.

Startup incubators can generate revenue from a wide variety of stakeholders in the ecosystem. In this report, we focus on four groups: (i) incubatee startups, (ii) industry partners, (iii) government and (iv) other entrepreneurial support organisations (ESOs). Given the core focus of incubators, it is recommended that at least 50% of their revenue should be generated from incubatee startups. There are four ways in which incubators can generate revenue from their incubatees: incubation fees, equity stake, revenue share and success fees. Incubators can rely on one or more of these sources to generate revenue, depending on the financial needs of the incubator over time, nature of the startups which are incubated and features of the local ecosystem in which the incubator is embedded. Observing the practices of mature high-performing incubators reveals that they usually deploy a hybrid model by combining revenue from different sources. A hybrid model creates flexibility for incubators to address specific needs without resorting to a one-size-fits-all approach. Hybrid model also reduces uncertainty for incubators on account of dependency on one particular source of income. The road towards financial sustainability is not easy and beset with several challenges. However, since several incubators in India have been operating effectively for close to two decades and have achieved financial sustainability, proven models have emerged to learn from. Having said that, incubator managers are also expected to be entrepreneurial and innovate themselves, in order to take their incubators and the ecosystem to new heights.

Introduction

India has emerged as one of the world's most vibrant and dynamic startup ecosystems, characterised by a surge in entrepreneurial activity and innovation across various sectors. The country boasts a large and youthful population, a growing economy, and a thriving technology sector, which have collectively contributed to the rapid expansion of the startup landscape. Key cities such as Bangalore, Mumbai, Delhi and Hyderabad have emerged as major hubs for startup activity, attracting talent, investment, and resources from around the world. Government initiatives such as Startup India, Make in India, and Digital India have further bolstered the startup ecosystem, even in Tier II and Tier III cities, by providing policy support, funding, and infrastructure to entrepreneurs. Thirty-one of the thirty-six states and Union Territories have a dedicated startup policy. Within this ecosystem, startup incubators play a crucial role in nurturing and supporting early-stage ventures by providing them with resources, mentorship, and networking opportunities. Today, India has more than 1000 incubators spanning the length and breadth of the country. Sponsor organisations for startups include the government, academic institutions and private corporations. Incubators serve as catalysts for innovation and entrepreneurship, helping startups overcome initial challenges and accelerate their growth trajectory. By offering access to co-working spaces, product development support, funding, mentorship programs, industry partnerships, and other support services, incubators enable startups to develop viable business models, validate their ideas, and scale their operations more efficiently. Additionally, incubators contribute to the overall growth and competitiveness of the startup ecosystem by fostering collaboration, knowledge sharing, and ecosystem building initiatives.

Since incubators have become a key component of India's entrepreneurship and innovation ecosystem, it is important to ensure that they become financially sustainable within a reasonable period of time. Many incubators have received public grants to take off and stabilise their activities. It is critical for incubators to create stable non-grant revenue streams which ends their dependence on external financing, especially for their operational expenses. A financially self-sustaining incubator is better positioned to create long-term impact, utilise resources efficiently, evoke the confidence of different stakeholders, maintain operational and strategic independence, provide high-quality services and contribute to a resilient ecosystem.

The economic model for an incubator also depends on the activities it undertakes. For example, some incubators offer, among other benefits, physical infrastructure such as working space and lab support for product development, while some run cohort-based accelerator programs. There are incubators which partner with corporations or governments to implement programs related to innovation and entrepreneurship on their behalf. Some incubators may also charge a success fee for enabling certain outcomes like fund-raising or revenue generation. Thus, the economic model for incubators would vary based on the mix of these activities in their portfolio of initiatives.

The primary objective of this report is to outline various non-grant revenue streams accessible to startup incubators and recommend a revenue mix which ensures that the incubator remains focused on its core activities related to provision of entrepreneurial support to its incubatee startups. It is important to differentiate between revenue streams and funding sources for an incubator. Funding for incubators typically comes in the form of grants from government and related agencies, corporations (mostly through corporate social responsibility grants) and philanthropic organisations. The focus of this report is only on revenue streams, not on funding sources, although there can sometimes be a close linkage between the two. The report assumes, as is common, that incubators receive seed funding at inception from government, philanthropic foundations or their host organisations. This seed funding gives incubators sufficient time to start generating revenue from their incubation activities.

I. Revenue Streams for Startup Incubators

Startup incubators can generate revenue from a wide variety of stakeholders in the ecosystem. In this report, we focus on four groups: (i) incubatee startups, (ii) industry partners, (iii) government and (iv) other entrepreneurial support organisations (ESOs).

1. Incubatee Startups

The relationship between an incubatee and an incubator is symbiotic, characterised by mutual support and collaboration. Incubators provide essential resources, mentorship, and networking opportunities to startups, guiding them through the early stages of development. In return, startups contribute innovation, creativity, and entrepreneurial drive to the ecosystem.

The relationship is built on trust, communication, and shared goals of success. Incubators offer guidance tailored to the unique needs of each startup, fostering growth and resilience. Meanwhile, startups leverage the incubator's expertise and resources to refine their business models, gain access to funding and the business ecosystem, understand do's and don'ts based on previous incubatees' experiences and navigate challenges, laying the foundation for long-term success. Certain incubators also provide access to labs and technical expertise critical for high-tech product development. Given the symbiotic nature of the relationship, the cost of incubation for an incubatee should be associated with the value addition it receives from the incubator. Incubators should avoid a one-size-fits-all cost model, like charging the same fees or taking the same equity stake from all startups, and link it to the nature and extent of value addition. For example, if an incubator takes a 5% equity stake in an incubatee to which it provides seed investment, it should take a lower equity stake in another incubatee that does not receive seed funding from the incubator.

There are four ways in which incubators can generate revenue from their incubatees: incubation fees, equity stake, revenue share and success fees for additional support. The philosophy behind equity stake and revenue share is that since startups do not have upfront cash resources, incubators would not charge the startups when they are in their early stages. Once startups progress in their journey and generate revenue or raise funding, incubators can partake in their success by liquidating the equity stake or taking an appropriate share in the revenue generated by the startups.

Incubators can rely on one or more of these sources to generate revenue, depending on the financial needs of the incubator over time, nature of the startups which are incubated and features of the local ecosystem in which the incubator is embedded. Observing the practices of mature high-performing incubators reveals that they usually deploy a hybrid model by combining revenue from different sources. A hybrid model creates flexibility for incubators to address specific needs without resorting to a one-size-fits-all approach.

A. Incubation Fees

Typically, incubators offer a package of tangible and intangible support and services. Tangible support includes working space, shared facilities like meeting rooms, pantry, internet connectivity, computing resources, prototyping facilities, product development support upfront seed grants etc.

Intangible support may include access to mentoring, advisory at low or no cost, legal and accounting expertise, guidance for intellectual property (IP) protection, business network, investors, markets and many more. Startups have the option to leverage the specific support which they need. As the cost of each of the tangible and intangible support is difficult to exactly quantify, incubators tend to combine them and charge consolidated incubation fees, typically on a monthly basis. However, support services are usually offered at significantly subsidised costs by incubators. Incubation fees could also include pay-per-use charges for specialised labs and testing facilities. Shared infrastructure like labs, testing facilities, conference and meeting rooms etc. can also be offered to clients other than incubatees at commercial rates. The positive aspect of charging incubation fees is that it brings a consistent and predictable flow of cash earnings for the incubator. That being said, incubators should be mindful about pricing their incubation services in a way that is affordable for early-stage startups that do not have adequate resources to pay exorbitant fees. A significant drawback of an incubation-fees-only model is that it does not allow the incubator to partake in the success of its incubatees. Hence, mature incubators tend to combine other sources of revenue with incubation fees for better economic outcomes.

Determining how much incubation fees to charge is essentially an exercise in pricing the support services of the incubator. Two pricing approaches are popular among profit-making corporations: (i) cost-plus pricing and (ii) value-based pricing. Cost-plus pricing involves listing all the costs incurred in providing a service and then adding a profit margin on top of the costs. In order to follow this approach, an incubator can start by listing all its costs: rental (if any), utilities (electricity, water, internet etc.), manpower, maintenance, consumables and so on. Once the total costs are estimated, the incubator can add a profit margin on top and spread it out across all incubatees, either equally or depending on degree of usage. Since early-stage incubators typically receive seed funding from the government, they can follow an “at-cost” approach without adding a profit margin or even a “cost-minus” approach to provide services at a subsidised cost. Value-based pricing entails estimating the market value of the service being provided for the target customer. In this approach, incubators focus on the market value of their offerings to determine the price. As an example, the commercial rate per square feet of office space or per desk price in co-working spaces can be used to determine the value of an office/desk being offered to incubatees. Even in this approach, the incubator can consider offering services at a discount to market prices in order to attract high-quality startups, particularly if they own equity stakes or have revenue-sharing arrangements with their incubatees.

B. Equity Stake

Equity stake refers to the percentage of ownership that an incubator acquires in a startup in exchange for the resources, funding, and support it provides. Incubators typically take an equity stake in startups to align incentives and share in the potential success of the ventures they support. An equity-based model helps startups reduce their upfront cash costs as incubators take equity in the company in lieu of fees for providing incubation support and services. However, incubators also take upfront risk by betting on the success of the startups.

An incubator will generate revenue from equity stakes by exiting, typically by selling its stake to an investor who participates in the following funding rounds. Given the typical lifecycle of startups, successful exits can take several years to materialise. While good returns will be realised only for a subset of the incubatees which turn out to be success stories, they typically tend to compensate for the portfolio ventures which fail. One important thing to keep in mind is the commercial model of the follow-on investors like angels or venture capitalists. Most of them will only provide funding if the startup has a potential to scale significantly within a certain period of time and be profitable when it achieves a stable state. Thus, successful exits for incubators are only possible if the business models of the startups are scalable and fundable. Thus, monetisation of equity stakes can be a challenge in ventures which don't have the potential for exponential growth. It is also clear that sale of equity stakes generates revenue for the incubators in discrete unpredictable blocks over time rather than generating predictable stable revenue every month or quarter. Hence, most incubators tend to use a hybrid revenue model which augments monetisation of equity stakes with other sources of revenue.

The quantum of equity taken by an incubator can vary depending on factors such as the stage of the startup, the level and nature of support provided, and the negotiations between the parties involved. Equity stakes for early-stage startups can range from 3% to 5%, although this can vary based on the specific circumstances and negotiations. It is important for both the incubator and the startup founders to carefully consider the equity split and negotiate a fair arrangement that reflects the value of the support provided and the potential future value of the startup. Acquiring the same stake in all incubatee companies irrespective of the value addition (incubation, mentoring, investment etc.) is not a fair deal for the incubatees.

Equity dilution should be affordable to an incubatee, and should not take away significant ownership of the company in its very early stage. Taking equity in double digits at an early stage of a startup without providing significant investment would be highly disadvantageous for the founders as the company's notional valuation will become significantly lower. The following rounds of funding will be benchmarked to the first round of equity dilution. In addition, founders will be left with significantly reduced equity in the future rounds of investments, which reduces their incentive for creating long-term value and discourages investors from infusing capital in later rounds. Thus, equity stakes should be structured in a way that aligns the interests of both parties and incentivizes collaboration and mutual success.

Equity is the dearest resource for startups and they part with even small portions of it only if they see that they will receive significant value in exchange for it. Thus, if an incubator tries to take equity stakes without providing commensurate value, it might attract only low-potential or low-performing startups, thus creating an adverse selection problem. Being able to get an equity stake from high-potential startups is a good test of the strength and perception of an incubator's value proposition.

The subset of successful incubatees, which are able to raise subsequent rounds of funding leading to an initial public offering (IPO) or an acquisition, have the potential to generate significant revenue for the incubator at different stages of their journey. Typically, as the valuation of the incubatees keeps increasing over time, the value of the equity stake held by an incubator also sees a significant increase. As the incubatee raises subsequent rounds of funding, incubators may choose to take partial exits at appropriate points in time and realise cash for their operations. Whether or not an incubator sells shares in a particular funding round, and how much, depends on a variety of factors including the valuation in that round, the need of the incubatee and participating investors to structure the capitalization table and the requirements of the incubator.

Table 1 lays out a simplified and stylised example of a successful startup's journey through various funding rounds leading to an acquisition (it could lead to an IPO as well) and the incubator taking partial exits at various stages. How much time it takes for a startup to raise funding at various stages, the valuation it receives and the amount of equity which the incubator dilutes at each stage can vary significantly depending not only on the nature of the startup, incubator, sector and geography, but also on the macroeconomic environment.

In the example below, the incubator receives 6000 shares, which represents 3% equity in the startup at the incubation stage. By gradually selling its equity, the incubator is able to earn just over 1.5 crores from funding rounds up to Series B venture capital. Post that, 6 crores of revenue is generated from the acquisition which happens over the long term. Typically, less than 20% of the incubatees would be expected to provide such high returns for incubators. In every funding round, new shares are issued to the incoming investor in return for invested capital. Hence, per-share valuation typically does not increase in the same proportion as the valuation of the incubatee.

A	B	C	D	E	F
Funding Round	**Time Period (Months)**	**Pre-money incubatee valuation (INR Crore)**	**Pre-money per-share incubatee valuation (INR)**	**Shares sold by incubator in funding round**	**Revenue generated by incubator: D x E (INR Lakh)**
Angel	12 - 18	6	300	500	1.5
Seed	18 - 24	30	1200	1000	12
Series A	24 - 36	60	2000	1000	20
Series B	36 - 48	300	8000	1500	120
Acquisition	72 - 120	1500	30000	2000	600

Table 1: Revenue generation for incubator via partial exits in funding rounds

C. Revenue Sharing

Another way for startup incubators to generate revenue is by taking a share of the revenue generated by the incubatee startups. The philosophy behind the revenue-sharing arrangement is similar to that of the equity stake: there is no upfront cost for the startup and it has to pay only when it generates revenue. Revenue-sharing can be attractive for startups because it allows them to retain ownership and control of their business while still accessing support and resources from the incubator. It also aligns the interests of the incubator and the startup, as both parties benefit from the success of the startup's revenue-generating activities. It creates an incentive for the startup incubator to ensure the progress of the startup in such a way that it achieves various milestones on the way towards revenue generation, typically by the end of the incubation period.

In this model, the incubator and the startup enter into an agreement specifying the terms of revenue sharing. Three key elements have to be defined:

1. Percentage share of the revenue which will be shared with the incubator: Typically, incubators charge 3-4% of the startup's annual revenue. This percentage can vary depending on factors such as the level of support provided by the incubator, the amount of funding received, and other terms negotiated between the parties.

2. Time duration for which the revenue will be shared with the incubator: Incubators usually take a share of the revenue for a limited period of time, in line with the number of years for which the startup was incubated. Since typically incubation periods are 2-4 years, incubators take a share of the revenue for 2-4 years after the startup begins generating revenue.

3. Cap and floor for revenue sharing: To make revenue sharing agreements more attractive for startups, incubators can consider agreeing to a cap i.e. a maximum absolute amount of revenue of the startup for which revenue sharing will be calculated. At the same time, to protect the incubator's downside, revenue share is only calculated and paid in years where the startup's revenue is above a certain minimum amount i.e. the floor.

Example: Startup has agreed to share 3% of annual revenue with the incubator for a period of 3 years after it starts generating revenue. The cap is 1 crore and the floor is 25 lakhs. Table 2 shows how revenue would be shared with the incubator:

Year	Revenue of the startup (in lakhs)	Will the year be considered for revenue sharing?	Revenue shared with incubator (in lakhs)
1	20	No, floor not exceeded	-
2	50	Yes, floor exceeded	1.5
3	80	Yes, floor exceeded	2.4
4	20	No, floor not exceeded	-
5	110	Yes, with a cap of 1 crore	3.0
6	130	No, revenue shared for 3 years	-

Table 2: Revenue sharing with floor and cap

D. Success Fees

Incubators offer a bouquet of services and incubated startups leverage the strengths of the incubator as per their needs and requirements. One of the critical functions of an incubator is to provide access to investors and customers. Since raising capital and earning revenue from initial customers are watershed moments in a startup's journey, incubators can seek success fees for such transactions, especially from startups that are associated with an incubator for specific support and do not pay incubation fees. Of course, success fees should be charged by incubators only for those startups in which they do not own equity stakes. Incubators can also charge success fees for curated support such as helping the startup achieve other important milestones, like a certain user base, revenue target, level of profitability, licensing agreements, international market entry, lab access for product development, product launches, regulatory clearances, strategic partnerships, or successful exit events like acquisitions. Seeking contingent fees for successful exits is particularly important for incubators which do not hold an equity stake in their incubatees. Success fees can be charged either as a flat fee or as a percentage of the size of the transaction, depending on what suits the particular type of event.

At the same time, it is important to note that incubators should resist charging fees for transactions emanating from government initiatives like startup grants or procurement schemes, even if government rules do not explicitly prohibit the same. This is particularly important in cases where such government initiatives are implemented through incubators.

Incubators which have been successful in enabling funding and revenue generation for their incubatees can consider special cohort-based programs to offer the same services for non-incubatee startups, and charge success fees from them as well.

2. Industry Partners

A well-functioning partnership between industry and incubators can create significant value for startups. Industry interaction can help startups to uncover and understand real-world problems, gain market access, receive high-quality mentorship and even raise funds. To enable better industry-startup collaboration, incubators can undertake and execute partnership programs for corporations. These could be in the form of accelerators, corporate social responsibility (CSR) initiatives, demo days and events like hackathons. Incubators can generate revenue from these activities in a variety of ways. They can earn program management fees from corporations for organising and spearheading these initiatives. They can also earn success fees from startups which experience favourable outcomes like receiving orders or funds from the industry partner. Organising open events for corporate partners can also allow incubators to earn fees from a larger target audience beyond their incubatees. By doing so, incubators can recover costs, build a network of industry mentors and provide better value addition to their startups. However, it is important for incubators to monitor and limit their dependence on industry for revenue generation. Further, while engaging in the organisation of corporate and open events, incubators should be careful not to lose their focus on their core mission of providing entrepreneurial support for their incubatee startups.

3. Government

Typically, most incubators in India have started their initial activities with the help of grants received from government agencies. While such grants are not exactly revenue for an incubator, these grants help finance the initial cost of setting up an incubator. In addition, governments have several programs which are and can be implemented through incubators. This provides incubators an opportunity to earn fees for the administration of such programs. Further, such programs are typically long term (3-5 years), and thus offer a visibility of revenue over the lifetime of the program. However, public funding can be accompanied by several expectations and restrictions, one of which is that the incubator should have a viable self-sustaining economic model by the end of the grant tenure. Government funding also has a significant focus on capital expenditure in order to create infrastructural facilities for the benefit of incubatee startups.

4. Other Entrepreneurial Support Organizations

Startup incubators can also earn revenue by providing a range of services to other entrepreneurial support organisations like other incubators, accelerators, innovation labs, research parks and universities. These can be in the form of consulting, training and workshops, partnership programs, resource sharing, incubator-in-residence programs, data and research services, accreditation and certification programs and network access, to name a few. Mature incubators are expected to engage in these activities in order to contribute to the overall entrepreneurship and innovation ecosystem.

II. Stages of incubator development and revenue mix for mature incubators

The core objective of incubators is to provide entrepreneurial support to early-stage startups. Thus, their success ultimately depends on the success of their incubatee startups. Since there is significant uncertainty associated with the success of startups, it is imperative for the incubators to create a long-term revenue-generation plan which eventually helps them attain financial sustainability. At a very broad level, incubators can be categorised into two types: (i) Early-stage: 5-7 years of age, and (ii) Mature: >7 years of age.

Revenue considerations for early-stage incubators:

Since most incubators in India are supported under various state or central government schemes, a significant portion of their costs are covered by those grants in the first 5-7 years. Such seed grants allow incubators to build critical infrastructure, hire a good team, build a network of mentors and onboard the first few cohorts of incubatees without worrying about revenue generation. However, incubators are expected to use this cushion to lay the groundwork towards financial sustainability by creating steady streams of revenue which will grow over time. Typically, early-stage incubators would generate revenue via incubation fees, rental, pay-per-use lab charges, management fees from partnership programs, events, training and consulting. Incubators can leverage excess capacity in their infrastructure (co-working space, conference rooms etc.) by renting it out for commercial activities like meetings, conferences and workshops to non-incubatee professionals and companies. An entrepreneurial and committed Chief Executive Officer (CEO) is extremely critical for the success of early-stage incubators.

Revenue mix for mature incubators:

While incubation fees generate revenue for incubators in the short-term, equity and revenue-sharing arrangements start paying back over the medium-to-long term, typically 5-6 years. Hence, early-stage incubators must focus on building a pipeline of high-quality companies which can provide attractive returns once the incubator matures. Sale of equity stakes in successful startups which receive multiple rounds of follow-on funding has the highest upside potential for incubators. Of course, the horizon for generating returns can vary significantly across different sectors. Startups in particular sectors, like SaaS, e-commerce and FinTech, can start generating revenue as early as 3-4 years and provide substantial returns for incubators via revenue-sharing arrangements. However, other sectors like biotechnology, space technology and high-grade medical devices have long gestation periods but can provide large exits via sale of equity stakes. It is important for incubators to create an incubatee portfolio which generates steady revenue over the short, medium and long term.

For a successful mature incubator, revenue generated from incubatees via incubation fees, sale of equity stakes, receipt of revenue share and success fees is expected to form a bulk of the incubator's revenue mix. Generating at least 50% of revenue from incubatees also ensures that the incubator remains focused on its core objective of providing entrepreneurial support for incubatee startups. Table 3 lays out the various sources of revenue for incubators from different stakeholders along with a recommended revenue mix for mature incubators.

<table>
<tr><th>Key Stakeholder</th><th>Sources of revenue</th><th>Revenue Share</th></tr>
<tr><td>Incubatee Startups</td><td>• Incubation Fees
• Equity Stake
• Revenue Sharing
• Success Fees</td><td>50 - 70 %</td></tr>
<tr><td>Industry Partners</td><td>• Accelerator Programs
• Program Management Fees</td><td rowspan="2">10 - 25 %</td></tr>
<tr><td>Government</td><td>• Program Management Fees</td></tr>
<tr><td>Other Organisations</td><td>• Consulting
• Training and Workshops
• Accreditation and Certification
• Data and Research</td><td>10 - 25 %</td></tr>
</table>

Table 3: Recommended revenue mix for mature startup incubators

Conclusion

In this report, we have laid out the major sources of revenue for startup incubators. Of course, this is not an exhaustive list and incubators can be creative in generating revenue by creating value for a variety of stakeholders. As an example, certain incubators have developed an in-house capability to generate revenue by providing research-as-a-service. Being a key actor in the entrepreneurship and innovation ecosystem, incubator managers are also expected to be entrepreneurial and innovate themselves, in order to take their incubators and the ecosystem to new heights. As India marches on to become one of the world's leading entrepreneurship and innovation ecosystems, it is crucial to develop a large and stable network of successful and mature incubators. Achieving financial sustainability for incubators is a key factor to take India's ecosystem into a higher orbit. The road towards financial sustainability is not easy and beset with several challenges. However, since several incubators in India have been operating effectively for close to two decades and have achieved financial sustainability, proven models have emerged to learn from. Hybrid models which rely on a variety of sources of income have proven to be resilient through tough times. There are also instances where mature incubators have set up their own venture capital funds to invest in the growth of their startups. These funds also allow incubators to earn management fees from the fund. At the same time, a balance has to be struck between serving the needs of different stakeholders, with a core focus on incubatee startups. Incubators need to invest heavily in developing and improving sound processes and practices which allow them to select high-quality startups. If startups succeed, it will naturally translate into the flourishing of incubators. At the same time, mature incubators can enable the success of more startups. India's entrepreneurship and innovation ecosystem relies significantly on the success of this symbiotic relationship.