

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, Committee on Small Business
From: Nydia M. Velázquez, Chairwoman
Date: September 26, 2019
Re: Full committee hearing: “SBA Management Review: Small Business Investment Company Program”

The Committee on Small Business will meet for a hearing titled, “SBA Management Review: Small Business Investment Company Program.” The hearing is scheduled to begin at **11:30 A.M. on Thursday, September 26, 2019 in Room 2360 of the Rayburn House Office Building.** The hearing will allow Members to learn about the SBA’s Small Business Investment Company (SBIC) program designed to provide debt and equity financing to high-risk small businesses lacking access to adequate capital from traditional sources. Members will also be able to explore the current administrative challenges facing the program and its industry participants. The witnesses will be:

Panel 1:

- Mr. Joseph Shepard, Associate Administrator for the Office of Investment and Innovation (OII), U.S. Small Business Administration, Washington, DC

Panel 2:

- Mr. Brett Palmer, President, Small Business Investor Alliance, Washington, DC
- Mr. John Paglia, Professor of Finance, Graziadio Business School – Pepperdine University, Malibu, CA
- Ms. Ronda Penn, Chief Financial Officer, Raleigh, NC
- Mr. Walt Rodgers, Chief Executive Officer, Family RV, Cincinnati, OH

Background

SBA administers programs to support small businesses, including investment programs designed to provide the high-growth small business community with access to financial capital and research and development funds to develop commercially viable innovations.¹ Authorized by the Small Business Investment Act in 1958, the Small Business Investment Company (SBIC) program is designed to enhance small business access to venture capital by stimulating and supplementing the flow of private equity capital and long-term loan funds.²

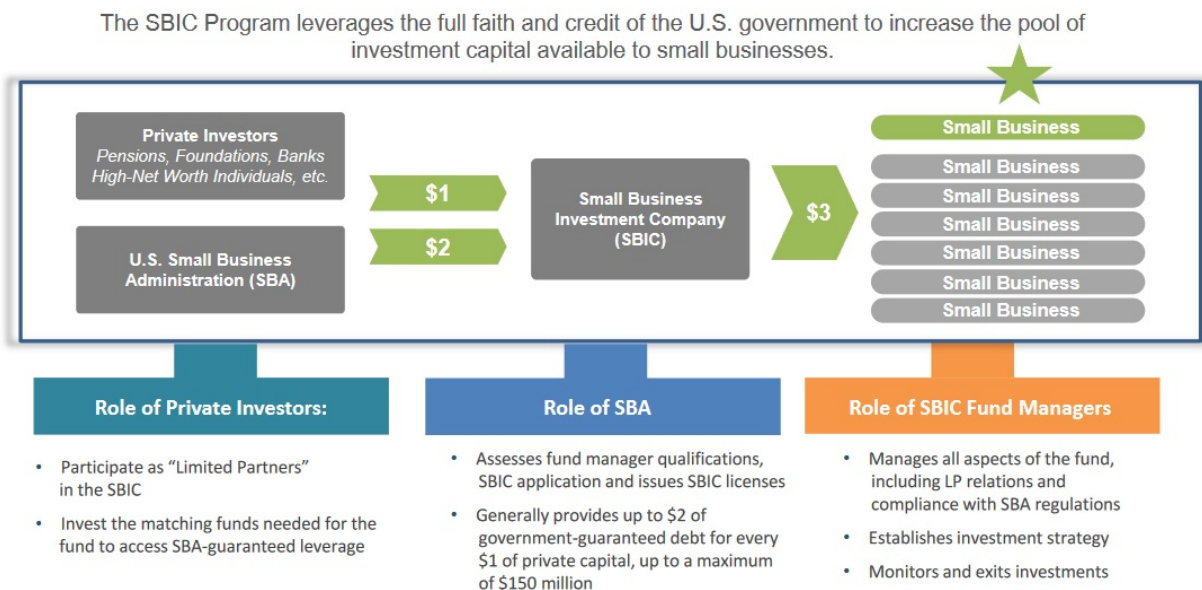
¹ U.S. Small Bus. Admin., Off. of Investment and Innovation, <https://www.sba.gov/offices/headquarters/ooi> (last visited Sep. 16, 2019).

² ROBERT J. DILGER, CONG. RES. SERV., R41456, SBA SMALL BUSINESS INVESTMENT COMPANY PROGRAM (2019) [hereinafter CRS R41456].

The SBIC program was created to address concerns raised in a Federal Reserve Board report to Congress that found a gap existed in the capital markets for long-term funding for growth-oriented small businesses.³ The report concluded that there was a need for a federal government program to assist small firms in gaining access to long-term financing and equity financing.⁴

Program Overview

SBA partners with privately-owned and managed SBICs licensed by SBA to provide financing to small businesses with private capital raised by the SBIC (regulatory capital) and with funds (leverage) the SBIC borrows at favorable rates because SBA guarantees the debenture (loan obligation).⁵



Source: Small Business Administration

Types of Licenses

Generally, there are five types of SBICs:

- **Standard Debenture License:** Funds have been licensed as standard licensees since the program was founded in 1958. They have the broadest investment mandate and are required to have a private capital investment of at least \$5 million.⁶
- **Impact Investment License:** The Impact license was created in 2011 and was designed for funds with an investment mandate targeting social as well as financial returns.⁷ The managers of these funds pledge to invest 50 percent of their capital in "impact" investments and are eligible for an expedited licensing process.⁸ However, in 2017, the SBA announced it was no longer accepting new applicants because the costs

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

were not commensurate with the benefits, few qualified SBICs applied, and those having applied would have applied to the SBIC program anyway.⁹

- **Early Stage Innovation License:** The Standard and Impact licenses are most suitable for investors targeting later-stage companies with cash flow.¹⁰ The Early Stage Innovation License, by contrast, is designed to attract investment fund managers with experience supporting companies in their earliest stages of growth.¹¹ These SBICs are required to invest at least 50 percent of their financings in early stage small businesses, defined as small businesses that have never achieved positive cash flow from operations in any fiscal year.¹² In recognition of the higher risk associated with investments in early stage small businesses, these SBICs must raise more regulatory capital of at least \$20 million.¹³
- **Participating Securities License:** Created in 1992 and established in 1994, these SBICs receive leverage through the issuance of participating securities (redeemable, preferred, equity-type securities, often in the form of limited partnership interests, preferred stock, or debentures with interest payable only to the extent of earnings).¹⁴ Like the investment licenses, SBA is no longer issuing new commitments due to the cost of the program.
- **Bank-owned, non-leveraged License:** SBICs do not receive leverage, but commercial banks may invest up to 5 percent of their capital and surplus to partially or wholly own a SBIC.¹⁵

Eligibility Requirements

A SBIC can be organized in any state as either a corporation, a limited partnership (LP), or a limited liability company.¹⁶ Most SBICs are owned by relatively small groups of local investors, although many are partially owned, and some (49 of 302) are wholly owned by commercial banks.¹⁷ A few SBICs are corporations with publicly traded stock.¹⁸

One of the primary criteria for licensure as a SBIC is having qualified management.¹⁹ SBA reviews and approves a prospective SBIC's management team based upon its professional capabilities and character.²⁰ Specifically, SBA examines the SBIC's management team and looks for:

- At least two principals with substantive and analogous principal investment experience;

⁹ CRS R41456, *supra* note 2.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ CRS R41456, *supra* note 2.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

- Realized track record of superior returns, based on an overall evaluation of appropriate quantitative performance measures;
- Evidence of a strong rate of business proposals and investment offers (deal flow) in the investment area proposed for the new fund;
- A cohesive management team, with complementary skills and a history of working together;
- Managerial, operational, or technical experience that can add value at the portfolio company level; and
- A demonstrated ability to manage cash flows so as to provide assurance SBA will be repaid on a timely basis.²¹

Application Process

Applying for a SBIC debenture license is a multi-step process, beginning with the submission of the SBA Management Assessment Questionnaire (MAQ) and an initial, nonrefundable licensing fee of \$10,000.²² The MAQ includes, among others, questions concerning:

- The fund's investment strategy (including geographic focus, industry focus, diversification strategy, primary types of securities to be used, whether it plans to be primarily an equity or debt investor, and others);
- The management team's history and professional experience;
- The fund's investment decision-making process, from deal origination to portfolio monitoring;
- The fund's economics;
- The fund's capitalization;
- The fund's governance structure; and
- A 10-year financial forecast for the fund.²³

After receiving the firm's application, a member of SBA's Program Development Office reviews the MAQ, assesses the investment company's proposal in light of the program's minimum requirements and management qualifications, performs initial due diligence, and prepares a written recommendation to SBA Investment Division's Investment Committee.²⁴ If the Investment Committee concludes that the investment company's management team may be qualified for a license, that management team is invited to SBA headquarters in Washington, DC for an in-person interview.²⁵

Following the interview, if the Investment Committee votes to proceed, the investment company is provided a "Green Light" letter formally inviting it to proceed to the final licensing phase of the application process.²⁶ Once an applicant receives a Green Light letter, the applicant typically has up to 18 months to raise the requisite private capital.²⁷ Final licensing occurs when SBA accepts an applicant's complete licensing application, which is submitted after raising sufficient private

²¹ CRS R41456, *supra* note 2.

²² *Id.*

²³ *Id.*

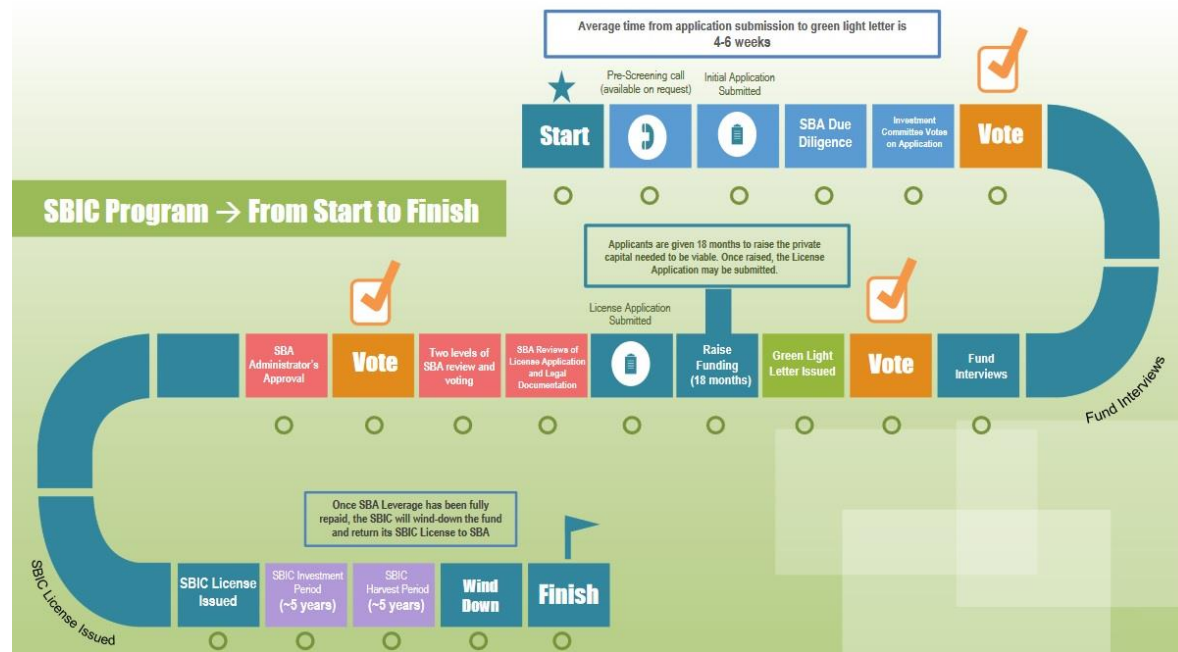
²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ CRS R41456, *supra* note 2.

capital, and receives a final licensing fee (currently \$20,000).²⁸ Obtaining a SBIC license for the first time usually takes six to eight months from the initial MAQ submission to the license issuance.²⁹ The graphic below illustrates the typical life cycle of a SBIC.



Source: Small Business Administration

Investments in small businesses

SBICs provide equity capital to small businesses in various ways, including by:

- Purchasing small business equity securities (e.g., stock, stock options, warrants, limited partnership interests, membership interests in a limited liability company, or joint venture interests);
- Making loans to small businesses, either independently or in cooperation with other private or public lenders, that have a maturity of no more than 20 years;
- Purchasing debt securities from small businesses, which may be convertible into, or have rights to purchase, equity in the small business; and
- Providing small businesses, subject to limitations, a guarantee of their monetary obligations to creditors not associated with the SBIC.³⁰

Program Statistics

As of June 30, 2019, there were 302 licensed SBICs in operation (225 debenture SBICs, 22 participating securities SBICs, 49 bank-owned, non-leveraged SBICs, and 6 SSBICs).³¹ From the inception of the SBIC program to December 31, 2018, SBICs have invested approximately \$97.6 billion in approximately 181,185 financings to small businesses.³² As of June 30, 2019, SBA had

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

a guarantee on an outstanding unpaid principal balance of \$11.3 billion in SBIC debentures, \$5.8 million in SBIC participating securities, and \$40.6 million in other, primarily SSBIC, financings.³³ SBA also had an outstanding commitment on \$2.9 billion in SBIC debentures and \$2.6 million in other, primarily SSBIC, financings.³⁴ As of June 30, 2019, the SBIC program had invested or committed about \$30.6 billion in small businesses, with SBA's share of capital at risk about \$14.2 billion.³⁵

In FY 2018, SBICs made 2,711 financings, with an average financing amount of \$2,029,730.³⁶ In FY 2018, SBIC funds were used primarily for acquiring an existing business (57.9%), operating capital (18%), refinancing or refunding debt (13%), new building or plant construction (0.9%), research and development (0.8%), purchasing machinery or equipment (0.6%), marketing activities (0.6%), plant modernization (0.4%), and other uses (7.8%).³⁷

Financing to specific demographic groups

Poor diversity numbers have long been an issue in the SBIC program. In 2007, SBA acknowledged at a hearing in this Committee that “women and minority participation [in the SBIC program] is low.”³⁸ Further, in 2009 the Small Business Investor Alliance (SBIA) asserted at a hearing that SBA's SBIC licensing process “has done an abysmal job at attracting and licensing funds led by women and minorities.”³⁹ The program's diversity numbers have not changed much since 2007. In FY 2018, SBICs made 4.8% of all financings, amounting to \$132.4 million to minority-owned and controlled small businesses.⁴⁰ Additionally, in FY 2018, SBICs made 2.2% of all financings to women-owned small businesses and 0.9% of all financings to veteran-owned small businesses.⁴¹

Current Issue – Delays in licensing approvals and staffing vacancies

According to SBIA, beginning in about 2017, there have been “serious problems with the management of the SBIC program.”⁴² In a letter addressed to Chairman Marco Rubio and Ranking Member Ben Cardin (the “February 27 letter”), SBIA President Brett Palmer states:

Until the day before this hearing, over four months into FY2019 and through more than one third of the fiscal year, SBA had issued zero SBIC licenses. Less than 24 hours before this oversight hearing, the Office of Investment and Innovation (OII) finally released the first SBIC licenses of the fiscal year. All three licenses were approved by SBA's Agency Committee on November 16, 2018, but the leadership of OII was unable or unwilling to release the SBIC licenses until hours before the

³³ CRS R41456, *supra* note 2.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ CRS R41456, *supra* note 2.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² Letter from Brett Palmer, President, Small Business Investor Alliance, to Chairman Marco Rubio & Ranking Member Ben Cardin, Senate Committee on Small Business & Entrepreneurship (Feb. 27, 2019) (on file with the House Committee on Small Business).

Committee's oversight hearing. Until 2017 releasing licenses would have taken 1 to 2 weeks.

The February 27 letter also contains a chart setting forth various timelines for the licensing process, including rough averages for those timelines from FY 2010-16, February 2017-February 2019, and in FY 2019. The chart, reproduced below, shows that beginning in February 2017, the time it took SBA to complete various phases of the SBIC licensing process increased sharply, while the number of funds licensed per year declined.

	FY 2010-2016	Feb. 1, 2017-Feb. 10, 2019	FY 2019 (SBICs licensed from Oct 1, 2018 through date of Hearing Feb. 13, 2019)
Time for Greenlight Approval for Repeat Funds	Commonly 0.5 Months	Commonly up to 6 Months	Average of 7.25 Months (100% repeat SBICs)
Time to Receive License After Approval by Agency Committee	Commonly 1-2 Weeks	Commonly 1 - 2 Months (sometime more)	3 months
Annual Pace of funds licensed per year	26.4 Licenses Per Year Average (Fewest 21 and highest 34 per year)	Averaging 16 Licenses Per Year for the last 24 months <ul style="list-style-type: none"> 7 in FY17 (excludes licenses issued by previous Administration in FY 2017) 25 in FY 2018 (repeat and new SBICs) 	On pace for 9 to 12 licenses (No new platforms licensed as of date of hearing)
Average Time for Licensure	6.6 Months (185 first-time and repeat funds)	SBA reported numbers for FY 2017 are 5.1 months – this number is misleading because more than 50% of licenses issued were issued in a timely manner by the previous Administration (further, this data excludes SBA-caused delays) (includes new and repeat funds) 8.7 Months for FY 2018 (includes new and repeat funds and <i>excludes SBA-caused delays that are omitted from SBA's reported data</i>) Zero SBICs Licensed from Oct. 1, 2018 through Feb 10, 2019	9.7 months (100% repeat SBICs, which should be much faster to analyze than first time funds)

Source of data 2009-2018 SBA, Source of FY 2019 SBIA (OII appears to have ceased releasing SBIC data for FY 2019)

Industry stakeholders anecdotally confirmed the delayed timelines set forth above, saying approvals that used to take six months now commonly take a year or more.⁴³ Other industry insiders have raised concerns regarding the inefficient management of the program. For example, in a recent publication, a stakeholder states:

⁴³ Dietrich Knauth, Buyouts, *Trump administration knocked over long delays in SBIC licensing* (Feb. 1, 2019), <https://www.pehub.com/buyouts/trump-administration-knocked-over-long-delays-in-sbic-licensing/> (last visited Sep. 16, 2019).

There are so many great things about the SBIC program, so it's a real disappointment when it's not active and run as effectively and efficiently as it could be. I think that [the slowdown] could at some point cause institutional investors to look elsewhere and have less confidence in the commercial viability of the program. I don't think that's happened yet, though, and I hope that it doesn't.⁴⁴

According to the same article, one general partner said it was pursuing alternatives to a planned SBIC fund after its license lingered in limbo for two years.⁴⁵ A limited partner from an insurer said their institution was forced to look outside the SBIC space to deploy capital to the small private equity space.⁴⁶

Furthermore, OII has reportedly been unacceptably understaffed. According to the February 27 letter, "the OII has numerous critical career director, manger, and chief positions have been vacant for extremely long periods of time, but there has been no attempt by the leadership of the OII to post these open positions for replacement."⁴⁷

Library of Congress Reports

In 2015, SBA contracted with the Federal Research Division (FRD) of the Library of Congress to conduct an independent evaluation of the SBIC program. FRD enlisted the aid of two experienced scholars with experience in financial markets to perform the research. The researchers prepared and issued three reports; one on diversity within the program, another on the program's role in small business job creation, and the final on the program's role in financing small businesses.

Diversity within the SBIC Program

The SBIC program has historically struggled with attracting and licensing women-led and minority-led funds. The FRD report made a series of findings regarding diversity within the SBIC program. For instance, the report noted that SBICs have better racial and gender diversity in leadership positions compared to the private equity (PE) community.⁴⁸ In addition, they found that racially diverse SBICs make more investments in minority-led and minority-owned portfolio companies, as well as in women-led and women-owned businesses than non-racially diverse SBICs.⁴⁹ Notably, the researchers also found no evidence that gender-diverse or racially diverse SBICs perform better or worse than white-male-only-managed SBICs.⁵⁰ Overall, the findings suggest that granting SBIC licenses to well-qualified gender-diverse and racially diverse funds increases the rates of investment into other women-led, women-owned, minority-led, minority-owned companies while also producing returns that are comparable to their non-diverse

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ Letter from Brett Palmer, President, Small Business Investor Alliance, to Chairman Marco Rubio & Ranking Member Ben Cardin, Senate Committee on Small Business & Entrepreneurship (Feb. 27, 2019) (on file with the House Committee on Small Business).

⁴⁸ John Paglia & David T. Robinson, Fed. Res. Div.-Libr. of Congress, *Measuring the Representation of Women and Minorities in the SBIC Program* (Oct. 2016) https://www.sba.gov/sites/default/files/aboutsbaarticle/Measuring_the_Representation_of_Women_and_Minorities_in_the_SBIC_Program_2016_10.pdf (last visited Sep. 16, 2019).

⁴⁹ *Id.*

⁵⁰ *Id.*

counterparts.⁵¹ Taken together, the findings indicate that diverse populations are better served by and through a diverse team of fund managers.⁵² The hearing will allow Members of the Committee to further examine the gender and racial diversity within the SBIC and among the broader venture capital and private equity community.

The SBIC Program's role in job creation

The SBIC program is considered by many to be a program that effectively facilitates small business job creation and findings support that notion. Specifically, the SBIC-funded small businesses in the researchers' sample created almost 3 million jobs during the sample period (October 1995-December 2014).⁵³ Looking at *jobs created or sustained* (an expanded scope of job creation), SBIC-funded small businesses created or sustained almost 9.5 million jobs during the sample period. On average, one new job was created for every \$14,458 of funding invested through the SBIC program, while an average of one job was created or sustained for every \$4,525 invested.⁵⁴ Notably, the researchers found that the average administrative cost to the SBA was approximately \$35 per job created, and about \$11 per job created or sustained.⁵⁵ According to the researchers, these findings indicate that SBIC-funded small businesses are a robust source of job creation in the U.S. economy.⁵⁶

SBIC Program's role in financing small businesses

The researchers were also tasked with evaluating the role SBICs play in the broader PE market for financing small businesses. They found the SBIC program is not only widely diversified by industry sector and geographic subregion, but varies from non-SBIC private equity funding on key dimensions concerning the companies, industries, and regions receiving investments.⁵⁷ Specifically, they found that SBIC investments support companies that are less likely to be considered by traditional PE sources of similar size and investment focus, and fund different sectors.⁵⁸

They also found that SBIC investments are more widely geographically distributed than the broader investment fund community, both in terms of the proportion of deals by region and the proportion of dollars invested by region.⁵⁹ This led the researchers to conclude that “[a]s compared to the broader financing landscape for small and mid-sized businesses – where over 35,000 deals were made and over \$1.5 trillion was invested – SBICs have higher capital distribution ratios among small businesses and distribute capital more evenly among nine geographic subregions.”⁶⁰ However, it should be noted that SBA, to “prevent any misunderstandings by the reader,” attached

⁵¹ *Id.*

⁵² *Id.*

⁵³ John Paglia & David T. Robinson, Fed. Res. Div.-Libr. of Congress, *Measuring the Role of the SBIC Program in Small Business Job Creation* (Jan. 2017) https://www.sba.gov/sites/default/files/files/SBA_SBIC_Jobs_Report_0.pdf (last visited Sep. 16, 2019).

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ John Paglia & David T. Robinson, Fed. Res. Div.-Libr. of Congress, *Measuring the Role of the SBIC Program in Financing Small Businesses* (July. 2017) https://www.sba.gov/sites/default/files/2019-08/SBA_SBIC_Financing_Small_Business.pdf (last visited Sep. 16, 2019).

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

a disclaimer notice to this report, saying that it “identified a number of weaknesses and limitations in the underlying data and methodology.”⁶¹

This hearing allows Members of the Committee to further understand and address access to capital issues for small businesses. In addition to the overall category of small businesses, SBIC financing can also be utilized to finance underserved small businesses. Underserved small businesses are businesses that women, veterans, or minorities own, or they are in underserved geographic areas, which include low- and moderate-income areas.⁶² In FY2018, SBICs financed 1,151 small businesses and 315 underserved small businesses.⁶³ SBIC funds can be an additional critical source of capital, either as private equity capital or long term loan funds, to supplement more traditional forms of access to capital.

Conclusion

SBA’s SBIC program plays a unique role in the world of small business finance. It is a positive force in helping entrepreneurs grow their businesses and create small business jobs, and in helping spread capital in a more dispersed manner across the country, serving geographic areas underserved by traditional private equity. However, the program has been plagued in recent years by reports of administrative inefficiency and mismanagement. Accordingly, this hearing will allow Members to learn more about the SBIC program as an engine of small business job creation. It will also enable Members to conduct much-needed oversight over the program and its management, and explore the concerns consistently raised by SBIC funds regarding delays and understaffing at OII.

⁶¹ *Id.*

⁶² U.S. Small Bus. Admin., *FY2020 Congressional Budget Justification and FY2018 Annual Performance Report*, p. 40 (2019).

⁶³ *Id.*