

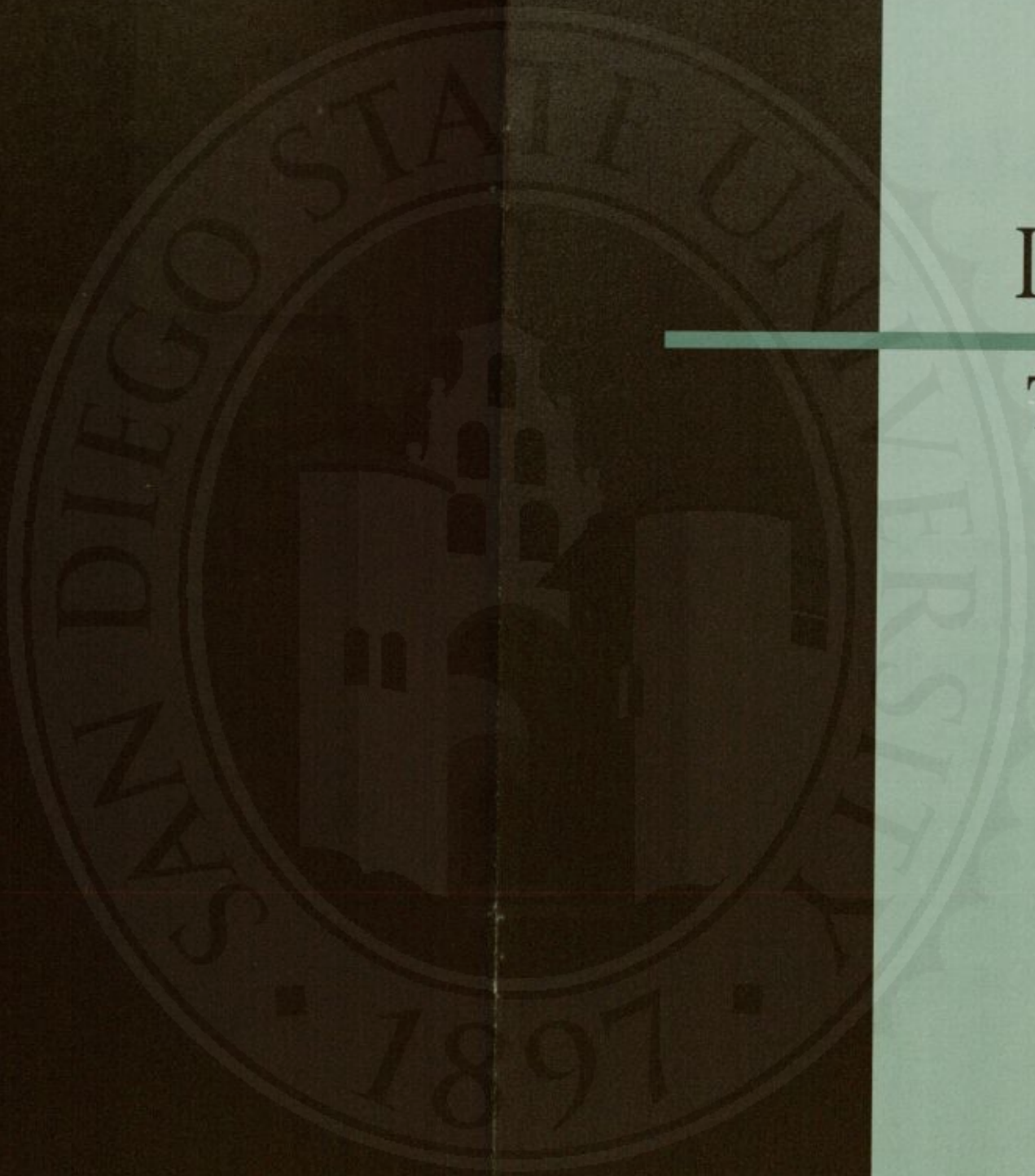
SBA

U.S. Small Business
Administration

Small Business Investment Companies

The S B I C Program

Helping Build America's Future



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The SBIC Program

Thirty-five years ago, an entrepreneur looking for the capital to launch a small business had very few sources. 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 **The Small Business Investment Company (SBIC) Program** in 1958. SBICs, licensed by the U.S. Small Business Administration (SBA), are privately organized and privately managed investment firms. They are participants in a vital partnership between the federal government and the private sector. With their own capital and funds obtained at favorable rates through assistance 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 Specialized Small Business Investment Companies, or SSBICs. SSBICs are specifically targeted toward the needs of entrepreneurs who have been denied the opportunity to own and operate a business because of social or economic disadvantage.

The name "SSBIC" is used to describe this type of SBIC, therefore it is used in this booklet. However, this name is unofficial. The official name for such SBICs is Section 301(d) SBICs. They are so-named because they are organized under Section 301(d) of the Small Business Investment Act.

With few exceptions, the same rules and regulations apply to both "regular" SBICs and SSBICs. Therefore, in general, the SBIC name is used to refer to both SSBICs and "regular" SBICs.

Who Benefits from the SBIC Program?

Small businesses qualifying for assistance from the SBIC Program benefit from 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 obtained at favorable rates through assistance from the federal government.

The U.S. taxpayer also benefits. Tax revenues generated each year from successful SBIC investments more than cover the cost of the program. Likewise, the SBIC Program provides the taxpayer with more job opportunities. SBIC-financed small businesses are proven job creators.

Principal Advantages to the SBIC

An SBIC begins with people who have 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.

Private Capital Requirements

Private capital must be sufficient for the SBIC to be operated soundly and profitably considering its operating plan. At a minimum, SBA requires private capital to be \$2.5 million for an SBIC and \$1.5 million for an SSBIC.

Government Leverage

An SBIC or an SSBIC in good standing, with a demonstrated need for funds, may receive leverage equal to 300 percent of its private capital. In addition, an SBIC with at least 65 percent (30 percent for SSBICs) of its "total funds available for investment" invested or committed in "venture capital" may receive an additional tier of leverage per dollar of private capital for total leverage of 400 percent of private capital. However, in no event may any SBIC or SSBIC draw down leverage in excess of \$35.0 million.

To obtain leverage, regular SBICs issue their debentures which are guaranteed by SBA. Pools of these SBA-guaranteed debentures are formed, and SBA-guaranteed participation certificates, representing an undivided interest in the pools, are sold to investors through a public offering. Under current procedures, the debentures have a term of three or ten years, and they provide for semi-annual interest payments and a lump-sum principal payment at maturity. Debentures may be prepaid with a penalty. The debenture rate is determined by market conditions at the time of the sale.

Like the SBICs, SSBICs may receive leverage equal to four hundred percent of private capital not to exceed \$35.0 million.

Unlike an SBIC, an SSBIC qualifies for leverage equal to 100 percent of its private capital through the sale of its 4 percent, cumulative, preferred stock to SBA. The preferred stock provides for its mandatory redemption within 15 years.

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

SSBICs may also issue their debentures for inclusion in the aforementioned guaranteed debenture pools and public offerings of guaranteed participation certificates together with the regular SBICs. SSBIC debentures have a term of ten years, provide for semi-annual interest payments and a lump sum principal payment at maturity. Prepayment would incur a penalty.

While the rate of interest is determined by market conditions at the time of the sale, SSBICs receive an interest rate subsidy of three percentage points for the first five years of the ten-year term. To effect the subsidy, an SSBIC's reduced interest payments during the subsidy period are supplemented by interest payments made by SBA on behalf of the SSBIC.

Tax Advantages

Besides the opportunities for government leverage, all SBICs can benefit from a number of tax advantages. Tax counsel should be consulted regarding tax laws and regulations.

Advantage to Banks

Bank ownership in an SBIC subsidiary permits 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 percent of its capital and surplus in a partially or wholly owned SBIC.

Financing Small Business Concerns

SBICs are to stimulate and supplement the flow of private equity capital and long-term loan funds which small businesses need for the sound financing of their operations and for growth, expansion and modernization. SBICs provide financing tailored to the needs of each small business.

Equity Securities

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

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. Debt securities may be convertible into or have rights to purchase equity in the small business concern. These securities may also have special amortization and subordination terms.

Loans

An SBIC may provide loans independently, or in cooperation with other public or private lenders. SBIC loans to small businesses 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.

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 Small Business Investment Act of 1958, as amended, and the rules and regulations issued thereunder.

With only a few exceptions, there are no restrictions on the ownership of SBICs. Almost any applicant will qualify that meets the capitalization requirement and has an SBA-approved, full-time manager who will be in charge of the licensee's operations and serve the licensee's small businesses.

For example, SBICs may be:

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

Once licensed, each SBIC is subject to annual financial reporting and biennial on-site compliance examinations by the SBA. The SBIC 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 businesses and the integrity of the program, and to insure its overall effectiveness.

Sizes and Types of Businesses

SBICs may invest only in qualifying small businesses, or if the SBIC has temporary idle funds, certain short-term instruments (federal government 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; or
- In an unincorporated SBIC, 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 it has financed, nor may it borrow from the small concern's owner 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 business. For SSBICs the limit is 30 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 businesses. The cost of money is limited to 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, 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 SSBICs 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 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 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 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 certain 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 \$2.5 million (\$1.5 million for SSBICs) in private capitalization. SBA may require additional capital based on a review of your business plan.
- Prepare a well-structured business plan to be included in the license application, detailing the SBIC's plans for investing in small businesses. 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 geographic 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 businesses and the necessary expertise to do so. A well-qualified manager should have at least five years of successful experience in a responsible business investment position, e.g., 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 SBA's central office. Be sure to review the application and instructions, SBA Regulations and the Small Business Investment Act of 1958, as amended.
- 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 Investment Division of the Small Business Administration in Washington, D.C. 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.

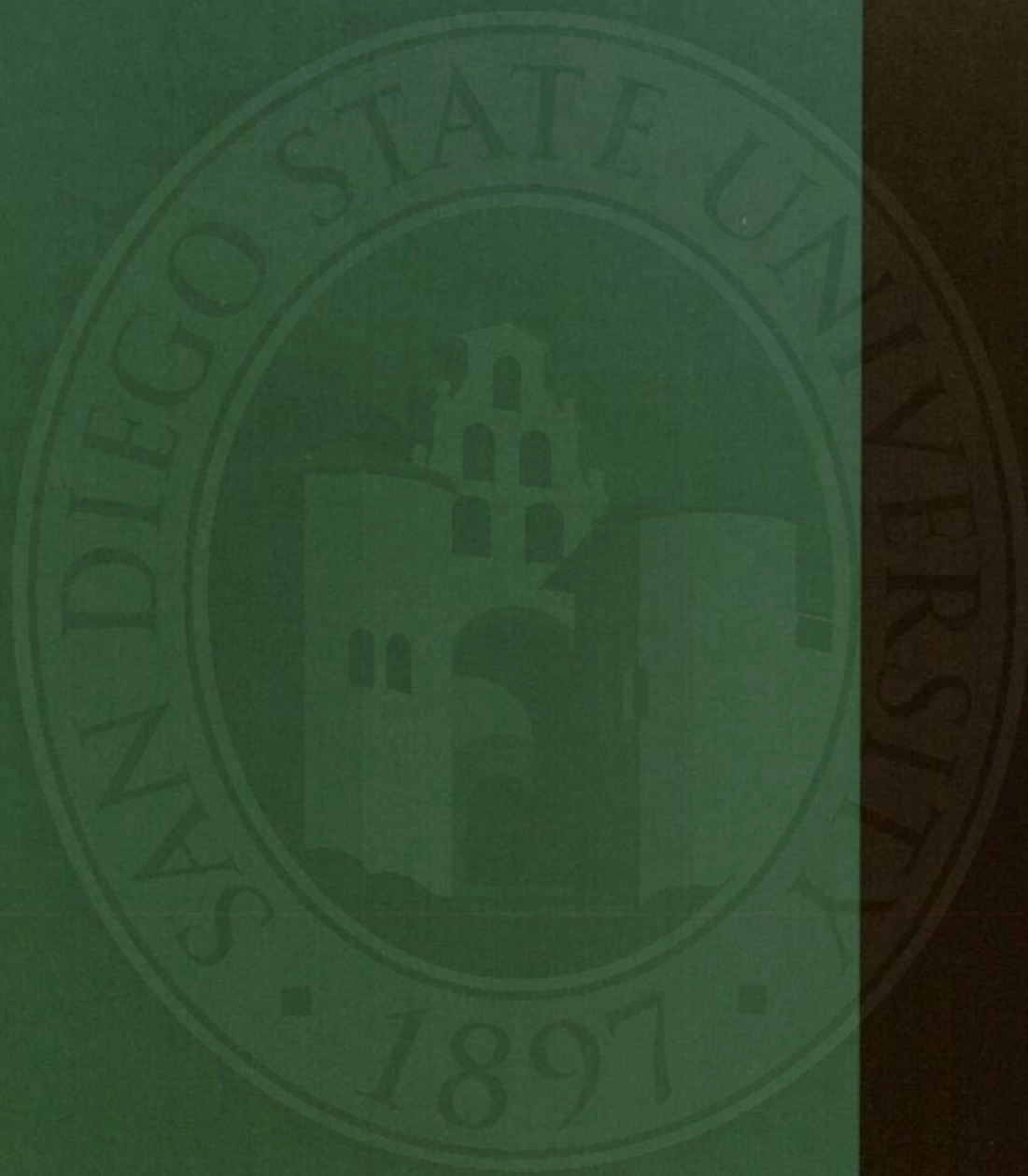
For Your Information

The SBA encourages responsible individuals and organizations to establish SBICs. For more detailed information, write:

Associate Administrator for Investment
U.S. Small Business Administration
409 Third Street, S.W.
Washington, DC 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.

All of SBA's programs and services are extended to the public on a non-discriminatory basis.



SBA

U.S. Small Business Administration
Investment Division
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