SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

Testimony

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before the
House Committee on Small Business
July 15, 2020

Access to Patient Capital:

The Long-Term Solution for Small Business, Job Creation, and Recovery

Thank you for giving the Small Business Investor Alliance (SBIA) a chance to share our views on the longterm solutions to problems faced by small businesses. My name is Brett Palmer and I am the President of the SBIA. The SBIA is the trade association representing small business investors, including Small Business Investment Companies (SBICs). SBICs are venture capital and private equity funds that invest long-term capital into domestic small businesses. SBICs are licensed and regulated by the Small Business Administration (SBA).

For many, but not all, our economy was doing well prior to the pandemic and the ensuing governmentmandated shutdowns. The pandemic's economic disruption has exposed, amplified, and intensified pre-existing problems faced by the nation's small businesses. It has also created new ones. These amplifications affect vast numbers of small businesses, but they are not evenly spread by geography, industry sector, stage of business, or race. It is important to remember that the job loss and business injury we have experienced are only first order effects of the pandemic. Second order impacts are only now beginning to emerge, and there are many bankruptcies and layoffs yet to come.

Existing Federal Programs Can Help

Like the variety of domestic small businesses, the problems are varied; however, there are common threads that can be addressed so that the economy can come back faster and stronger to benefit more Americans. As Congress considers how best to set policy and allocate government resources to help rebuild the economy, now is the appropriate time to review and improve existing government programs to make sure they provide maximum benefit, that they do so without creating unintentional barriers to their full use, and that they benefit all Americans.

Policy adjustments should address the immediate needs of small businesses in a way that takes into account past deficiencies and meets future needs. Three of the four proposals we offer for consideration cost no money and could be implemented quickly. One option may need a one-time appropriation, but would have out-sized job creating benefits and would not need ongoing government support. Instead of simply stimulus spending where the benefit is temporary, Congress has a chance to focus long-term and empower private sector investment to provide sustainable benefits to communities by enabling SBICs to grow businesses and create jobs.

Our economic problems are intense and will be long lasting, but access to patient capital is the core of the solution for small business.[1]

Improving the SBIC program will help address the well-documented small business problems that existed prior to the COVID Recession, which include:

- Challenges accessing capital, which is particularly acute in lower income areas – both rural and urban;
  - Challenges accessing equity capital, also particularly acute in low income areas – both rural and urban;
- Massive concentration of venture and growth capital in a select few areas of the country;
- Large disparities accessing startup and growth equity for minorities;[2]
- Underinvestment in domestic manufacturing;
- Underrepresentation by women and minorities in venture capital and private equity funds;
- Too few small funds (fund size) which provide smaller investment amounts to serve growing small businesses (both equity and debt); and
- Rescission of short-term lines of credit, commonly pulled from small businesses in a recession.

There are also a host of new problems that have emerged in the COVID Recession. Unprecedented government-ordered shutdowns of the economy have caused outsized injury to many small businesses. A recent *Frontiers in Entrepreneurship* report detailed the severity and segmentation of the impacts on small businesses and entrepreneurship. For many, rent, loans, and other bills are due, but there is no revenue or not enough revenue. The threat of deadly illness to and from employees and customers is disconcerting and very expensive to address. Firms, especially minority and younger firms, have already failed or are at risk of failing at a much higher rate. This damage is happening before the second order economic impacts have emerged.

As we emerge from the uncertainty and open up to a new economy, small businesses across the country are faced with a host of new problems that SBICs can help address:

- Massive unemployment- 40+ million jobs lost, some permanently lost;
- Failure of many small businesses – estimates of up to 22%;

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[1] Attached as an addendum to this testimony is a study of the SBIC program by professors from Duke and the University of North Carolina's business schools that was released just as the COVID pandemic was taking off, so it did not receive adequate attention. It is an excellent summary of the market gaps and challenges as well as the SBIC opportunity to fill those gaps and is very relevant to the subject of this hearing.

[2] https://frontiers.unc.edu/wp-content/uploads/2020/06/June2020QuarterlyTrendsReport.pdf

- Catastrophic failure of minority owned small businesses – up to 41% of Black-owned businesses lost;[3]• Ongoing uncertainty about course of disease and consumer demand;
- Concern among small businesses about taking on more debt because they cannot service it, or it will breach existing loan covenants; and
- Newer, high growth companies under greater duress.[4]

The American entrepreneurial spirit is strong, but to re-emerge and recover, small businesses will need:

- A semblance of certainty about the course of the disease and how both employees and customers can be protected in an open economy;
- Access to "Patient Capital" – equity, long term debt, or equity-like debt, which is capital that can sustain the ups and downs, fits and starts, of the pandemic;
- Capital to restart shuttered businesses; these businesses and equipment are still physically intact, and some can be restarted;
- To remove unintentional barriers to minorities forming SBIC funds:
    - Studies have shown that investment funds that include minorities as part of the investment team invest in more minority-owned and led businesses;
    - The number of black-owned businesses at risk or lost is staggering and need to be recapitalized;
- More SBIC funds with smaller capitalizations serving smaller businesses in more parts of the country:
    - Small funds invest smaller dollar amounts, which is helpful for small businesses that need capital in lower amounts than is available from many SBIC funds; and
    - Smaller SBIC funds that are the right size for smaller markets and less densely populated regions.,

SBIA believes that the SBA already has a framework in place that deals with many of the issues small business face. The framework, however, needs to be adjusted. Modifying existing programs is much faster, cheaper, and more effective than the alternatives. The proven SBIC program should be tailored to meet both preexisting and new needs.

[3] https://siepr.stanford.edu/research/publications/impact-covid-19-small-business-owners-evidence-early-stagelosses-april-2020

[4] https://frontiers.unc.edu/wp-content/uploads/2020/06/June2020QuarterlyTrendsReport.pdf

Proposed SBA Program Modifications

SBIA proposes modifying the SBIC Program with the following:

- **MicroSBICs. Remove unintentional barriers to minorities and smaller communities forming SBIC Funds with a MicroSBIC "On Ramp" to forming a first time SBIC fund.**

- **Equity Capital. Enable SBICs to provide more of the most patient, impactful, and job-creating capital – Equity.**

- **Geographic Diversity. Make existing SBIC tools that provide patient "Equity-Like" capital to small businesses in all parts of the country.**

- **Underserved Communities. Encourage and enable SBICs to look for opportunities and make investments in underserved communities (both rural and urban).**

- **Capacity Investments. SBA's Office of Investment and Innovation needs to be fully staffed and have better technology.**

The Role of SBA and Small Business Investment Companies

The SBIC program has been extremely successful in fulfilling its mission to expand and empower domestic small businesses and help create millions of jobs.[5] The SBIC program has been more inclusive to women and minorities than the broader venture capital and private equity markets.[6] However, there are still too few SBICs, too few small SBICs, too few equity SBICs, too many geographic gaps, too few women and minorities running their own SBICs, and too few women and minorities accessing capital.

The needs created or exposed by the current unprecedented economic dislocation warrant changes in the SBIC program to address both the new needs and to address areas where SBICs have not yet been able to maximize their positive impact to as many communities as possible.

Over time and for many reasons, SBA has steered many SBIC funds away from earlier stage and growth equity strategy and toward more of a debt/equity mix and later stage transformational growth investing strategy, and away from forming smaller SBIC funds. The emphasis from SBA has been toward less risky

[5] https://www.sba.gov/sites/default/files/articles/SBA_SBIC_Jobs_Report.pdf
[6] https://www.sba.gov/sites/default/files/files/SBIC-Diversity-Report_0.pdf

debt and away from equity. SBA and many Limited Partners seem more comfortable with larger SBICs. So over time, fewer SBICs have been licensed to invest in the smallest businesses or in earlier stage businesses.

This movement to safer investing and toward more debt has enabled the SBIC program to continue to have a positive impact on small businesses and job creation, while maintaining a zero subsidy rate for nearly 22 years However, it has also unintentionally limited access to critical capital, leaving certain business and geographic sectors across the county underserved. SBICs are effective and extremely beneficial to many small businesses, but there are still market gaps for capital that call for policy changes to expand the reach of SBICs to help fill those gaps.

The statutory mission of the SBIC program has always been important, but it is needed now more than ever:

> "It is declared to be the policy of the Congress and the purpose of this Act to improve and stimulate the national economy in general and the small-business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and longterm loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply: Provided, however, That this policy shall be carried out in such manner as to insure the maximum participation of private financing sources. It is the intention of the Congress that the provisions of this Act shall be so administered that any financial assistance provided hereunder shall not result in a substantial increase of unemployment in any area of the country.
>
> It is the intention of the Congress that in the award of financial assistance under this Act, when practicable, priority be accorded to small business concerns which lease or purchase equipment and supplies which are produced in the United States and that small business concerns receiving such assistance be encouraged to continue to lease or purchase such equipment and supplies."[7]

The government does not need to create new programs to address the long-term needs of small businesses, but it does need to adjust. Congress should take successful programs, like the SBIC program, and modify and modernize them to:

- Create more jobs faster;

[7] https://www.sba.gov/sites/default/files/Small%20Business%20Investment%20Act%20of%201958_0.pdf

- Increase access to “patient capital”; Remove unintentional barriers to SBIC fund formation and thereby increase inclusivity of the program and the small businesses seeking capital;
- expand access to underserved communities; and
- Expand institutional capital and expertise to smaller businesses than those currently being served.

SBICs can help mitigate the job losses, empower job creation, save businesses that are under duress, and capitalize newly formed businesses.

<u>Remove Unintentional Barriers with a MicroSBIC “On Ramp”</u>

The SBA requires, among other requirements, that a person must have successfully run a venture capital or private equity fund before it will award an SBIC applicant a license. This requirement makes a lot of sense and has been a core element to the success of the program, but it narrows the pool from which SBIC fund managers can be drawn. It will be very difficult and slow to increase inclusivity recycling from the same talent pool without a creative strategy to break this cycle.

SBIA suggests that Congress create a MicroSBIC license option to create a meaningful path to entry into the SBIC program for a far broader group of people who have a successful and relevant track record growing small businesses. This is a far broader group of people than those who have already run an SBIC fund. These MicroSBIC licensees would first have to raise adequate external private capital as a condition of licensure because if the private market provides backing then it demonstrates to the SBA the likelihood of success for a MicroSBIC applicant. These MicroSBICs should also have a much lower leverage ratio and limit than regular SBICs because leverage amplifies investing both to the positive and negative, and firsttime funds are riskier. Another requirement for this particular license should be that the Investment Committee of the MicroSBIC must have at least two experienced SBIC fund managers to provide the investing experience that the MicroSBIC would not otherwise have. Many SBIC fund managers would be interested in helping the next generation of fund managers succeed. Having successfully run a MicroSBIC, the managers will be much more likely to successfully raise institutional capital and earn a full SBIC license with greater access to leverage.

MicroSBICs would fill important unfilled market needs. MicroSBICs will be smaller funds doing smaller transactions and, therefore, would fill a sizable gap in the smaller end of the market. MicroSBICs also can form anywhere in the country and thereby better serve underinvested areas including rural areas, inner cities, and smaller cities where there is very little access to venture capital, growth capital, or private equity.

Enable SBICs to provide more of the most patient, impactful, and job-creating capital – Equity

Equity capital is the most patient form of capital. There are no interest payments or defaults. Equity does not put loan covenants at risk. To the contrary, equity makes access to lending far more attainable. It is capital for the long term.

When the SBIC program had equity tools, more jobs were created, and more minorities received capital. SBIC equity investments averaged 480 to 580 new jobs per investment[8]. Debenture SBICs create about 150 new jobs per investment. SBIC equity and debt structures are both powerful job-creating engines, but the equity investments create more.

We need both tools, but with the significant job loss that must be recreated, small businesses badly need access to SBIC equity.

Massive amounts of venture capital and private equity are available in the market, but almost all of the money goes to large businesses, is deployed in too large chunks to be consumable to most small businesses, or is concentrated in a few geographies. SBICs invest in smaller amounts across a far broader geography – both rural, suburban, and urban.

Congress should create a simple, workable equity option for the SBIC program to provide patient capital and fast track job creation, promote domestic production, get equity outside of the few concentrated areas that are given nearly all the venture investment, and empower a new generation of entrepreneurs that represent all Americans. Establishing a revolving fund to provide equity capital via SBIC funds would greatly increase access to patient capital to the rest of America. With the vast majority of venture funds located and investing in just three places[9], SBICs could and would serve the rest of the country. Equity tools would benefit all of America and are desperately needed in minority communities and rural areas. In a recent op-ed, Eddie Brown, founder of Brown Capital Management, amplified this point, explaining that "[t]oday, younger generations of blacks experience the same economic disparities as their grandparents did in the 1950s. Equity ownership, the rocket fuel for wealth creation, is also in few black hands".[10] Equity investments create opportunity. SBIA has model legislative language to offer as a

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[8] https://www.sba.gov/sites/default/files/articles/SBA_SBIC_Jobs_Report.pdf

[10] *Eddie C. Brown* https://www.washingtonpost.com/opinions/2020/07/08/im-black-ceo-ive-beendiscounted-wall-street-because-my-skin-color/?arc404=true

straightforward and simple equity component to the SBIC program, and we are happy share it with any members of Congress interested in the issue.

Make Patient "Equity-Like" Capital Available

Millions of small businesses were injured by the COVID disruptions. For many small businesses, their revenues crashed, but their financial obligations did not. They are struggling under existing debt and other ongoing obligations and are hesitant or unable to take on more debt that must be serviced. Many small businesses drew down entire lines of credit to hoard cash and hunker down so they could survive the shutdown. Unlike the Great Recession, where bank regulators forced banks to call the loans on millions of small businesses, causing their failures, this time regulators have encouraged the banks to be patient with small businesses – and this has helped many small businesses. Many banks have not enforced loan covenant violations and have provided forbearance. But, at some point, banks are going to have to call loans, reduce lines of credit, and make fewer loans. This is not a matter of if, but when. Without this capital, many businesses that otherwise would be able to survive and grow back will fail.

Fortunately, the SBIC program has a proven tool that can provide "equity-like" capital that operates at a zero-subsidy rate, but access to its use is highly limited to certain geographies. Existing SBIC discounted debentures should be opened up for use in all areas of the country. These SBIC loans to small businesses waive interest payments for the loan's first five (5) years, after which normal interest is due. This makes these loans have many of the benefits of equity but, unlike equity, these loans are non-dilutive. As banks inevitably pull back from the small business loan market, injured businesses will be able to recover if they are able to access this type of SBIC patient capital.

Making the existing discounted debentures geographically agnostic could be done immediately but does need legislative action.

Encourage and enable SBICs to look for opportunities and make investments in underserved communities - both rural and urban

SBICs invest across a far broader geography domestically than conventional venture capital or private equity funds. Even so, there are still significant geographic and demographic gaps. SBIA proposes that Congress create a no-cost incentive for SBIC managers to seek out opportunities in underserved communities. SBIC investments in smaller enterprises that are in Low-Moderate-Income (LMI) areas, Opportunity Zones, or that are in underserved groups (women, minorities, veterans, etc.) should get an

SBIC leverage cap waiver for those investments (up to a limit). Private capital requirements and leverage ratios would remain unchanged because there needs to be private capital coverage and no additional cost to SBA. This "bonus leverage" would encourage more SBICs to broaden their search and to look into these communities to find new opportunities because the more of these underserved investments made the greater total number of investments they will be able to make later.

SBA's Office of Investment and Innovation needs more people and better technology

Last summer, I testified before this Committee at an unusual oversight hearing of the SBIC program where we documented gross incompetence and mismanagement of the then-Associate Administrator. It was strangling the SBIC program. One year later, I am pleased to share that SBA Administrator Carranza's fresh leadership has been extraordinary and transformative. She brought in new management and appointed Christopher Weaver to run the SBIC program. The results have been extremely positive. Under their watch, more SBIC licenses have been issued in the last three months, during the stresses and dislocations of the pandemic, than were issued in the first 11.5 months of fiscal year 2019. The leadership of the Administrator and the professionalism of Mr. Weaver will result in the SBIC program helping many thousands of small businesses and their employees. Small business investors are also once again able to work collaboratively with the SBA to serve the common good. We offer sincere thanks to both the Administrator, Mr. Weaver, and this Committee.

Small businesses need SBA to be able to function at the highest level. SBA now has good management, but they are still very short staffed and lack the basic technology tools readily available to other agencies and the private sector. Congress should replenish FTEs lost from the Office of Investment. Congress should also fund computer systems that will provide Congress better and more timely data for oversight and that will better enable SBA to make informed decisions and manage risk.

Investments in adequate staffing and updated technology will allow SBA to better serve small businesses over the long term.

Thank you for this opportunity to testify, and I would be happy to answer questions from Committee members.

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[Addendum attached]

FEBRUARY 2020

Filling the U.S. Small Business Funding Gap

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February 2020

Abstract

Despite having the deepest and most diverse capital markets in the world, the United States still struggles to provide sufficient capital to many small businesses outside of major commercial centers as well as to women-owned and minority-owned businesses regardless of size or location. This paper reviews the academic literature and provides an analysis of some recent data to gain understanding of the causes of these gaps as well as the solutions for filling the gaps. Results indicate that the Small Business Administration's SBIC program is an effective mechanism for providing capital to underserved geographies as well as to businesses owned by women and underrepresented minorities.

Introduction

Capital markets in the United States are the envy of the world. The highly liquid U.S. public stock and bond markets provide trillions of dollars of capital to U.S. and global businesses. The U.S. banking system is highly developed and efficient, even if regulations introduced after the financial crisis have resulted in a reduction of lending activity to the small business sector.[11] Rapid development over the last three decades of other private capital markets including private equity (PE) buyout funds, venture capital (VC), and growth capital funds have resulted in these vehicles now regularly deploying more than $100 billion in new capital each year.

Undoubtedly, the U.S. has the largest variety of institutional funding mechanisms in the world, resulting in the ability to provide capital to businesses of any size in all industries and geographies. However, the *ability* to provide capital is not the same as actually *providing* it. As we discuss in detail below, research documents systematic differences in access to capital for certain types of businesses, especially those located outside of major cities and those owned by women and underrepresented minorities.[12] This paper reviews the literature on funding gaps and provides a brief analysis of more recent data on Small Business Investment Companies (SBICs) and venture capital funds (VCs) to better understand how current funding vehicles may be effective in closing these funding gaps.

Our analysis shows that SBICs tend to provide more geographically dispersed funding and a higher percentage of funding to women-owned businesses. However, because SBICs are only a small part of the broader funding ecosystem, pronounced geographic and demographic differences in funding remain. This suggests the need to further scale the SBIC program in order to make more funds available to fill small business funding gaps.

The Role of Small Businesses in the U.S. Economy

Small businesses are a crucial segment of the U.S. economy. In addition to providing economic mobility, small businesses breed innovation, provide crucial services for communities and drive aggregate growth. Small businesses are responsible for about 45 percent of the total U.S. economic activity and contribute 41 percent of private-sector payroll (Kobe and Schwinn, 2018;

[11] See, Chen, Hanson, and Stein (2017)

[12] See, for example, Paglia and Robinson (2016).

SBA, 2017). Small businesses comprise more than 99 percent of all U.S. firms and created about 8.4 million new jobs from 2000 to 2017 (SBA, 2017). In 2012, 8 million—or 29.3 percent—of these firms were minority-owned businesses and 9.9 million (36.3 percent) were women-owned (SBA, 2017). To a large degree, small business owners reflect the American populace.

Small businesses range in industry and size and include sole proprietorships, light manufacturers, "Main Street" retail businesses, technology startups and wholesale distributors among others. The majority of small business are sole proprietorships, constituting about 23 million firms, with about another 4 million "Main Street" firms in traditional industries employing fewer than 500 people. Half of these "Main Street" firms have fewer than five employees and another third have between five and 19 employees (Mills and McCarthy, 2016). In addition, the U.S. has an estimated 1 million small business supply chain firms that specialize as wholesale intermediaries or service providers to other businesses. Recent academic research has shown these supply chain firms tend to have above average growth in employment and wages (Mills and McCarthy, 2016) and provide crucial logistics support to the broader business sector (Mills, 2015; Mills and McCarthy, 2016).

The small business sector also includes nascent firms. A vast body of research has shown that most job growth occurs in newly founded businesses, and that new firm formation in response to economic shocks is a critical source of job creation in the U.S. economy (Decker, Haltiwanger, Jarmin, and Miranda, 2014; Adelino, Ma, and Robinson, 2016). Within the United States, there are about 200,000 high-growth startup firms which commonly operate in the technology and health care sectors.[13]

Small businesses are integral to the success of a wide range of industries across the U.S. For example, more than 80 percent of construction employees and 60 percent of accommodation and food service workers are employed by small business firms (SBA, 2018). In addition, the U.S. is home to about four million professional, scientific and technical services small businesses and 2.6 million health care small businesses operating in a variety of sub-industries (SBA, 2018).

[13] High-growth startups are defined as firms with fast growing, innovation-driven businesses and above average gross job creation. Only about 3 percent of all firms qualify as high-growth startups (Mills and McCarthy, 2016).

The Landscape of Small Business Funding

Almost every business begins as a small business. Research from the Kauffman Firm Survey shows that new businesses are typically financed through a combination of personal savings, contributions from friends and family and individual borrowing in the form of home equity lines, personal loans and credit cards (Robb and Robinson, 2014). More recently, "angel investors" and networks of angel investors have become more active in helping fund new startups. Angel capital groups typically invest personal capital into young or early stage firms (Drover et al., 2017). According to National Venture Capital Association, $7.5 billion of angel funds were invested in 2018 (National Venture Capital Association, 2019).

Bank credit remains one of the main sources of financing for small businesses and "is key to helping small firms maintain cash flow, hire new employees, purchase new inventory or equipment and grow their businesses" (Mills and McCarthy, 2016). According to the Small Business Administration, banks loaned about $600 billion to small businesses in 2015 alone (SBA, 2016).

Apart from self-financing and bank credit, small businesses can increasingly obtain capital to grow through private investment funds. For example, certain businesses can access capital through venture capital funds. However, venture capital funds invest primarily in mid-to-latestage rounds of young, high-growth firms with the ability to scale rapidly (Drover et al., 2017). According to the National Venture Capital Association, $131 billion was invested in 2018 by the venture capital industry. Yet, of that total, only $9 billion was invested in early-stage companies while $62 billion was invested in late-stage companies (National Venture Capital Association, 2019).

Undoubtedly, the venture capital industry is a powerful force for fueling growth among U.S. companies. Akcigit, Dinlersoz, Greenwood, and Penciakova (2019) use the VentureXpert dataset to document that venture capital back firms on increased employment by approximately 475% when compared to a control sample over the same time horizon. In addition, the authors find venture capital backed firms are more likely to be in the top decile of firms in terms of employment ten years later. Babina, Ouimet, and Zarutskie (2019) use U.S. IPO data from 19922006 to show that small firms have a causal impact on aggregate employment growth. The authors find evidence indicating that employment increases by more than 20% annually over the three years following an IPO.

But while the venture capital sector is responsible for a large portion of firms that go on to be publicly traded, only a tiny fraction of firms in the U.S. ever receive venture capital funding (Puri and Zarutskie, 2012). These investments are highly concentrated in firms with a specific growth profile, primarily located in the health care, technology and financial services industries.

The capital-raising challenges facing the typical small business have been known for decades and pre-date the growth in venture capital and private equity funds. In an attempt to facilitate better access to funding, the U.S. created the Small Business Administration (SBA) in 1953 with the mission of facilitating funding and providing technical assistance to support small businesses. Overall, SBA programs which facilitate traditional bank lending have been successful. Many studies document the positive impact of SBA-backed loans on small business growth and especially in underserved sectors. For example, Craig, Jackson, and Thomson (2008) use SBA loan data from 1991 to 2001 and find that SBA loans have a positive impact on business growth and household income levels in low-income communities.

In order to provide an alternative source of financing for high-risk small businesses lacking access to capital from traditional sources such as banks, the Small Business Administration (SBA) created the Small Business Investment Company (SBIC) program in 1958 (Paglia and Robinson, 2016). SBICs traditionally operate with a general partner (GP) who manages assets in a fund structure that includes passive investors who serve as limited partners (LPs). SBICs typically combine equity investments from private investors with government-guaranteed debt backed by the SBA (Paglia and Robinson, 2017). By leveraging their equity capital, SBICs are able to reduce their weighted average cost of capital and increase returns on equity. As of December 2015, SBICs have deployed more than $80 billion in capital (two-thirds from private sector sources) into approximately 172,800 financing rounds for small businesses (Paglia and Robinson, 2017).

Of course, not all investment is good investment, so research has also examined the durability and broader impact of SBA programs and SBICs in particular. Results indicate that access to funding through SBA programs generally has a positive effect not just on short-run growth but also on long-term growth and job creation. For example, recent evidence on the effect of SBIC investments documents a positive and durable impact on job creation. Using data from the SBA, Paglia and Robinson (2017) conclude that due to SBIC investments, 9.5 million jobs were created or sustained between October 1995 and December 2014. Of the 9.5 million, 3 million were new jobs. In addition, employment in small businesses funded by SBIC programs grew by 45.6 percent. More broadly, research shows that SBIC equity investments have a positive impact on net sales and employment growth and also accelerate broad economic gains (Link, Ruhmand and Siegel, 2014; Paglia and Harjoto, 2014).

Another source of funding overseen by the SBA is the Small Business Innovation Research (SBIR) program. The SBIR program specifically promotes investment in research and development by small businesses to generate pioneering new products and services. Link, Ruhm and Siegel (2014) use data on SBIR funding to investigate the effect of investments on innovation and commercialization. The authors find that firms which receive investments are more likely to engage in innovation strategies and exhibit accelerated commercialization of new technologies.

While the research discussed above documents the positive relationship between small business access to capital and growth, it does not address the question of whether the level of investment is sufficient, efficient or equitably allocated across the full spectrum of small businesses.

Funding Gaps

Not all small businesses that would benefit from investment are able to access external funds. This resulting inefficiency in capital access is commonly referred to as a "funding gap" (Servon, Visser, and Fairlie, 2011). According to National Small Business Association 2017 Year-end Economic Report, one in four small business is unable to access needed financing (National Small Business Association, 2017).

Broad Trends

The funding gap is most prominent for financing amounts under $5 million because public markets and institutional fund investors are typically not interested in transactions below this threshold. Financings in the range of $250,000 to $5 million make up the majority of funding dollars but only 30 percent of transactions. Of the 70 percent of small businesses seeking financing in amounts under $250,000, more than 60 percent want loans under $100,000 (Mills and McCarthy, 2014). Only 37 percent of firms seeking $100,000 or less received the full amount requested, whereas 73 percent of firms requesting large amounts ($10 million or more) received the full amount (Mills and McCarthy, 2016). The Federal Reserve Bank Small Business Credit Survey notes this trend, reporting that 53 percent of responders who sought funding for the first time received less funding than requested and only 48 percent of firms have met their financing needs (Federal Reserve Bank, 2019). Of the small businesses surveyed, 31 percent cited credit availability as a financial challenge experienced in the last 12 months, and 23 percent of firms applied for financing but experienced a shortfall (Federal Reserve Bank, 2019).

As a case study to investigate capital access gaps, Servon, Visser, and Robert (2011) measure the capital access gap for small business within New York City. Using data from the Characteristics of Business Owners Survey, Survey of Business Owners, Survey of Small Business Finance and County Business Patters Data, the researchers compare supply and demand for small business loans and develop an estimate that in New York City alone, there exists a $6 billion capital access gap (in New York City alone). Taken together, these results pose an important question: What is causing the funding gap?

By their very nature of most young or small businesses have few hard assets and lack extensive credit histories. A Federal Reserve study confirmed this challenge, citing that 33 percent of firms were denied credit due to insufficient credit history (Federal Reserve Bank, 2019). The lack of credit history presents a challenge for banks when small businesses seek traditional bank loans. In order to obtain information about credit worthiness, banks rely on information about the small business from other sources such as personal wealth, income, debt or home ownership to determine loan default probability (see, Craig, Jackson III, and Thomson, 2008; Berger, Frame, and Miller, 2005; Ahmed, Beck, McDaniel, and Schropp, 2015).[14] In addition to a lack of credit history, fulfilling collateral requirement can be challenging and prohibitive for new small firms

[14] Personal financial wealth is an important signal of credit quality for new businesses (Cavalluzzo and Wolken, 2005; Robb and Robinson, 2017). Adelino, Schoar, and Severino (2015) demonstrate this connection using county business patterns data from 1998 to 2010 obtained from the U.S. Census Bureau. The authors found that "areas with rising house prices (and increased leverage) experienced a significantly bigger increase in small business starts" (Adelino, Schoar, and Severino, 2015). Cavalluzzo and Wolken (2005) use data from 1998 Survey of Small Business Finances and find that personal wealth is a significant indicator for predicting loan denials. In particular, "home ownership is associated with approximately a 30 percent reduction in the predicted probability of loan denial."

in obtaining needed funding. A recent Federal Reserve Bank survey reported that insufficient collateral as one of the reasons why small businesses were denied loans, finding that 35 percent of loan denials were due to insufficient collateral (Federal Reserve Bank, 2019).

Another headwind for small businesses seeking to obtain traditional bank loans has been bank consolidation. Over the last 30 years, banks have undergone substantial consolidation across the nation. In 1986, there were 14,252 commercial banks across the U.S. compared with just 4,687 by the end of 2018. When banks consolidate into a larger institution, they are less likely to lend in smaller amounts as these loans are generally more expensive and less profitable. Since the mid-1990s, small loans as a share of total loans on the balance sheets of banks have declined in nearly every year even though the overall commercial loan balances of banks have continued to rise (Mills and McCarthy, 2016; Mills and McCarthy, 2014, Ahmed, Beck, McDaniel, and Schropp, 2015).

Geography and Industry

Within these broader trends, some small businesses are more effected than others. Increasingly, institutional capital markets discussed above are focused on large firms. Most of these firms are publicly traded and headquartered in major metropolitan areas, but there is a significant geographic dispersion of public company headquarters. However, the rapid growth of private equity, venture capital, and growth capital funds has resulted in businesses avoiding public markets and accessing an ever-growing pool of institutional private capital.[15] While there are likely many benefits to firms staying private longer, one consequence has been a shift in focus as to where capital is provided. For example, certain types of private capital such as venture fund investments are highly concentrated in a few geographies and in certain industries. In contrast, other investment vehicles such as SBICs are less concentrated by geography and industry. To demonstrate these differences, we undertake an analysis comparing recent investments made by venture capital firms and SBICs from 2014-2018.

We collect data from two sources. The first is from the SBA on SBIC funding by state and by year from 2014-2018. These data capture all SBIC financing rounds for this recent five-year period. Overall, the data show 13,576 financing rounds for 5,724 small businesses receiving $29

[15] See Ewens and Farre-Mensa (2017).

billion in capital. There exists a wide dispersion in geography with at least one company in all 50 states receiving an SBIC financing round during this period. Unfortunately, we do not have data from the SBA for these years by industry or by business ownership type. To better understand industry and ownership gender trends we collect information on a subset of transactions from PitchBook. We find information on transactions totaling $5.3 billion, roughly one-fifth of all financing dollars. To compare SBIC financing with venture capital funding, we collect similar data from PitchBook on venture capital funding rounds. We obtain information on $429 billion in VC funding from 2014-2018.

There are significant differences in the geographic dispersion of funding between SBICs and VCs. Table 1 shows total funding by state rank.[16] A large majority (71.4 percent) of venture capital funding goes to just the top three states. In contrast, the top three states account for onethird of SBIC funding. Consequently, relative funding in remaining states is higher for SBICs than for VCs. The differences persist even to the bottom 25 funding states, which receive just 1.3 percent of VC funding compared to 8.3 percent of SBIC funding.

Table 1. Total Funding Percentages by State Rank, 2014-2018

States	Venture Capital	SBIC	Difference
Top 3 States	71.4%	33.3%	38.1%
4-10	16.2%	30.4%	-14.2%
11-20	9.1%	20.3%	-11.2%
Bottom 25 States	1.3%	8.3%	-7.0%

Data Sources: PitchBook; SBA

Figure 1 examines these differences graphically by plotting the percentage of total capital provided by VCs and SBICs by state. Panel A shows results for VCs and Panel B shows results for SBICs. The shade of blue indicates the percentage of overall funding. For example, the dark blue shading for California in Panel A indicates that more than 20 percent of funding from VC funds from 2014-2018 was in California. Panel B shows that during this time period, there was

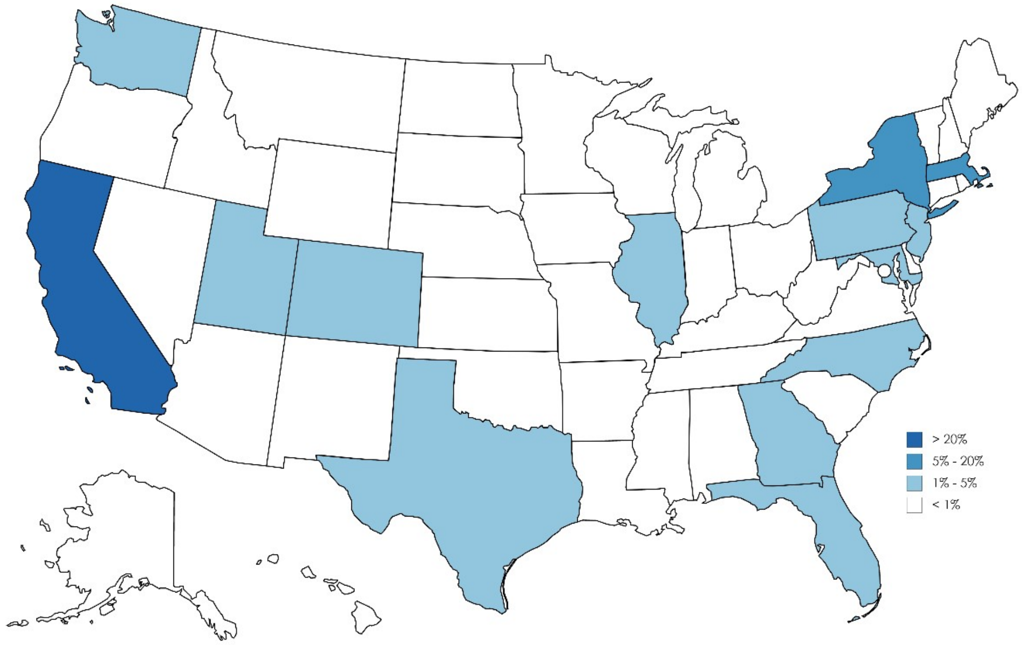
[16] Specifically, states are ranked by total funding levels for the 2014-2018 period independently for VC and SBIC investments. For example, the top three states for VC investments are California, Massachusetts and New York and the top three states for SBIC investments are California, New York, and Texas.

no state that received 20 percent or more of SBIC funding. The graph shows that two states (New York and Washington) received between five and 20 percent of VC funding whereas five states received between five and 20 percent of SBIC funding. Most apparent is that only another 11 states received more than one percent of overall VC funding whereas another 22 states received one percent or more of SBIC funding. Together these results indicate that funding tends to be concentrated in more populous states for both VCs and SBICs but the dispersion in funding by SBIC is much greater than for VCs. Nonetheless, the scale of VC investing is more than an order of magnitude larger than SBIC funding, so the differences in funding amounts (as opposed to percentages) do not reflect these differences.

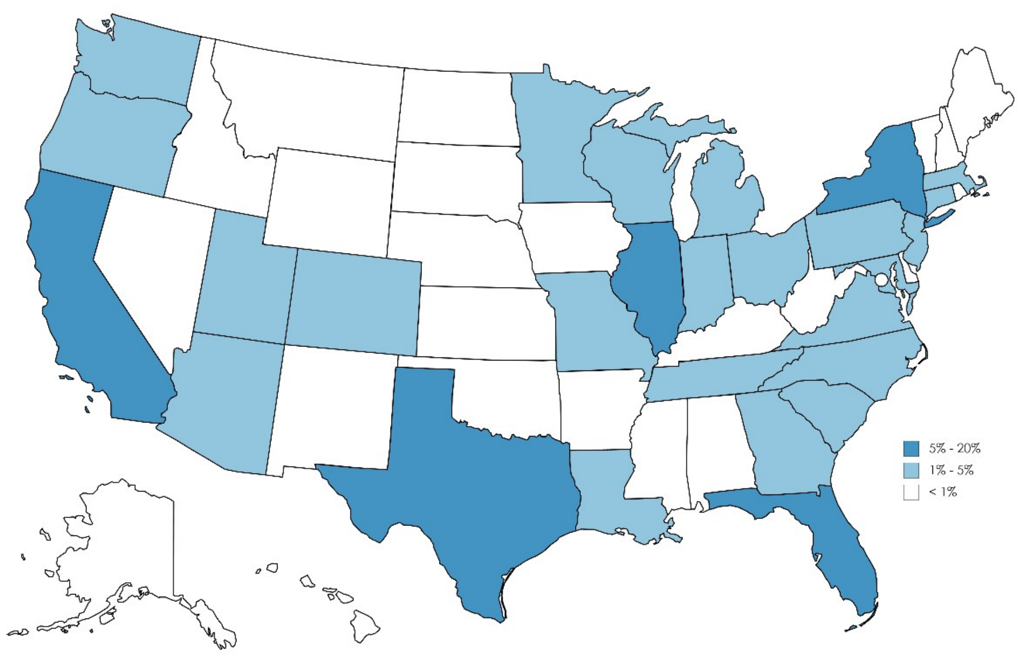
The industry-level data on SBIC and venture capital funding also indicate some important differences. As discussed previously, VC funding has historically been concentrated in just a few industries whereas SBIC funding has been more widely distributed. Table 1 shows data from 2014-2018 based on data provided by PitchBook. Between 2014 and 2018, 82.3 percent of funding was provided to the top three sectors: information technology (IT), health care and business-to-consumer. Over this same period, SBICs also provided close to 80 percent of funding to these sectors but with more of a focus on health care and less on IT. SBICs were more inclined to provide capital to the business-to-business sector than VCs, and less inclined to make investments in financial services. One possible concern about these data are that reporting in PitchBook is skewed toward certain sectors given PitchBook's focus on the venture capital industry. Again, we emphasize the differences in scale between the SBIC and VC funding levels, so even after adjusting for incomplete coverage of SBIC funding, the VC funds provide more capital to every sector.

Figure 1. Percentage of Financing to Businesses by State, 2014-2018

Panel A. Venture Capital



Panel B. SBIC Program



Data Source: PitchBook; SBA

Table 2. Total Capital Invested by Industry Sector, 2014-2018 (US$ million)

Sector

Type of Investment	Businessto-Business	Business-toConsumer	Energy	Financial Services	Health Care	Info Tech	Materials & Resources	All
Venture Capital								
Amount	40,493	85,463	10,791	20,551	101,700	166,050	4,015	429,063
Percentage	9.4%	19.9%	2.5%	4.8%	23.7%	38.7%	0.9%	
SBIC*								
Amount	996	1,030	140	20	2,141	879	113	5,318
Percentage	18.7%	19.4%	2.6%	0.4%	40.3%	16.5%	2.1%	

Data Source: PitchBook

** SBIC data represent only 18.2 percent of total SBIC financings during this period.*

Women and Minorities

Gender and race influence small business owners' ability to access credit.[17] Using data from the National Institute of Health, Gicheva and Link (2013 and 2015) find that female-owned companies are less likely to receive private investment. Similarly, Asiedu, Freeman and NtiAddae (2012) examine data from the 1998 and 2003 Survey of Small Business Finances and find that loan denial rates for black-owned small businesses are significantly higher than for white male owners and other minority groups.

While the literature has not fully identified the reasons for these gaps, certain characteristics are consistently present among the studies including lack of credit history, fear of rejection and underrepresentation in the investment industry. Minorities, on average, have a lower household net worth than whites, which directly affects loan size and increases the rate of loan denial (Bates, Bradford, and Seamans, 2018; Fairlie, Robb and Robinson, 2016). For example, the median net worth for black households is $12,780 compared to $110,500 for white households (U.S. Census Bureau, 2019). Differences in lending activity are largely due to the relatively low credit scores for black business owners and not to differences in need for capital. In addition, funding discrepancies between minority and white startups persist after years of operation (Fairlie, Robb and Robinson, 2016). Cole and Sokolyk (2016) using data from the Federal Reserve Board's Surveys of Small Business Finances (SSBFs) find that between 21 and 55 percent of businesses whose owners did not apply due to fear of rejection would have been approved for credit. Recent research indicates that this fear may disproportionally affect women

[17] See, Mijid and Bernasek, 2013; Bates and Robb, 2015; Gicheva and Link, 2013; Gicheva and Link, 2015; Asiedu, Freeman, and Nti-Addae, 2012; Robb 2013.

and minorities; for example, black entrepreneurs are about three times more likely to not apply for credit due to fear of credit denial.[18] Nevertheless, low average credit scores among minority business owners are a major factor in explaining the average differences in access to credit across racial groups (Fairlie, Robb and Robinson, 2016; Robb and Robinson, 2017).

Several studies note a chronic underrepresentation of women and minority investment professionals in the venture capital and private equity industry. Research also documents the relationship between a lack of diverse investment professionals and investments in gender and racially diverse companies.[19] A 2016 survey issued by the National Venture Capital Association finds that only 14 percent of VC firms surveyed had at least one female investment partner and only three percent had at least one black investment partner (NVCA-Deloitte, 2019).

While the typical private equity and venture capital fund (and portfolio investment companies) lack diversity, other types of investment vehicles appear to mitigate the problem. Using PitchBook and SBA diversity data from 2013 to 2015, Paglia and Robinson (2016) find that SBIC funds had a higher percentage of female investment professionals (11.9 percent compared to the broader venture capital and private equity investment community with just 7.9 percent). The study was unable to draw a firm conclusion about racial diversity because of a lack of diversity data available in PitchBook but found that 10.2 percent of SBIC funds have at least one minority partner. The authors also find that racially diverse investment groups are more likely to invest in minority-owned and minority-led companies as well as invest more in LMI communities.

We use the PitchBook data from 2014 to 2018 to update the results of Paglia and Robinson (2016) on financing provided to women-owned businesses. We classify a company as femalefounded if any member of the founding team is a woman. Results are presented in Table 3. We confirm that in this more recent period, female-founded companies received a higher percentage of SBIC funding than VC funding. From 2014 to 2018, SBICs in our sample provided about 44 percent of total funds to female-founded businesses. In contrast, female-founder businesses received only about 10 percent of total funds invested by VCs during the same period. In some specific sectors such as IT, financial services, health care, and B2B, the difference is

[18] See, Bates and Robb, 2013, 2015; Mijid and Bernasek, 2013; Fairlie, Robb, and Robinson, 2016.
[19] See, Paglia and Robinson, 2016; Kanze, Huang, Conley, and Higgins, 2018.

quite large, though the sample size is very small for SBIC funding of financial services. Overall, these results are consistent with prior evidence on the ability of SBICs to provide funding to businesses identified as prone to funding gaps even though the dollar values of funding are low compared to VC funding.

Table 2. Total Capital Invested by Industry Sector, 2014-2018 (US$ million)

Type of Investment	Sector							
	Businessto-Business	Business-toConsumer	Energy	Financial Services	Health Care	Info Tech	Materials & Resources	All
Venture Capital								
All	40,493	85,463	10,791	20,551	101,700	166,050	4,015	429,063
Female-founded	2,310	9,614	1,535	2,461	13,479	11,784	295	41,478
Percentage	5.7%	11.2%	14.2%	12.0%	13.3%	7.1%	7.3%	9.7%
SBIC*								
All	996	1,030	140	20	2,141	879	113	5,318
Female-founded	495	38	30	20	887	760	95	2,324
Percentage	49.7%	3.6%	21.5%	100.0%	41.4%	86.4%	84.3%	43.7%

Data Source: PitchBook

** SBIC data represent only 18.2 percent of total SBIC financings during this period.*

Conclusions

Significant funding gaps exist for U.S. small businesses needing capital to grow. These gaps are not uniformly spread across all businesses, but instead have a disproportionate impact on small firms in certain industries, geographies and ownership structure. A variety of initiatives and programs seek to close the gaps for all businesses but with a special focus on businesses where more institutional capital providers (e.g., large banks and venture capital funds) are less likely to provide funding. We specifically review the literature related to the role of SBICs in closing funding gaps. We also provide preliminary analysis of funding trends in recent years (20142018) for venture capital funds and SBICs. We find that SBICs tend to provide relatively more capital outside of the largest states, have a more well-diversified industry profile and are making investments in women-owned businesses at higher rates. However, the current smaller scale of SBICs limits the aggregate impact of these advantages. These results suggest the potential for significant reduction in small business funding gaps if SBIC activity can be scaled significantly without affecting the mix of small businesses receiving investments.

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