Testimony of Rodger Davis with Northcreek Mezzanine

On behalf of the Small Business Investor Alliance

Before the House Small Business Committee

October 26, 2011

Good afternoon and thank you for the opportunity to testify before you today on behalf of the Small Business Investor Alliance, formerly known as the National Association of Small Business Investment Companies.

My name is Rodger Davis and I am a co-founder and managing partner of Northcreek Mezzanine located in Cincinnati, Ohio. Northcreek is a licensed Small Business Investment Company (SBIC) with total capital of approximately $70 million that makes debt and equity investments in domestic small businesses.

Thank you for your support of small businesses and the SBIC program.

Today I want to tell you a little bit about who we are, what we do, and how the Small Business Investment Company program has helped Northcreek grow small businesses and increase jobs by 20% – at no net cost to the taxpayer. I would also like to share my thoughts on what you can do to facilitate more small business investment and increase the number of jobs that go with it.

My partner, Barry Peterson and I were lifelong bankers to small and medium sized businesses. I spent 18 years at Provident Bank in Cincinnati, and Barry worked eight years with me at Provident after working for Continental Bank in Chicago. Our careers have centered around providing credit to privately held small business owners. Of all of things we did in banking, helping privately owned family companies achieve their goals was the most rewarding.

The credit crunch of 2008-2009 became the catalyst for the creation of our SBIC, Northcreek. Small businesses always have greater challenges accessing capital, but the financial crisis drove many large financial institutions away from most small businesses because “small” equates to “risky.” This flight from risk, some of which was partly driven by banking regulators, left small businesses with almost nowhere to turn for capital.

Thank goodness for the SBIC program. The SBIC program was designed in 1958 to create a market-based system to facilitate investments in domestic small business. What was true in 1958 is still true today: the larger the financial institution, the harder it is for them to provide capital to small businesses. SBICs are highly regulated private equity funds that invest exclusively in domestic small businesses. Debenture SBICs raise private capital, pass a rigorous licensing process, and then are able to increase the amount of capital available for investment by accessing leverage through an SBA-backed credit facility. The SBIC program is successful because 1) it is market driven (there is no political picking of winners or losers) and 2) it aligns investor interests with the public interest (SBICs create jobs and SBICs have very strong incentives to protect the taxpayer's money). In fact, debenture SBICs are actually making the taxpayer money, while providing the capital critical for job creation.

The conditions in the credit markets and our interest in creating a vehicle to provide loans to small business, led us to the SBIC program. The access to low cost leverage, the regulatory oversight of the SBA, and focus on small businesses were all factors in our ability to attract private capital. Without this program we might not be investing in small businesses today.

We applied for our license in 2009 and a little less than a year later were in business as a licensed SBIC. The SBA deserves credit for reducing licensing times from over two years to about six months while maintaining very high standards and taxpayer protections. Fixing administrative problems such as these have made the SBIC program much more attractive not only to us, but to scores of other funds who are currently raising SBIC funds.

When we launched Northcreek we thought there was a need for our capital, but we never envisioned the response we would receive. In the year and half since we received our SBIC license we have reviewed over 350 opportunities from business owners throughout the United States. Small businesses have a myriad of reasons for needing capital, but the demand far outstrips what is available. The SBIC program has been a critical resource in filling this need. Since 2009 over 50 SBICs were licensed representing billions in new small business investment. In FY 2011 alone there was over $2.6 billion invested in domestic small businesses – an increase of over 60% from FY 2010 – and FY 2010 had been a record year. I think you can expect SBICs to continue to increase investments and to continue to create jobs in FY 2012.

For larger companies, the credit markets have improved over the last several years. The most recent Federal Reserve Study of Senior Loan Officers reported an easing of credit for companies with revenues in excess of $50 million. Pepperdine University's Capital Access studies have repeatedly shown that large businesses can access capital, but for many smaller businesses it remains nearly impossible. They found that well over 90 percent of small business owners were ready to execute growth strategies, but over 80 percent could not access capital to execute those growth strategies. The Pepperdine studies find that credit is more accessible for businesses with over $15-20 million in earnings and much more accessible, almost frothy, for business above that mark. However, access to investment grows significantly harder the smaller the businesses. If not for SBICs, many small businesses would have few options.

These capital starved small businesses represent an enormous segment of the US economy and the employer base. For example, there are approximately 650,000 companies in the US with revenues between $5 and $20 million. By contrast, there are 200,000 companies in the US with revenues between $20 and $100 million. Herein, lies the value of the SBIC program and a firm like Northcreek. By targeting the small business segment of the market we are addressing a basic and fundamental need for capital that is not being served by traditional sources of capital. We invest 100 percent of our capital in domestic small businesses and at least 25 percent in the smaller subset of small businesses – and we do it at no net cost to the taxpayer.

Job Creation

We are proud to report that of the five (5) companies that have received capital from Northcreek, four (4) are "smaller enterprises" as defined by the SBA. We started Northcreek to assist privately held company owners achieve their dreams and aspirations and that is exactly what we are doing. Since our inception in 2010, we have provided seven (7) loans to five companies located in Cincinnati, Ohio; Elkhart, Indiana; Austin, Texas; Boulder, Colorado; and Orlando (Sanford), Florida. The impact of our capital is quite impressive**. In aggregate, these five companies have added over 200 jobs in less than a year**. **On the original employment base, that's over a 20% growth in employees.** The management teams can now run their business without fear of the bank calling their loan, or dedicating all available cash flow to paying down their bank debt. The impact on the management teams, the company owners, and the employees is profound.

Why do companies come to Northcreek? Here is a common theme. A company may have experienced a downturn of revenues and profits in 2009 at the height of the recession. As you know, many did. In many cases that company was transferred to the workout area of the bank, otherwise known as the Special Assets Division. Although the company survived the recession and experienced improving results in 2010, they remained in the workout area of the bank. Now the company is ready to capitalize on improving market conditions and they have little to no capacity to expand their credit at the bank. These businesses survived the collapse, are ready to grow, and are not able to access growth capital from banks. I guess you could call this the hangover from the credit crunch.

To pursue their growth strategy, these companies turn to private equity. In some cases, a new bank may be brought in together with a mezzanine provider like Northcreek to refinance their existing debt and to provide the capital they need to begin to grow again. Since our founding, this has been a common theme of companies we have helped and opportunities we have evaluated. We are not stripping out businesses or layering them with debt. We are empowering them to adjust to the new economy and to grow.

Patrick Industries in Elkhart, Indiana- Patrick is a manufacturer and distributor of materials and products for the recreational vehicle and manufactured housing industries. Northcreek initially assisted in an entire refinancing of Patrick's debt and has recently participated in the funding for an acquisition. If you were to talk to Todd Cleveland and Andy Nemeth they could share with you the impact of having the capital to grow and, more importantly, the time to think about how to grow their business. Located in one of the hardest hit economies during the recession, the company is now poised for growth.

Girard Environmental Services in Sanford, Florida- Girard is one of the largest privately held and independent providers of commercial landscape maintenance and installation services in the State of Florida. Northcreek and a local bank recently joined to refinance their existing bank debt and provide capital for growth. Randy and Rick Girard could tell you how they can now take advantage of growth opportunities in the market: to acquire equipment, hire new employees and to open new offices to meet the increased demand for their products and services. Most importantly, they can now sleep at night knowing that they have capital providers that want to do business with them and are incentivized to see their business grow and prosper.

iNET Interactive in Cincinnati, Ohio- The Company owns a portfolio of properties that generate revenue through advertising, events, and premium content subscriptions. The vast majority of the Company's properties are websites pertaining to community forums involving information technology development, Internet services, and tech hardware discussion. Northcreek has provided capital to support two acquisitions and has committed to a third. Troy Augustine of iNET Interactive in Cincinnati could tell you how difficult it has been to get bank financing and how the SBIC program and Northcreek, in particular, have been essential to their growth strategy.

All of these companies need capital, but more importantly, they earned the capital by running their businesses well, making it through the recession, and positioning their companies for growth. Thanks to good management of the program, constructive oversight of the program, and a solid private sector partnership, the SBIC program is growing rapidly to fill critical market needs of small businesses. Our investments are examples of how SBICs are creating jobs in the U.S.

Opportunities and Threats to Small Business Investing

I am pleased to report that many successful SBIC funds are staying in the program, many new SBICs are forming, and many new investors are looking to provide capital to SBICs. This is great news because it means that the people that are the best at investing in the small business space are sticking with small businesses. To continue this trend we strongly support Representative Chabot's bill, H.R. 3219, "the Small Business Investment Company Modernization Act of 2011" which would raise the SBIC leverage limit for multiple SBIC license holders and raise the individual SBIC leverage limit for proven, repeat SBICs. Neither of these provisions cost the taxpayer money nor would they increase the risk of the program. It makes sense that we should keep successful managers in the program and not curtail their ability to grow. These provisions would benefit only high performing, repeat licensees. With your continued support and improvements to the program, like those in Representative Chabot's bill, even more capital can be released to domestic small businesses.

One of the biggest constraining forces for growing the program is the amount of institutional capital that is being invested in SBICs. SBICs are relatively small in the private equity universe and most large institutions will not provide capital to funds below $100 million dollars in private capital. Given the 2:1 leverage ratio of the program, the Chabot bill would make investment in SBICs much more attractive for large institutional investors. If more institutional investors start providing capital to SBICs, you will see a significant increase in capital to small businesses.

Banks are significant investors in SBICs. Scores of community banks as well as regional and national banks have been investors in SBICs. Banks are supposed to get Community Reinvestment Act Credit for investments in SBICs. However, some bank regulators are not giving full dollar-for-dollar credit to banks investing in SBICs. Banks want to invest in small businesses via SBICs, but regulatory uncertainty does not increase capital to small businesses. We would welcome any support from the Small Business Committee with the banking regulators to provide clarity that SBIC investments will receive full credit and to determine if any additional incentives might be available to keep and perhaps stimulate investment in SBIC's by banks.

Finally, it is important to mention tax reform. While there has been a lot of talk about Warren Buffet and "carried interest" taxation. It is critical to set the record straight. SBICs are not Warren Buffett and none of us live anything like him. Increasing the tax on carried interest would be significantly more damaging to small business investing than it is any hedge fund or billionaire. SBIC fund managers are making long term investments in small businesses and are only rewarded if these companies grow and prosper. Management Fees earned by small fund managers are used to fund the overhead of the business, and our profit incentive lies in the carried interest. If Congress acts to increase the taxes on the carried interest you can be sure that investment in small businesses will decline. My partner and I are all in on Northcreek and by raising the tax on carried interest it will simply reduce the funds we will have available to invest in small businesses going forward. Please speak to your colleagues on the tax writing committees and super committee to make sure they consider the impacts on small business investing before they do anything rash with treatment of carried interest.

Thank you for the opportunity to testify. I would welcome any questions you might have for me.