

August 2021

# Challenges Facing Transitioning Federal Small Businesses: A Proposed Framework and Solution Executive Summary

PROJECT DIRECTOR  
Mercedes O. Enrique

LEAD AUTHOR  
Fanyi (Lele) Meng



August 2021

# Challenges Facing Transitioning Federal Small Businesses: A Proposed Framework and Solution

## Executive Summary

PROJECT DIRECTOR  
Mercedes O. Enrique

LEAD AUTHOR  
Fanyi (Lele) Meng



# Contents

I. Abstract ..... 1

II. Executive Summary ..... 2

Endnotes .....10

# List of Figures

- Figure 1: Why NAICS 236220? .....4
- Figure 2: Entering - NAICS 236220 .....4
- Figure 3: Exiting - NAICS 236220.....5
- Figure 4: Exiting NAICS 236220.....5
- Figure 5: Transitioning - NAICS 236220 .....6
- Figure 6: Dollar Bands - NAICS 236220 .....7
- Figure 7: Dollar Bands Obligated Dollars - NAICS 236220.....9
- Figure 8: Dollar Bands Obligated Actions - NAICS 236220 .....9

# Challenges Facing Transitioning Federal Small Businesses: A Proposed Framework and Solution

## I. Abstract

Too few small business federal prime contractors successfully transition from small to other-than-small and continue to win federal awards. The challenges of making the transition from small to large and the drastic change in competitive landscape often lead firms to exit the federal market or stifle normal business growth trajectories in order to take advantage of small business set-asides. This results in a stratified market wherein there are fewer firms competing in the mid-sized arena, leaving Government procurement officials with fewer qualified contractors. This directly affects the Government's ability to meet mission requirements.

The scope of this project includes reviewing prior research into problems facing transitioning federal small business contractors and whether these problems exist within NAICS 236220. Through existing research, the study team identified key challenges that exist across all industries including fewer entrants and a low rate of successful transitions from small to other-than-small. The team then turned to studying NAICS 236220 and whether the same trends exist within this particular sector. Using government data aggregated through Fedmine.us, the team collected all awards made between FY2005-2020 under NAICS 236220. The team then used this data to track entrants, exits, and successful transitions from small to other-than-small. Further, the team analyzed the rate of small business participation relative to award size.

The resultant research demonstrates that firms within NAICS 236220 share many of the same challenges as those documented by prior research into the entire federal market. As a result, only six percent (6%) of the small businesses that won other-than-small awards during the years studied went on to successfully transition. Additionally, the team identified that there is an inverse relationship between award size and small business participation.

Based on the research findings, the team believes that the SBA ought to implement a pilot moratorium program that will provide small businesses both an incentive and an opportunity to grow. The moratorium program will allow capable, established small businesses to make the transition from small to other-than-small by facilitating a smoother transition. The current "all-or-nothing" nature of small business set-asides creates a perverse incentive for small businesses to intentionally remain small. By addressing this issue, the moratorium program benefits both small and mid-sized firms while increasing the capacity of capable federal prime contractors for the Government.

## II. Executive Summary

On December 5, 2019 the SBA issued a final rule changing its method for calculating the average annual receipts used to prescribe size standards for small businesses. Pursuant to the Small Business Runway Extension Act, the rule increases the period for calculating annual receipts from the previous 3-year average to a 5-year average for all SBA receipts-based size standards.<sup>1</sup> The accompanying Report, H. Rept. 115-939 (“Congressional Report”), places great emphasis on the unique challenges facing mid-sized businesses.<sup>2</sup> Fundamental to the legislative intent is the “other-than-small conundrum” which Congress characterizes as a dilemma for newly graduated firms when “they no longer qualify for small business contracts” and “yet must compete in the open market against these titans of industry.”<sup>3</sup> As a result, businesses that newly outgrow their SBA size standard must commonly sell to a larger corporation, restructure their business models to focus on subcontracting, or deliberately lose or impede their success in order to remain small and eligible for small business benefits. Each of these alternatives implicates significant detriments for businesses faced with exceeding SBA size standards. Businesses that choose to sell commonly face the risk of a significant devaluation from the value they previously had as small businesses while businesses that turn their emphasis towards subcontracting hinder their own ability to gain project management and general contracting skills for future growth. The last option, deliberately remaining small, not only stifles the individual firms but also the capacity of the entire industry in support of the federal government mission.

The Center for Strategic and International Studies (CSIS) published a report titled “*New Entrants and Small Business Graduation in the Market for Federal Contracts*” (CSIS Study).<sup>4</sup> The CSIS Study concluded (1) the number of vendors entering the federal arena has remained relatively low and constant since 2013 and (2) the survival rates show that around 40 percent of new entrants exit the market for federal contracts after three years, around 60 percent after five years, and only about one-fifth of new entrants remain in the federal contracting arena after ten years. Notably, the results indicate that while small businesses tend to have higher survival rates than their other-than-small business (OTSB) counterparts across federal agencies, the low graduation rates of small businesses that survived for ten years is alarming for the efficacy of small business set-aside programs. The CSIS Study suggests that “small businesses face a perverse incentive regarding their business model where since they have safety nets when they remain small, they could be avoiding normal business growth trajectories to maintain the advantages associated with small business status.”<sup>5</sup>

For those businesses studied beginning in 2001, around 16-19 percent of small businesses that survive 10 years graduated from small business status. Contrasting, those businesses studied beginning in 2006 only around 6-8 percent of small businesses that survive 10 years graduated from small business status. That the graduation rate sharply declined from the class of 2001 to the class of 2005 is

alarming. The researchers considered small business graduation to occur through both organic firm growth and acquisition by a larger firm; as such, these figures reflect that graduation rates have significantly dropped even when accounting for market consolidation. In light of considerations from the Congressional Report, one explanation may be that businesses are devalued once they exceed their size standards. In other words, the value of small businesses is contingent upon their small business status. It is not only difficult for small businesses to independently grow beyond the small business set-aside programs but also to retain value if they seek acquisition.

In August 2019, the United States Government Accountability Office (GAO) published a report which was presented to the Committee on Small Business, House of Representatives titled “Federal Contracting: Awards to Mid-Sized Businesses and Options for Increasing Their Opportunities” (GAO Study). The GAO Study found that only 2.5 percent of small businesses that outgrow their applicable SBA size standard continued to win and compete in the federal market.<sup>6</sup> Of the number of businesses that received small business set-aside contracts in fiscal year 2008 and any kind of federal contract in fiscal year 2017, over 93 percent remained small. Of the 5,339 small businesses that were awarded only set-aside contracts in fiscal year 2008 and awarded any kind of contract in fiscal year 2013, only 104 grew to be mid-sized by 2013. A further analysis of those 104 businesses showed that in FY2014-2017 showed that 17 businesses became small again, while only 23 remained mid-sized and 3 became large.<sup>7</sup>

While the aforementioned reports reflect federal contracting as a whole, the research team turned its focus towards businesses in NAICS 236220. NAICS 236220, Commercial and Institutional Building Construction, comprises establishments primarily responsible for the construction of commercial and institutional buildings and related structures. 236220 includes commercial and institutional building for sale builders, commercial and institutional design-build firms, and commercial and institutional building construction management firms.<sup>8</sup> Within Sector 23 Construction, the federal government purchases approximately 80 percent of all its non-civil works construction under NAICS 236220 (see **Figure 1**).<sup>9</sup>

The results of the research demonstrate that federal contracting within NAICS 236220 reflects similar trends that prior research found throughout the entire federal contracting marketplace. The team used federal data through Fedmine.us, the largest library of aggregated federal award data sets on the internet.<sup>10</sup>

The study team tracked entrants and exits within 236220 from fiscal year 2005 through fiscal year 2020. The pattern of declining entrants and few businesses successfully exiting from the small business market into the other-than-small business (OTSB) market within 236220 mirrors the trends found in the existing research of the entire federal contracting landscape (see **Figures 2, 3, and 4**).

Figure 1: Why NAICS 236220?

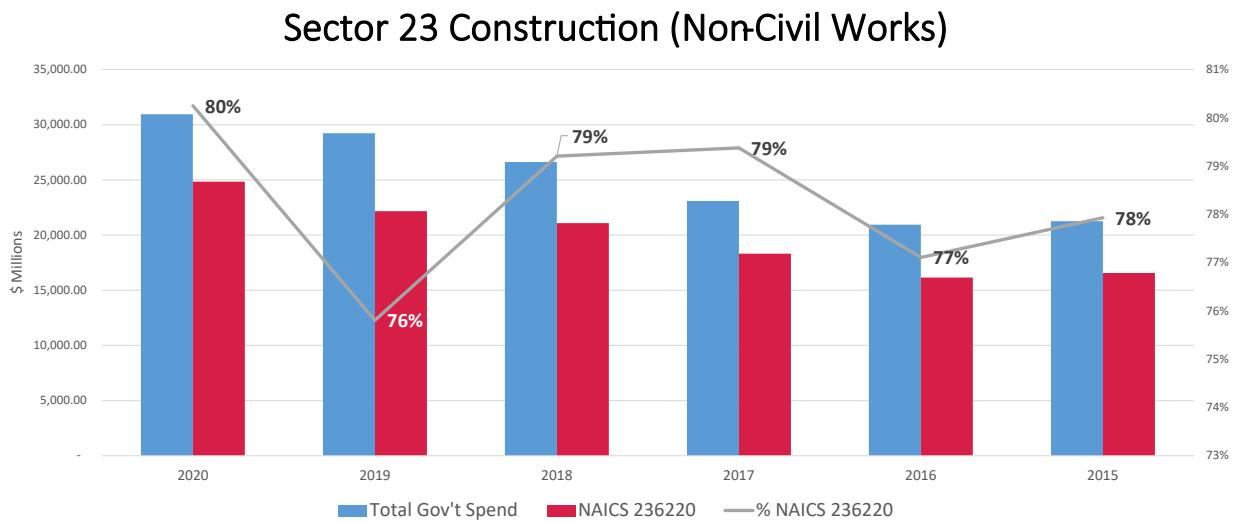


Figure 2: Entering - NAICS 236220.

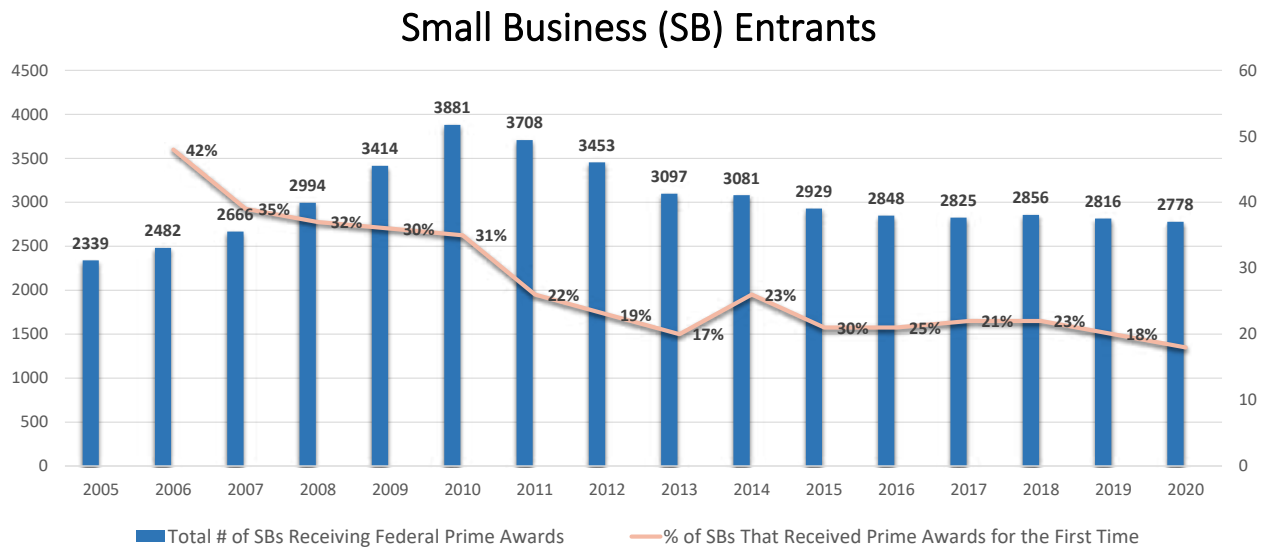


Figure 3: Exiting - NAICS 236220.

## Avg. % of SBs That Transitioned from Winning SB Awards to OTSB Awards Per Year, 2006-2020

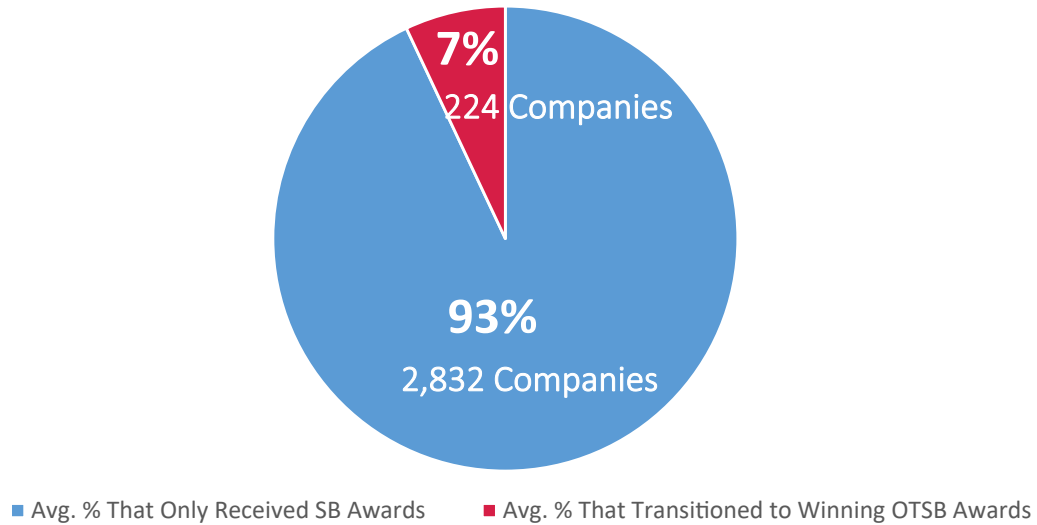
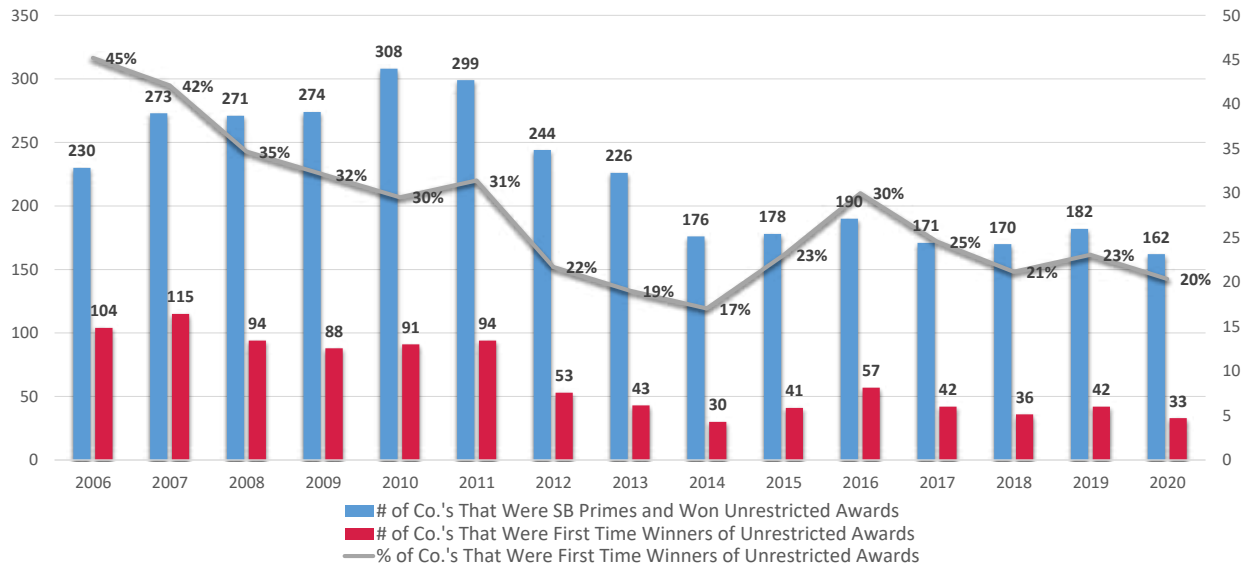


Figure 4: Exiting NAICS 236220.

## Fewer Firms are Successfully Exiting into the Unrestricted Federal Market



Based on the research, very few businesses in NAICS 236220 successfully transition from small to other than small and continue to win federal prime awards. During the 16 years between FY2005-2020, 1,228 companies won both small business and other than small business awards. Of those companies, only 75 won other than small awards in at least 10 of the 16 years.<sup>11</sup> This shows that only 6 percent (%) of the total companies that won both small and unrestricted awards successfully transitioned from their small business size and continued to win federal prime contracts (see **Figure 5**). This indicates that while many small businesses are capable of winning unrestricted awards, very few continued to regularly win unrestricted awards and successfully transitioned from small to OTSB.

At the same time, research demonstrates there is an inverse relationship between contract size and small business participation. During the FY 2005-2020 period, small businesses received 88 percent (%) of total dollars awarded in the less than 1 million dollar band of government award actions. Small businesses received 70% of dollars awarded in the 1-5 million dollar band and 62% of the dollars awarded in the 5-10 million dollar band. However, OTSBs received the majority of dollars awarded in the larger dollar bands. In the 10-25 million dollar band range, 63% of dollars were awarded to OTSBs (small businesses received 37%). As the dollar band size increases, small business participation sharply declines. In the 75-100 million dollar band range, only 3% of the total dollars obligated went to small businesses. In the greater than 100 million range, the figure is only 1% (see **Figure 6**).<sup>12</sup>

*Figure 5: Transitioning - NAICS 236220.*

## SBs Winning OTSB Prime Awards for 10 Years or More Between 2005-2020

Total Companies = 1,228

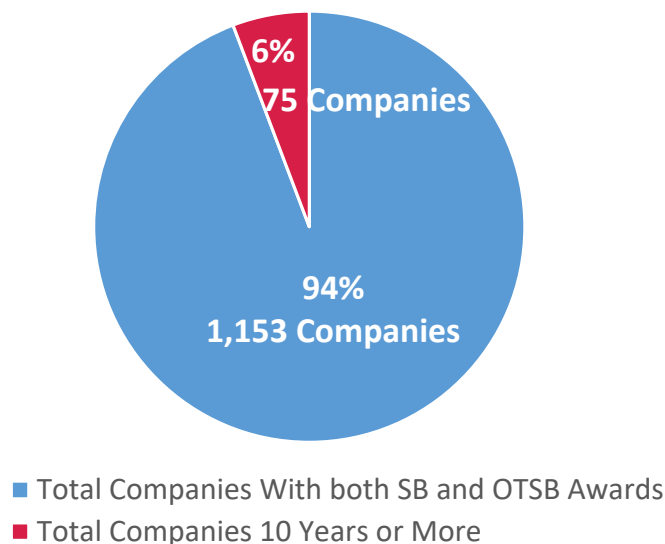
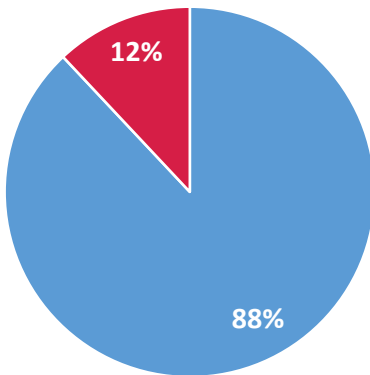


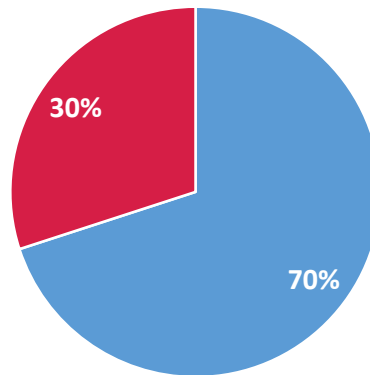
Figure 6: Dollar Bands - NAICS 236220.

< \$1M Dollar Band Avg. 2005-2020



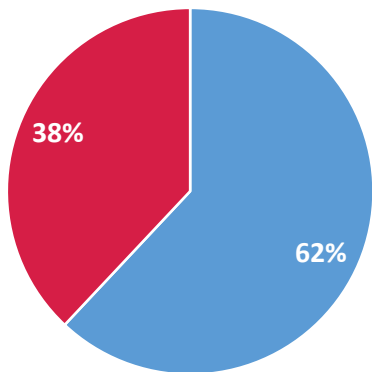
■ Small Business Award (by Obligated \$)  
■ Other than Small Business Award (by Obligated \$)

\$1M-\$5M Dollar Band Avg. 2005-2020



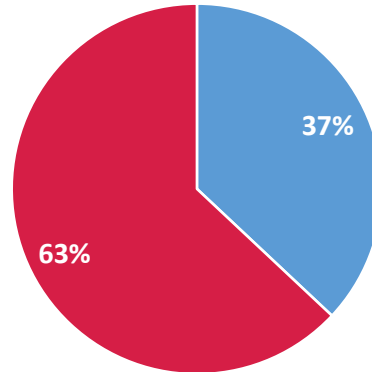
■ Small Business Award (by Obligated \$)  
■ Other than Small Business Award (by Obligated \$)

\$5M-\$10M Dollar Band Avg. 2005-2020



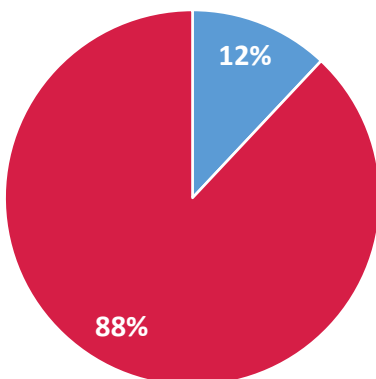
■ Small Business Award (by Obligated \$)  
■ Other than Small Business Award (by Obligated \$)

\$10-\$25M Dollar Band Avg. 2005-2020



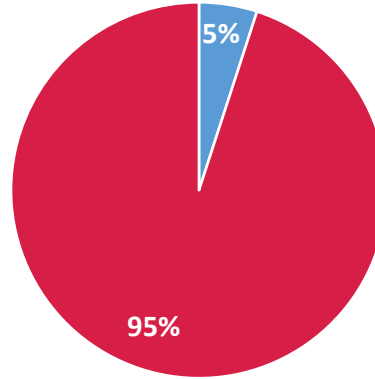
■ Small Business Award (by Obligated \$)  
■ Other than Small Business Award (by Obligated \$)

\$25M-\$50M Dollar Band Avg. 2005-2020



■ Small Business Award (by Obligated \$)  
■ Other than Small Business Award (by Obligated \$)

\$50-\$75M Dollar Band Avg. 2005-2020

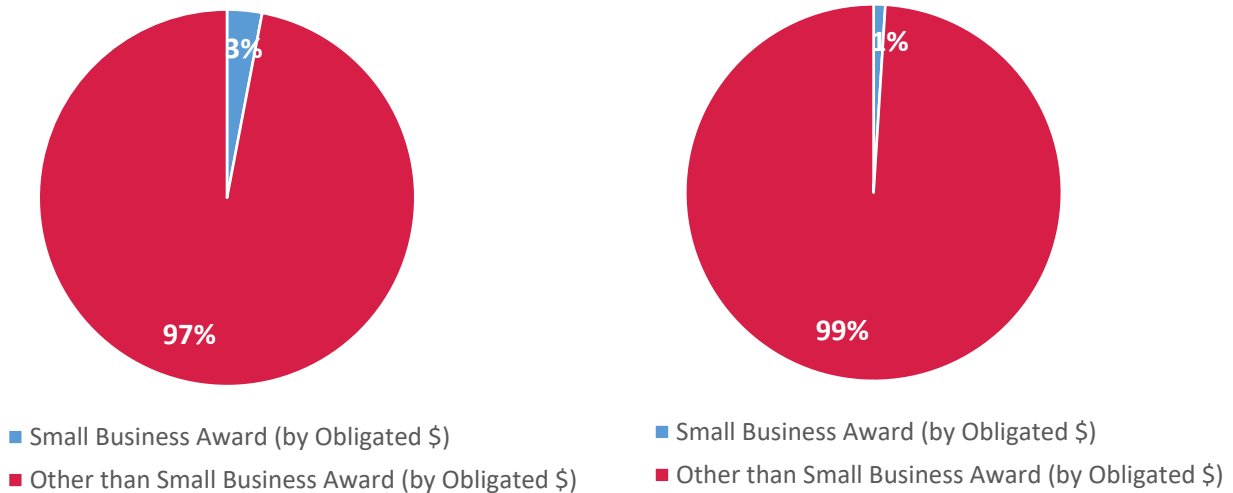


■ Small Business Award (by Obligated \$)  
■ Other than Small Business Award (by Obligated \$)

Figure 6: Dollar Bands - NAICS 236220. (continued)

\$75M-\$100M Dollar Band Avg. 2005-2020

>\$100M Dollar Band Avg. 2005-2020



By the same token, of the total dollars obligated to small businesses in NAICS 236220 each year, 62 percent (%) derived from awards of less than \$5 million (see **Figure 7**). When calculated by the number of contract actions, contract awards in the less than \$5 million range constitute over 99 percent (%) of total actions obligated to small businesses (see **Figure 8**). These figures, combined with the results from the aforementioned dollar band analysis, demonstrates that the current landscape inhibits small business growth in NAICS 236220. Federal solicitations require sufficient past performance of projects in similar size and scope.<sup>13</sup> The data demonstrates that small businesses have been significantly less successful, compared to OTSBs, in obtaining larger awards. This creates a cycle whereby the small businesses cannot successfully compete for future large awards because they lack the requisite past performance.

In summary, prior research demonstrates that federal small business contractors face tremendous obstacles as they transition into the unrestricted market. These obstacles often lead small businesses to intentionally remain small in order to take advantage of small business programs. As a result, across federal contracting agencies, very few small business federal contractors successfully make the transition from small to OTSB and continue to receive federal awards. Within NAICS 236220, between FY 2005-2020, only 6% of businesses who were once small won unrestricted awards and continued to do so for at least ten years. Further, there is an inverse relationship between award size and small business participation; small businesses lack opportunity to build up past performance in order to win future awards. Taken as a whole, small businesses lack both the opportunity and incentive to grow under the current structure of SBA set-aside programs.

Figure 7: Dollar Bands Obligated Dollars - NAICS 236220.

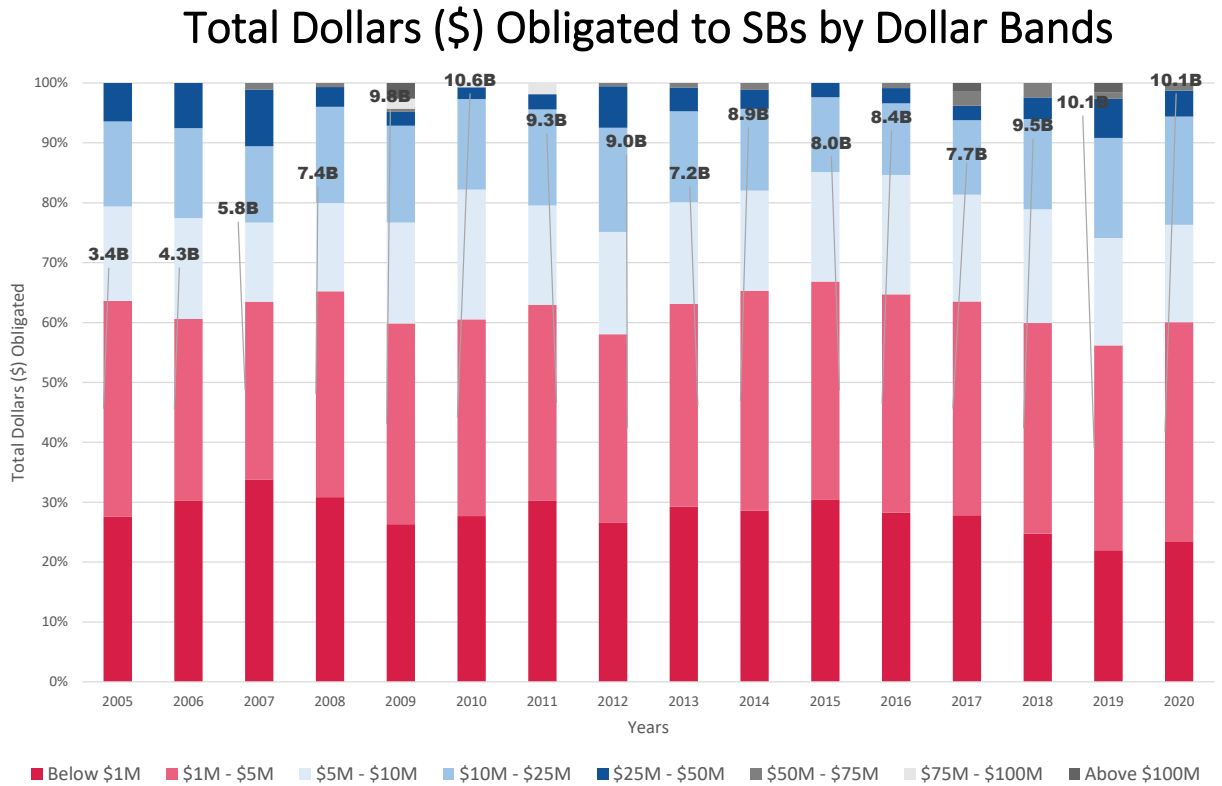
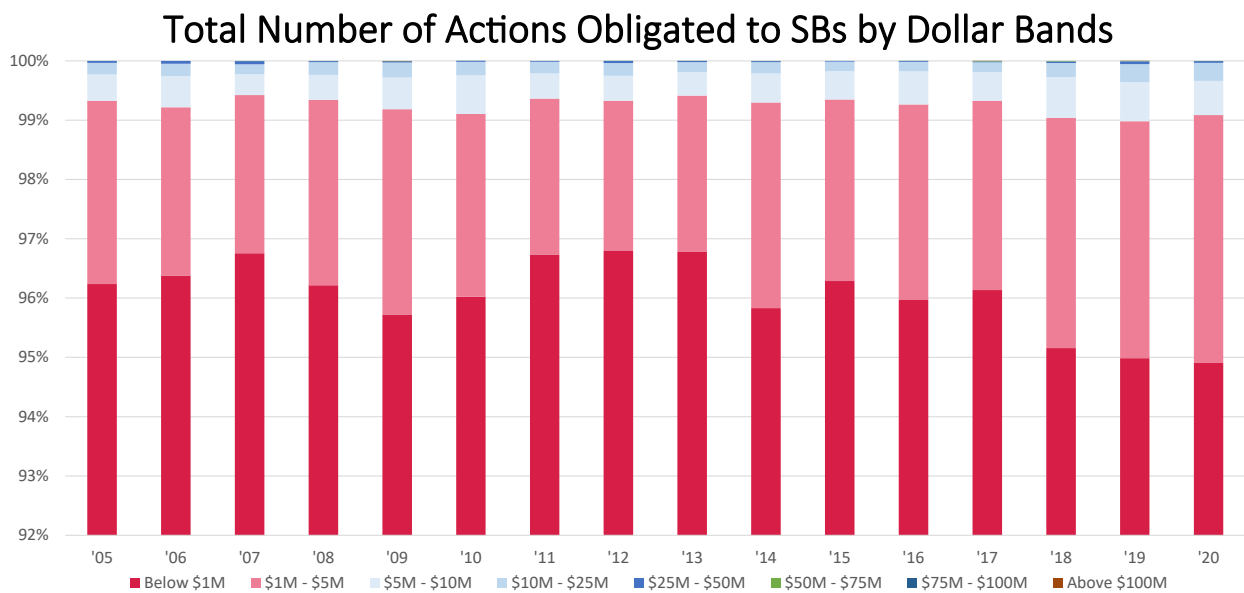


Figure 8: Dollar Bands Obligated Actions - NAICS 236220.



Businesses that grow beyond their SBA size standards are not rewarded for their growth, as evidenced by the majority who fail to become large sustainable federal prime contractors. If the perverse incentive to remain small continues, it will become increasingly difficult for federal contracting agencies to find sufficient reliable small businesses to meet their contracting goals and capacity needs. According to the Department of Defense, a dynamic, robust, and modernized small business industrial base is critical to the United States' efforts to maintain its technological superiority and military readiness.<sup>14</sup> While small business set asides lead to a healthy federal contracting market vis-à-vis increasing the competitiveness of participating firms, the success is jeopardized if, after graduation, those firms have difficulty remaining competitive or staying in business.<sup>15</sup>

The latest research focusing on NAICS 236220 proposes a pilot program that ought to be implemented by the SBA. This moratorium program, if implemented, would provide both an incentive and opportunity for small businesses to grow and continue to participate in the federal market. The details of the proposed moratorium program as well as further details about the research and methodology used can be found in "Challenges Facing Transitioning Federal Small Businesses: A Proposed Framework and Solution."

## Endnotes

---

<sup>1</sup> 13 C.F.R. § 121 (2020). On Dec. 5, 2019, SBA published a final rule modifying its method for calculating average annual receipts used to determine size standards for small businesses. Specifically, in accordance with the Small Business Runway Extension Act of 2018, Public Law 115- 324, SBA is changing its regulations on the calculation of average annual receipts for all of SBA's receipts-based size standards from a three-year averaging period to a five-year averaging period. SBA's new size standard average annual receipts calculation rule took effect Jan. 6, 2020. SBA adopted a transition period through Jan. 6, 2022, during which firms could choose between using a three-year averaging period and a five-year averaging period.

<sup>2</sup> H.R. Rep. No. 115-939 (2018).

<sup>3</sup> *Id.* at 3.

<sup>4</sup> Samantha Cohen et al., Ctr. for Strategic & Int'l Stud., *New Entrants and Small Business Graduation in the Market for Federal Contracts* (2018), [https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/181120\\_NewEntrantsandSmallBusiness\\_WEB.pdf?GoT2hzpdiSBJXUyX.IMMoHHerBrzzoEf](https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/181120_NewEntrantsandSmallBusiness_WEB.pdf?GoT2hzpdiSBJXUyX.IMMoHHerBrzzoEf).

<sup>5</sup> *Id.* at 12. Researchers found that in 2001 around 16-19 percent of small businesses that survive 10 years graduate from small business status; in 2006 only around 6-8 percent of small businesses that survive 10 years graduate from small business status. The researchers considered small-business graduation to occur through either organic firm growth or acquisition by a larger company. A small business is considered to graduate when it changed during the 10-year observation period from small- business status to medium- or large-business status for the majority of its contract obligations with the federal government. The graduation rate is calculated by dividing the number of graduated firms that also survived in year 10 over the 10-year observation period by the total number of small firms that entered the market in the baseline year. Across 6 samples comprised of small business entrant classes from 2001 to 2006, the graduation rates of small businesses consistently decrease. In 2001, around 14 percent of small businesses contracting with all federal agencies that survived for 10 years graduated from small business status. In 2006, only around 7 percent of small businesses that survived 10 years graduate from small business status.

<sup>6</sup> U.S. Gov't Accountability Off., GAO-19-523, *Federal Contracting: Awards to Mid-Sized Businesses and Options for Increasing Their Opportunities 2* (2019). The methodology of this report analyzed (1) the extent to which small businesses grew to be mid-sized and continued to receive federal contracts; (2) instances in which mid-sized businesses can perform work on contracts set aside for small businesses; and (3) options for increasing federal contracting opportunities for mid-sized businesses and views on the strengths and limitations of the proposed options. The study defined mid-sized businesses as having revenue or employees up to five times above the SBA size standard and large businesses as those with revenue or employees exceeding five times the SBA size standard.

<sup>7</sup> *Id.* at 14. 24 of the businesses studied did not receive any federal contracts between FY2014-2017. The remaining businesses varied in size in those years. The sizes of some businesses varied because, depending on the contract because businesses can submit solicitations under several NAICS codes and a business may be considered small under one NAICS code but not under others.

<sup>8</sup> 236220 – *Commercial and Institutional Building Construction*, NAICS Association, <https://www.naics.com/naics-code-description/?code=236220> (last accessed Aug. 3, 2021).

<sup>9</sup> Sector 23 Construction comprises 24 different NAICS codes. Of those, two NAICS codes (237310 and 237990) relate to civil works construction (highway, street, bridge, and other civil construction).

<sup>10</sup> *About Fedmine*, Fedmine, <https://www.Fedmine.us/about-us/> (last visited Aug. 2, 2021). Fedmine.us automatically aggregates the real-time federal government data sets from FPDS-NG, SAM.gov, and other government sources. Fedmine then assigns unique Fedmine IDs to government contractors and tracks all federal awards.

<sup>11</sup> For our methodology, we used ten years as a benchmark for successful transitions from small to other than small. Unlike the GAO study, we did not use multipliers to estimate “mid-sized” and “large-sized” firms. Rather, we measured the number of small businesses, as indicated by winning a small business award, that successfully won not only one unrestricted award but also went on to do so in at least ten of the years studied. Rather than tracking only a baseline group of businesses that received awards in one year and looking at their status at the end of the observation timeframe, we tracked all businesses winning awards in 236220 each year using their unique Fedmine IDs. By tracking all businesses annually over the entirety of the 16 years, we accounted for those businesses that may have won awards in non-consecutive years or perhaps just did not win federal awards for a few years.

<sup>12</sup> These figures reflect the average distribution of awards over 16 years between 2005 and 2020.

<sup>13</sup> For example, a typical solicitation evaluates proposals on several non-price factors including Technical Approach, Safety, Corporate Experience, Technical Solution, and Past Performance. When evaluating the Corporate Experience factor, the Government looks to relevant past construction projects to determine diversity in project types, significant construction and design experience, significant design-build experience, experience working as a design-build team with the proposed designer of record, and demonstrated ability to perform simultaneous projects. For the Past Performance factor, the Government looks at relevant sample construction projects. Thus, given that prime contractors in NAICS 236220 are heavily evaluated based on prior relevant experience, it is extremely difficult for small businesses to accumulate relevant experience and obtain large awards in the future without requisite large projects in their repertoire.

<sup>14</sup> Dep’t of Def., *Small Business Strategy*, (2019) <https://business.defense.gov/Portals/57/Documents/Small%20Business%20Strategy.pdf?ver=2019-11-19-115847-510>

<sup>15</sup> Max V. Kidalov, *Small Business Contracting in the United States and Europe: A Comparative Assessment*, Pub. Cont. L. J., Winter 2011, at 443.