

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

Memorandum

To: Members, Subcommittee on Agriculture, Energy, and Trade
From: Committee Staff
Date: November 6, 2017
Re: Hearing: “Investing in Small Businesses: The SBIC Program”

On Tuesday, November 7, 2017 at 10:00 a.m., the Subcommittee on Agriculture, Energy, and Trade of the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of examining the United States Small Business Administration’s (SBA) Small Business Investment Company (SBIC) Program. As the Committee continues to explore the issue of access to capital, this hearing will provide Members the opportunity to hear directly from participants in the SBIC Program on how it impacts small businesses in communities around the nation.

I. Introduction

The lending environment for companies in the United States continues to disproportionately impact small businesses and hinder job creation and expansion. Despite being approximately ten years out from the start of the economic crisis that roiled global financial markets,¹ and notwithstanding a downward trending unemployment rate,² the nation’s smallest firms still face daunting lending prospects. According to the Federal Reserve’s most recent Small Business Credit Survey, loan approval rates for small businesses remained stagnant from 2015 to 2016.³ Moreover, approximately 60 percent of small businesses received a reduced amount of financing compared to what they applied for.⁴ While optimism is increasing, financial challenges remain for small businesses.

As a way to bridge the funding gap, the SBA offers numerous capital access programs to assist small businesses. While large corporations traditionally finance their endeavors through debt and equity markets, small businesses typically utilize conventional bank lending. In order to jumpstart the ability of small businesses obtaining equity to finance projects and activities, the SBA administers the SBIC Program.

¹ Federal Reserve Bank of St. Louis, The Financial Crisis, Full Timeline, *available at* <https://www.stlouisfed.org/financial-crisis/full-timeline>.

² <https://data.bls.gov/timeseries/LNS14000000>.

³ <https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf>.

⁴ *Id.*

II. The SBIC Program

Created in the 1958 Small Business Investment Act,⁵ the SBIC Program utilizes a private equity financing model to increase the availability of long-term capital. SBICs are for-profit enterprises that manage investment funds, but are licensed and regulated by the SBA. Unique to the program, SBICs invest in small businesses by leveraging private dollars with federal dollars through a multistage process. SBICs do not directly borrow federal money; rather, they raise private capital and then apply for an SBIC license, which allows them to leverage federal government funds.

Specifically, the licensing process⁶ is a comprehensive multiphase evaluation that includes a pre-screening, an initial review, a capital raising phase, and concludes with a licensing review.⁷ Importantly, SBA may not issue a license if a number of circumstances are not met. For example, the licensee must have a qualified management team in place.⁸ Outlined in the initial review process, SBA requires a Management Assessment Questionnaire that includes both qualitative and quantitative information.⁹ If certain measurements are met, the prospective SBIC team is invited to SBA's headquarters in Washington for a formal and in-person interview.¹⁰ Beyond the initial review, the licensee has to have sufficient capital in order to operate. The statutory minimum capital requirement is \$5 million.¹¹ After the licensee is reviewed, the proposed investment is scrutinized for information, such as whether or not there is a need for investment and if a sound business plan is in place that can produce results.¹² If a license is approved, the SBIC can then leverage private dollars for federal dollars using a borrowing mechanism whereby SBICs sell securities in private markets that contain a federal government guarantee. SBICs are required to repay the federal government for the leveraged amount.

As a simplified example, an SBIC invests in an established small business using a debenture SBIC to fund expansion. They qualify because they have sufficient cash flow to repay the SBIC for the initial investment. With the return on investment, the SBIC can repay the leverage they borrowed from the SBA and the federal government. In the end, a high-growth small business receives an investment that can translate into growth, expansion, or job creation.

III. SBA Fees and Oversight

Similar to SBA's 7(a) and 504/CDC loan programs, the SBIC Program administers fees to cover the cost of running and operating the program, including a 3 percent charge to investment companies on the value of the leverage.¹³ Due to the fees that are required and administered, the SBIC Program is currently running on a zero cost subsidy to the American

⁵ Pub. L. No. 85-699 (1958).

⁶ 15 U.S.C. § 681(c)(1).

⁷ <https://www.sba.gov/sbic/applying-be-sbic>.

⁸ 15 U.S.C. § 681(c)(3)(a).

⁹ <https://www.sba.gov/sbic/applying-be-sbic/phase-i-initial-review>.

¹⁰ *Id.*

¹¹ <https://www.sba.gov/sbic/applying-be-sbic/phase-ii-raising-private-capital>.

¹² 13 C.F.R. § 107.130.

¹³ 15 U.S.C. § 683(i).

taxpayer, meaning it receives no direct appropriations from Congress each year to continue operating.¹⁴

Beyond the licensing process, SBA oversees the program through its Office of Investment and Innovation¹⁵ with a concentrated focus on the issuance of leverage. Within this role, SBA determines whether or not leverage is needed and whether the issuance of leverage could increase risk of loss. Additionally, SBA conducts examinations to make sure all regulations are adhered to.¹⁶ Moreover, SBA ensures SBIC investments fit strictly into two defined small business size categories using a net worth and net income threshold or utilizing the traditional small business size standards.¹⁷ During the examination process, SBA will also require an examination fee that is commiserate with the licensee's asset size.¹⁸ In situations where an SBIC is out of compliance, such as violating leverage terms or being involved in fraudulent activities, SBA has the option of remediation.¹⁹ Continued robust oversight of the SBIC program by SBA is paramount to ensure the protection of American taxpayer dollars.

IV. SBIC Performance

The original authorization of the program included two different SBICs, the debenture SBIC and the participating security SBIC, with the main difference being the immediate repayment of leverage for debenture SBICs. The repayment requirements of the participating security SBIC lent themselves to more volatile startup investments and thus increased its risk. Due to losses in the program, SBA made the decision to stop licensing participating security SBICs in 2004.

However, despite challenges of the past, the SBIC program has more than 300 SBICs in operation with approximately \$28 billion of capital under management.²⁰ In FY 2016, the program issued \$2.51 billion in new debenture leverage, which is a slight decrease from FY 2014's \$2.54 billion and FY 2015's \$2.53 billion.²¹ FY 2016 also saw 21 new licenses granted by SBA²² and approximately 1,200 small businesses financed through the program.²³ With a focus on the licensing process, SBA showed a decline in the number of months it took for an SBIC to be licensed from 8.4 months in FY 2015 to 6.0 months in FY 2016.²⁴

¹⁴ SBA, AGENCY FINANCIAL REPORT FISCAL YEAR 2016 at 7 (2016).

¹⁵ SBA, FY 2018 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2016 ANNUAL PERFORMANCE REPORT 21.

¹⁶ 13 C.F.R. § 107.690.

¹⁷ SBICs can only invest in a small business defined as having a net worth less than \$19.5 million and an average net income level of \$6.5 million over the previous two years or a small business defined by the N.A.I.C. codes. Moreover, SBICs shall invest 25 percent into a "smaller" business with a net worth less than \$6 million and an average net income of \$2 million over the previous two years. <https://www.sba.gov/sbic/general-information/program-overview>.

¹⁸ 13 C.F.R. at § 107.691.

¹⁹ *Id.* at § 107.1800.

²⁰ SBA, FY 2018 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2016 ANNUAL PERFORMANCE REPORT 72.

²¹ *Id.* at 71.

²² *Id.* at 72.

²³ *Id.*

²⁴ *Id.*

V. Conclusion

Over the years, a number of high profile companies have utilized debenture SBIC funding, such as FedEx, Costco and Apple.²⁵ Although these companies are now large, small businesses across the nation that have an efficient and robust plan in place for growth have the opportunity to benefit from the SBIC Program. However, as with any lending program that includes federal government participation, robust congressional oversight is needed. This Committee looks forward to hearing from SBIC Program participants about the role the program has on communities and neighborhoods across the nation. With over 29 million small businesses in the United States,²⁶ programs like the SBIC program must contribute to the mission of the SBA, while protecting taxpayer funds.

²⁵ <https://www.sba.gov/sbic/general-information/program-overview>.

²⁶ SBA OFFICE OF ADVOCACY, SMALL BUSINESS PROFILE (2017), available at https://www.sba.gov/sites/default/files/advocacy/United_States_1.pdf.