Small Business Investment Company (SBIC) Program

SBIC Program Overview

- The SBIC Program has been a successful partnership between the private sector and the Federal Government for over 50 years.
- Private funds partnered with SBA to receive leverage up to 3:1 federal money to private investment in exchange for investing exclusively in domestic small businesses.
- SBICs are one of the only sources of capital for small businesses in this tight credit market.
- The SBIC program is a critical and underused to get capital to small businesses.
- The SBIC program pays for itself and actually makes about $300 million for the Federal government.

How the program helps the American people and economy

- Provides capital to the underserved small business community
- Creates and maintains jobs in small business
- Assures federal tax dollars are being invested wisely because private sector funds are at risk before any tax dollars are exposed to risk

Program Successes

- Since its inception the SBIC program has provided over $50 billion to over 102,000 companies.
- Notable SBIC successes include : Intel, Apple Computer, Federal Express, Callaway Golf, Staples, Quiznos, Outback Steakhouses, Whole Foods Markets, Costco, etc
- Over 1/3 of investments were made in manufacturing companies
- All investments have gone to small businesses

The Future of the Program

- The program needs an SBA Administrator who is interested and supportive of the program.
- The Program needs a head of the Capital Access division who is a strong and effective leader.
- The licensing of SBIC funds needs to match market needs – 1 year application process is too long and is asphyxiating the program.
- The program needs several relatively small technical changes that cumulatively can dramatically improve the program and increase the amount of capital available to small businesses.

Underlying Problems with the Existing SBIC Program

1. Too slow to get a license (Extremely Important)
   a. The process often can take over a year
   b. Even SBICs getting their 2nd, 3rd, or 4th licenses can take over a year.
2. The number of new SBICs is dwindling.
   a. The reputation of the program has been badly damaged.
      i. The reputational damage means many funds who would otherwise become SBICs may not apply for a license.
3. Most banks have abandoned SBICs and supporting small businesses
   a. Gramm-Leach-Bliley removed regulatory incentives for banks to invest in small businesses via SBICs
4. Too slow to access leverage
   a. After the license is granted it can take months to access the first round of leverage
5. SBA does not take a reasonable time to approve overline adjustments
   a. Some requests are approved quickly, but others are stalled for months
      i. There is no clear reason for the differentiation
6. Not enough investment in early stage companies
   a. The current administration nullified the equity parts of the program that were conducive to early stage investing
7. SBA Capital Access division could use greater resources

Goals for Improvement and Proposals to achieve the Goals

1) Increase Capital Flows to Small Businesses - Providing Stimulus

a. Increase the size limit of the amount under control by an SBIC family of funds to at least $150 million for a single fund or $225 million for a family of funds
   i. Provision already supported in Congress, easily passed the House.
   ii. A limit of $300 million for single SBIC and $500 million for a family of funds would be optimal

b. Increase the overline limit (amount available to invest in a single company) immediately (currently at 20% of private capital)
   i. Provision already passed the House in 2008
   ii. Pending the passage of new legislative use SBA's existing authority to review overline requests in a timely manner
   iii. Legislatively increase to 10% of the sum of private capital and total leverage projected[1] or increase the limit to 30% of private capital
   iv. Would allow immediate access to capital to solid companies that are adjusting to the difficult market.
      1. Saves good small businesses
      2. Would directly save jobs
      3. Would expand the market each SBIC would serve by increasing maximum investment size.

c. SBA should live up to the leverage commitments it made to the existing licensed funds for early stage investing (participating securities) that were cut off in 2008.
   i. Up to $500 million in leverage should be available to existing PS funds that are in regulatory compliance.
      i. Would produce immediate and meaningful capital into the small business economy[2]

d. Raise the limit that states can invest in SBICs
   i. State funds (economic development funds, pension funds, etc) have a cap on the leverage that can be accessed from their investment.
   ii. Raising (not removing) the state cap would increase the amount of capital that could be invested and multiplied with leverage[3]

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[1] Projection was already approved by SBA in original business plan

[2] There was about $850 million in leverage commitments that expired September 30, 2008. Some of the funds would draw the money for original investments and others would draw the money for follow-on investments in existing successful portfolio companies -many of which, have severe capital needs due to the credit crisis. It should be noted that the PS investments have a multiplier impact in addition to the initial direct impact. Each dollar of equity generally supports about three dollars of senior debt. Thus, the PS investments would enable portfolio companies to qualify for larger senior lines of credit. This is a very important multiplier for a company trying to weather the current economic storm.

[3] Economic development funds could be leveraged for maximum impact. State pension funds could seek better returns with a social/economic benefit.

2) Additional Stimulus

a. Provide $500 million to community and regional banks and Business Development Companies to invest in existing or new Debenture SBICs (or start their own SBICs). The money would be made available by a formula yet to be limited to a "use it or lose it" restriction. [4]

b. Provide a new package of $500,000 million of debenture leverage available to Debenture SBICs in good standing on a use it or lose it basis.
   i. For investments that do at least one of the following:
      1. Create or maintain threatened jobs
      2. Benefit energy efficiency or the environment
      3. Provide or service infrastructure
      4. Support or service manufacturing
      5. Invest in states with significant unemployment
   ii. Amounts borrowed should be excluded from an SBIC's maximum leverage obtainable from the SBA up to 33% of the SBIC's private capital.

c. Implement a temporary government guaranty program for a fixed period of time to promote investment in small businesses.
   i. Would have a potentially dramatic affect on our desire to invest now.
   ii. Provide a government guaranty of 50% of investments made by SBICs through the end of 2009.[5]

[4] A participating community bank could get an increase in its capital base, but only if the money was invested in SBICs. Again, the impact would be immediate, especially if the legislation directed SBA to allow 3:1 leverage as the statute contemplates.

[5] In other words, if an SBIC made a $6 million investment in a small business and used $4 million of leverage to fund the investment, that SBIC's losses on the investment (should they ever occur) would be limited to $3 million in total. This would be a way of reducing the risk to an SBIC of any investment it makes but would not remove the alignment of interest necessary to make the program work because losses would still be partially borne by an SBIC's private investors.

3) Streamline and expedite SBIC licensing (EXTREMELY IMPORTANT)

a. Faster licensing would make the SBIC program a very attractive program to existing smaller funds that have not participated in the program.

b. More licensed SBIC funds mean more private capital is being multiplied through leverage for the small business community

c. New licenses for licensed SBICs in good standing should be deemed automatically approved if:
   i. The licensed SBIC is in good standing with SBA
   ii. The management team of the SBIC is the same
   iii. All capital certificates are in place
   iv. The partnership agreement is the same as previously approved agreement or uses SBA model language

d. SBICs owned by Business Development Companies (BDCs) operating under the Investment Company Act of 1940 should be eligible for the maximum leverage available for a family of SBICs without getting a second license[6]

e. First time licensees should be able to be approved for a new license within six months
   i. SBIC applicants should be able to pay for expedited background checks (removing a significant procedural bottleneck)
   ii. Taxpayer protections must be maintained, but in a timely manner

f. Agency meetings should be required to be held monthly basis
   i. The lack of regular meetings has unnecessararily delayed licenses and other actions for many months

4) Optimize options in the program

a. Environmental considerations
   i. The energy debenture should be available to all licensed SBICs
   ii. There was a technical legislative error in the underlying statute that limited the energy debenture to only newly licensed SBICs
b. Licensed SBICs should be given the choice to use a normal debenture or the terms approved in the energy debenture for any investment

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[6] BDCs do not have a specific fund life like most SBICs and can freely add to its commitment over time.

5) Meaningful technical changes to allow the SBIC program to serve the small business interest better

b. Index to inflation what qualifies as a "Small Business"
    a. For example for capital intensive industries like technology, manufacturing, and communications companies

c. Exempt SBICs who are owned by BDCs (now available to SBICs with UBTI investors) under 107.720(b) (3). [7]

d. Streamline exemptions and prior approvals needed under the current conflict of interest rules.
    a. A simple safe harbor should be established:
        i. if the investment maintains or creates jobs,
        ii. if the Associate does not benefit from the transaction, and
        iii. if the SBIC obtains terms and conditions on a basis pari passu with (or better than) its Associate, no prior approvals or exemptions would be necessary. The existing Lending Institution safe harbor would also remain for "operating loans."[8]

e. Limitations on repayment of Loans and Debt Securities should be modified so that no SBA approval is needed for market-based minimum voluntary prepayment amounts. [9]

f. Get rid of prohibition of default interest rate for covenant defaults.
    a. This prohibition limits protections to both the tax payer and the SBIC fund
    b. This is very important as the limitation prohibits SBICs from participating in market-based features common in all commercial lending deals.
    c. Default interest rates of an additional 3-4% should be permitted for covenant defaults.

g. Raise or eliminate the cost-of money limitations.
    a. We believe this would increase SBIC's competitiveness against non-SBIC investors by removing an antique and unnecessary pricing limitation that served a purpose in 1959 but serves no viable purpose now.
    b. Increase capital to small business

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[7] Without an exemption, BDC-owned SBICs cannot invest in most equity tranches available in many transactions. This is because BDCs with registered investment company (RIC) status, must invest through "blocker," or holdco, subsidiaries in most equity transactions – an action prohibited by the SBA regulations. Without the blocker sub, all operating income is "bad income" under the BDC RIC test. If a BDC has too much "bad income," it loses the ability to qualify as a RIC and loses its non-taxable, flow-through status completely – not just for the income related to a particular SBIC investment.

[8] Currently, some conflicts require a "prior written exemption" from the regulations and others require "prior written approval" while others are protected under various safe harbors.

[9] 107.830 (c)(2) requires SBA approval for "restrictions" on prepayments. For loan administration purposes, it is common and necessary to require voluntary prepayments to be a minimum of, say $100,000 or $200,000 on a $5 million loan. The SBA routinely approves prepayment restrictions of up to 10% of the principal amount, but this requires a written pre-approval for every investment an SBIC does.