Small Business Investment Companies:

The SBIC Program

SAN DIEGO STATE UNIVERSITY
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SBA

U.S. Small Business Administration
Office of Finance and Investment

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Thirty years ago an entrepreneur looking for the capital to launch a small business had very few sources to turn to. There was no institutional resource to back up promising but untried ideas. Again and again, businesses with great potential for innovation failed — or never got off the ground.

To help solve this problem, Congress created in 1958, **The Small Business Investment Company (SBIC) program.** SBICs, licensed by the Small Business Administration, are privately organized and privately managed investment firms, yet they are participants in a vital partnership between government and the private sector economy. With their own capital and with funds borrowed at favorable rates from the Federal government, SBICs provide venture capital to small independent businesses, both new and already established.

The SBIC Program

Substantially all SBICs are profit-motivated businesses. A major incentive for SBICs to invest in small businesses is the chance to share in the success of the small business if it grows and prospers.

Today there are two types of SBICs — the original, or "regular" SBICs, and MESBICs — Minority Enterprise Small Business Investment Companies. MESBICs are Small Business Investment Companies specifically targeted toward the needs of entrepreneurs who've been denied the opportunity to own and operate a business because of social or economic disadvantage.

The name "MESBIC" is widely used to describe this type of SBIC, therefore it is used in this booklet. However, this name is actually incorrect. The *correct* name for such SBICs is *Section 301(d) SBICs, or 301 (d)s.* They are so-named because they are organized under Section 301 (d) of the Small Business Investment Act.

MESBICs are one type of SBIC. With a few exceptions, the same rules and regulations apply to both "regular" SBICs and MESBICs. Therefore in general, the name SBIC is used to refer to both MESBICs and "regular" SBICs simultaneously.

Who Benefits from the SBIC Program?

Small businesses qualifying for assistance from the SBIC program are able to receive equity capital, long-term loans, and expert management assistance.

Venture capitalists participating in the SBIC program can supplement their own private investment capital with funds borrowed at favorable rates from the federal government.

Most important, the *taxpayer* benefits. Because SBICs are extremely cost effective, taxpayers save money.

The SBIC Program also provides the taxpayer with more job opportunities. SBIC-financed small businesses are proven job creators. The employment growth rate of these companies is as much as ten times that of other small concerns.

Principal Advantages to the SBIC

An SBIC begins with people who have venture capital expertise and capital, and who want to form a venture capital investment company. By law, an SBIC can be organized in any state, as either a corporation or a limited partnership. Most SBICs are owned by relatively small groups of local investors. Many, however, are owned by commercial banks. Some SBICs are corporations with publicly traded stock, and some are subsidiaries of corporations.

Government Leverage

Within the limits of SBA regulations, a licensed SBIC may borrow money, or may issue debenture bonds, promissory notes, or other obligations. An SBIC in good standing with a demonstrated need for funds can apply to the SBA for the sale or the SBA guarantee of its debentures.

SBICs with private capital of at least $1,000,000 (the current minimum required for an SBIC to become licensed) may receive up to three guaranteed debenture dollars for each dollar of the SBIC's private capital. In addition, an SBIC with at least 65% (30% for MESBICs) of its total funds available for investment invested in venture capital can receive an additional, or fourth dollar of leverage per dollar of private capital. However, in no event can any regular SBIC draw down leverage in excess of $35,000,000. This ceiling does not apply to MESBICs.

The regular SBIC issues its ten year debenture which is guaranteed by SBA. Pools of these SBA guaranteed debentures are formed and participation certificates in the pool are sold through a public underwriting. Under current procedures, the debenture has a ten year maturity and does not allow prepayment during the first five years. The rate of interest on the debenture is determined by market conditions at the time of the sale.

Although repayment of the principal is due in full at the debenture's maturity, an SBIC in good standing may apply for the sale or SBA-guarantee of new debentures in order to refund its maturing debentures.

In addition to leveraging through debentures, a MESBIC qualifies for government leverage through the sale of its preferred stock. The 3% per annum dividend on the preferred stock is cumulative.

MESBICs may also sell a second tier of preferred stock to SBA if they have committed or invested a like amount of funds in qualifying securities of small concerns such as equity capital or unsecured, subordinated debt instruments.

Like the SBICs, a MESBIC can apply to the SBA for the sale of its debentures. The maximum limits of leverage it can receive are identical to the limits for SBIC debentures.

MESBIC debentures have the following features:

- MESBIC debentures have a ten year maturity.
- MESBIC debentures receive an interest rate subsidy. For the first five years of the debenture's life, its interest rate is equal to three percent below the rate determined by the U.S. Treasury at the time of the debenture's issue (or a minimum interest rate of 3%, whichever is higher).
- The SBA funds MESBIC debentures by buying them outright. Because the debentures have a subsidized interest rate, it is not feasible for the SBA to guarantee the debentures for sale to holders other than itself.

Tax Advantages

Besides the opportunities for government leverage, all SBICs can benefit from a number of tax advantages.

Because of recent changes in the tax laws and regulations, tax counsel should be consulted.

Advantage to Banks

Bank ownership in an SBIC subsidiary can allow the banks to invest in small businesses in which they could not have otherwise invested, because of banking laws and regulations. A bank may invest up to 5% of its capital and surplus in a partially- or wholly-owned SBIC.

Financing Small Business Concerns

SBICs can obtain financing through a number of means: acquiring private equity capital, publicly selling stock, taking advantage of government leverage, issuing debt securities, and obtaining loans.

In turn, it is the function of the SBIC to act as a financier for small business concerns. Such financing is specifically tailored to the needs of each small business concern. As financier, the SBIC has a variety of options.

Loans

SBICs can make long-term loans to small business concerns (incorporated or unincorporated) in order to provide them with funds needed for sound financing, growth, modernization, and expansion.

An SBIC may provide loans independently, or in cooperation with other public or private lenders. SBIC loans to small business concerns may be secured, and should be of reasonably sound value. Such a loan may have a maturity of no more than twenty years, although under certain conditions the SBIC may renew or extend a loan's maturity for up to ten years.

Debt Securities

An SBIC may elect to loan

money to a small business concern in the form of debt securities — loans for which the small business concern issues a security, which may be convertible into or have rights to purchase equity in a small business concern. These securities may also have special amortization and subordination terms.

Equity Securities

By law, the SBIC must provide equity capital to small business concerns, and may do so by purchasing the small business concern's equity securities. The SBIC may not, however, become a general partner in any unincorporated small business concern, or otherwise become liable for the general obligations of an unincorporated concern.

Licensing Requirements

A corporation or limited partnership may apply to the Small Business Administration for a license to operate as a Federal Licensee under the rules and regulations set forth pursuant to the Small Business Investment Act of 1958, as amended.

With only a few exceptions, there are no restrictions on the ownership of SBICs. Almost any person or organization with a minimum initial private capitalization of $1,000,000, and an SBA-approved full-time manager who will be in charge of the licensee's operations and who is able to serve the licensee's small business concerns, may be approved for ownership.

For example, SBICs may be:

- Owned and operated by U.S. or foreign operating companies, banks, insurance companies, finance companies, or savings institutions.

- Publicly or privately held.

- Managed under contract by asset management companies or fiduciaries.

- Owned as subsidiaries of other venture capital organizations who want to realize the advantages of the SBIC form of organization while retaining the parent company's autonomy.

Once licensed, each SBIC is subject to annual reporting and on-site examination by the SBA, and is required to meet certain statutory and regulatory restrictions regarding approved investments and operating rules.

Regulatory Requirements

The SBA, in the regulatory process, seeks to minimize its oversight of SBICs. The regulations listed below exist to protect the interests of small business concerns and the integrity of the program, and to insure its overall effectiveness.

Sizes and Types of Businesses

SBICs may invest only in qualifying small business concerns or, if the SBIC has temporary idle funds, certain short-term instruments (Federal Government securities, federally-guaranteed government agency securities, insured S & L deposits, CDs, and demand deposits). SBICs may not invest in the following: other SBICs, finance and investment companies or finance-type leasing companies, unimproved real estate, companies with less than one-half of their assets and operations in the United States, passive or casual businesses (those not engaged in a regular and continuous business operation), or companies which will use the proceeds to acquire farm land.

Conflict of Interest

An SBIC may not engage in "self-dealing" to the advantage of or with favoritism to its associates. The SBA defines associates broadly to include:

- Certain of its shareholders, officers, directors and employees;

- In the unincorporated SBIC, its members, control persons, and employees.

The SBIC may not directly or indirectly provide financing to any of its associates. It may not borrow money from a small business concern it has financed, nor from the small concern's owners or officers.

Control

An SBIC is not permitted to control, either directly or indirectly, any small business on a permanent basis. Nor may it control a small business in participation with another SBIC, or its associates. In cases of inordinately high risk the SBA may allow an SBIC to assume temporary control, in order to protect its investment. But in those cases the SBIC and the small concern must have an SBA approved plan of divestiture in effect.

Overline Limitations

Without written SBA approval an SBIC may invest no more than twenty percent of its private capital in securities, commitments, and guarantees for any one small concern. For MESBICs the limit is thirty percent.

Cost of Money

The cost of money on SBIC loans and debt securities issued by small concerns is regulated by the SBA in the interest of the small business concerns, and is limited by the applicable state regulations governing such loans and debt securities, or by SBA regulations, whichever is lower.

Prohibited Real Estate Investments

An SBIC may not invest in farm land, unimproved land, cemetery subdividers or developers, or any small concerns classified under Major Group 65 (Real Estate) of the SIC Manual, with the exception of subdividers and developers, title abstract companies, real estate agents, brokers, and managers.

Investment in real estate-related businesses is limited to one-third of the SBIC's portfolio, and combined investment in real estate-related activities (building contractors, hotels, and lodging places, etc.) is limited to two-thirds of an SBIC's portfolio investments.

Prohibited Relending, Reinvesting

SBICs may not provide funds for a small concern whose primary business activity involves directly or indirectly providing funds to others, purchasing debt obligations, factoring, or leasing equipment on a long-term basis with no provision for maintenance or repair.

However, SBICs and MESBICs may finance Disadvantaged Concerns engaged in relending or reinvesting activities (except agricultural credit companies, and those banking and savings and loan institutions not insured by agencies of the Federal Government).

Proceeds of Financing

In general, investment funds used to purchase securities must go directly to the small business concern issuing the securities. They should not be used to purchase already outstanding securities such as those on a stock exchange, unless such a purchase is necessary to insure the sound financing of a small concern, or when the securities will be used to finance a change of ownership. The purchase of publicly offered small business securities through an underwriter is permitted as long as the proceeds of the purchase will go to the issuing company.

Minimum Period of Financing

Loans made to and debt securities purchased from small concerns should have minimum terms of five years. Under certain circumstances, loans to disadvantaged concerns may be for minimum terms of four years. The small concern should have the right to prepay a loan or debt security, with a reasonable penalty where appropriate. Loans and debt securities with terms of less than five years are acceptable only when they are necessary to protect existing financings, are made in contemplation of long-term financing, or are made to finance a change of ownership.

Miscellaneous Regulations

In addition to the specific regulations listed here, SBICs are subject to some other regulations regarding activities, operations, and reporting, which must be followed to insure the continuation of the SBIC license and its related advantages.

The Basics of Setting Up an SBIC

- Commit the necessary capital. To qualify you must have a minimum of $1,000,000 in private capitalization. SBA may require additional capital in some market areas.

- Prepare a well-structured business plan to be included in the license application, detailing the SBIC's plans for investing in small business concerns. Include information on the proposed types of investments, the types of industries in which the SBIC plans to invest, the developmental stages of these businesses, their geographical locations, and other factors relevant to the investment activities of the proposed SBIC.

- Make sure you have qualified management on your staff. To be licensed, your company must be managed by individuals with a real interest in serving small business concerns, and the necessary expertise to do so. A well-qualified manager would have at least five years of successful experience in a responsible position, in a business involved with investing in business concerns — for example, a venture capital firm, or an investment banking firm. Individuals with comparable experience and educational backgrounds may also be acceptable. A degree in a business related field may be substituted for up to two years of practical experience.

• Obtain an SBIC "Licensing Kit" from your nearest SBA Office or from our Central Office. Be sure to review the Application and instructions, SBA Regulations and Small Business Investment Act of 1958, as amended. The SBA is vitally interested in encouraging responsible individuals and organizations to establish SBICs.

• Although you are welcome to contact SBA yourself with any questions about preparation of required documents, legal counsel is usually advisable because of the complexities of organizing an SBIC.

• Submit a License Application, along with all pertinent exhibits and required forms to the Small Business Administration at its Washington, D.C. Central Office. Enclose a check for the non-refundable filing fee of $5,000. The application will not be processed until the filing fee is received.

• Expect that the time required to process your application may be as long as four months. A significant portion of that time is needed for background checks of the individuals who will be involved in the ownership and management of your prospective SBIC. During the application process the SBA may find that additional information is necessary and, if so, will notify you in writing. The quicker you reply, the quicker the SBA can process your application.

Obtaining SBIC Financing For Your Small Business

What Types of Businesses Qualify?

SBICs exist to supply equity capital, long-term loans, and management assistance to qualifying small businesses.

They invest in all types of manufacturing and service industries. Many investment companies seek out small businesses with new products or services, because of the strong growth potential of such firms. Some SBICs specialize in the field in which their management has special knowledge or competency. Most, however, consider a wide variety of investment opportunities.

Only firms defined by the SBA as "small" are eligible for SBIC financing. The SBA defines small businesses as companies whose net worth is $6.0 million or less, and whose average net (after tax) income for the preceding two years does not exceed $2.0 million. For businesses in those industries for which the above standards are too low, alternate size standards are available. In determining whether or not a business qualifies, its parent, subsidiaries, and affiliates must also be considered.

Approaching an SBIC

Research the SBICs

If you own or operate a small business and would like to obtain SBIC financing, you should first identify and investigate existing SBICs which may be interested in financing your company. Try to learn as much as possible about those SBICs in your area, or in other areas important to your company's needs. In choosing an SBIC, consider the types of investments it makes, how much money is available for investment, and how much will be available in the future. You should also consider whether or not the SBIC can offer you management services appropriate to your needs.

The SBA publishes a regularly updated directory listing all current SBIC licensees. The amount of each SBIC's private capital and the amount of government leverage it has received are listed, as well as information on each SBIC's type of ownership and investment policy. A special section in the directory identifies MESBICs, or Section 301(d) SBICs.

Plan in Advance

You should research SBICs and determine your company's needs well in advance — long before you will actually need the money. Your research will take time.

Preparing a Prospectus/Business Plan

When you've identified the SBICs you think are best suited for financing for your company, you'll need to prepare for a presentation. Your initial presentation will play a major role in your success in obtaining financing. It is up to you to demonstrate that an investment in your firm is worthwhile. The best way to achieve this is to present a detailed and comprehensive business plan, or prospectus. You should include at the minimum the following information about your business:

Identification

• The name of the business as it appears on the official records of the state or community in which it operates.
• The city, county, and state of the principal location and any branch offices or facilities.
• The form of business organization and, if a corporation, the date and state of incorporation.

Product or Service

• A description of the business performed, including the principal products sold or services rendered.
• A history of the general development of the products and/or services during the past five years (or since inception).
• Information about the relative importance of each product or service to the volume of the business and to its profits.

Marketing

• Detailed information about your business's customer-base, including potential customers. Indicate the percentage of gross revenue accounted for by your five largest customers.
• A marketing survey and/or economic feasibility study.
• A description of the distribution system by which the products or services are provided to customers.

Competition

• A descriptive summary of the competitive conditions in the industry in which your business is engaged, including your concern's position relative to its largest and smallest competitors.
• A full explanation and summary of your business's pricing policies.

Management

• Brief resumes of the business's management personnel and principal owners, including their ages, education, and business experience.
• Banking, business, and personal references for each member of management and for the principal owners.

Financial Statements

• Balance sheets and profit and loss statements for the last three fiscal years or from your business's inception.

• Detailed projections of revenues, expenses, and net earnings for the coming year.

• A statement of the amount of funding you are requesting and the time requirement for the funds.

• The reasons for your request for funds and a description of the proposed uses.

• A description of the benefits you expect your business to gain from the financing — improvement in financial position, increases in revenues, expense reduction, increase in efficiency.

Production Facilities and Property

• Description of real and physical property and adaptability to new or existing business ventures.
• Description of technical attributes of production facilities.

FOR YOUR INFORMATION

You can obtain the Directory of Operating Small Business Investment Companies by visiting the SBA regional or district office nearest you, or by writing to the U.S. Small Business Administration.

The SBA is vitally interested in encouraging responsible individuals and organizations to establish SBICs and/or to apply for SBIC assistance. For more detailed information, write:

Deputy Associate Administrator
for Investment
United States Small Business
Administration
1441 "L" Street, N.W.
Washington, D.C. 20416

The statements in this brochure contain, in many cases, simplified summaries of complex regulatory and statutory provisions. Before any business decision is made, relevant and current regulations and statutes should be consulted and, if necessary, legal counsel should also be consulted.

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