

## The SBIC Program – An Oasis of Liquidity in an Arid Economic Environment

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### **Client Advisory**

June 23, 2017 by Stephen M. Fields

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Raising capital has never been easy. In today's economy it is even more difficult. For every successful business flush with cash there are many times that number unsuccessfully seeking capital from banks, investors and traditional lenders. Why is that? Are the borrowers undeserving? Are the credit criteria too stringent? Is the collateral insufficient? None of this is clear but in these uncertain times what is clear is that investors and lenders are taking longer to commit to new deals, reducing the amount of their exposure and being more careful about which companies they invest in and lend to. These are not new issues. What is new is the unprecedented unmet demand for capital by businesses of all types and sizes. The lack of investment has adversely impacted job creation, has stifled growth, innovation, modernization and exports. This situation has compelled an otherwise highly partisan Congress to coalesce behind one of the few federal programs designed to alleviate these problems.

### **SBICs – Prior History**

The Small Business Investment Company ("SBIC") Program, which is administered by the U.S. Small Business Administration ("SBA"), was originated in 1958 and has provided an uninterrupted flow of capital to lenders and equity investors since that date. The unmet demand for capital compels a new look at this evolving old program. The statutory purpose of the SBIC Program is to enhance the growth, modernization and expansion of U.S. businesses by providing capital to qualified professional investors who are required to invest such capital in small U.S. businesses, i.e., those that have historically created the most jobs. Because of the relatively small investment size ceilings historically allowed, and the minimal private capital previously necessary to obtain a license, many of the larger and more sophisticated lenders and investors paid little attention to this tiny program. The SBIC Program was viewed in the marketplace as primarily a program for first time funds, for small investment banks and individual entrepreneurs with time on their hands who had no ability to raise a fund and access investment capital through traditional fundraising from institutional investors. In addition, since the established investment community had access to traditional funding, it saw no need to subject itself to the myriad and complex rules, regulations and oversight of the SBA if it did not have to.

As a result and because their clients had little or no interest in the SBIC Program, virtually none of the large legal and accounting firms ever developed experience or familiarity with the intricacies, policies, procedures and personnel of the SBA, the federal regulator charged with administering the flow of taxpayer dollars into this arcane SBIC market.

### **Funding and Modernizing the SBIC Program**

The recent availability of significant amounts of capital at the SBA and various changes to the regulations over the last few years has changed everything. According to statistics provided by the SBA for FYE 2016, the SBA issued \$2.51 billion in new commitments to SBICs; \$5.99 billion in

financing dollars were invested in small businesses; 1,201 small businesses were financed, and, an estimated 122,381 jobs were created, all at no cost to the taxpayers. These results have occurred in part because:

(i) Capital Available – the capital available to SBICs (on a two to one (2-1) matching basis) is now up to \$150 million per licensee (if they raise \$75 million, they receive \$150 million); \$350 million is available for a family of affiliated funds.

(ii) Increased Size Ceilings of Investments – SBICs are now permitted to invest 75% of investible capital in U.S. companies that do not exceed, on a pre-investment basis, \$19.6 million tangible net worth and \$6.6 million net after-tax income, averaged for the two (2) full fiscal years preceding the investment. Twenty-five percent (25%) must be invested in companies that do not exceed one-third (1/3) that size. Alternate size standards under the North American Industry Classification code regarding maximum number of employees and maximum revenue are also applicable.

(iii) Extremely Low Interest Rates – the two to one (2-1) matching capital (three to one (3-1) may, in rare circumstances, be available to qualified funds once they have demonstrated successful investments and compliance with SBA regulations) is in the form of a long-term loan, i.e. each SBIC issues a 10 year interest-only non-recourse debenture. The SBA guarantees the principal thereof and securitizes it by putting that debenture together with all those of other SBICs seeking capital in a pool, with participating interests in the pool sold to the public by Goldman Sachs, JP Morgan Chase and Credit Suisse. The public buys interests in the pool because of the security of the guarantee and because of the guarantee the debentures are issued at a below market interest rate. The interest rate, payable in cash semi-annually, is tied to a small spread above 10 year Treasury Notes. The last sale to the public on March 21, 2017 had a coupon rate of 2.845%. The SBA also has an annual charge on commitments issued in FY 2017 of 0.347%, so that the total charge (exclusive of a one-time, approximate 2% fee to the underwriters that sold the securities to the public and a one-time commitment fee of 1%) to the SBICs is 3.192%. Note that these underwriters have never, since the inception of the SBIC Program in 1958, failed to sell interests in the pool sufficient to satisfy SBIC demand therefor.

(iv) Interest Rates Charged to Portfolio Companies – should an SBIC charge a portfolio company the maximum rate permissible under the regulations (14% for a loan accompanied by an equity security, and 19% for a loan absent an accompanying equity security) it can receive a significant spread over the 10 year Treasury Note rate. Of course the actual rate charged to borrowers will be governed by market conditions (9% – 12% for a mezzanine loan has not been uncommon).

(v) Interim funding – since the sale of these securities to the public takes place twice a year, in March and in September, licensees that receive leverage in the interim are financed by the Federal Home Loan Bank of Chicago which acts as a bridge lender at a Libor-based interest rate until such short term security is rolled into the ten year instrument at the next six month (March or September) sale of debentures to the public.

(vi) Amount of Capital Available – The SBA's guarantee authority for FYE 2017 is \$4 billion, all of which has been appropriated by Congress and \$1,071,645,000 of which was sold to the public in the March 21, 2017 sale and were issued by 82 SBICs. Each SBIC accesses capital from these semi-annual sales by applying for a commitment for leverage in an amount generally up to two (2x) times its private capital immediately after license issuance, pays a 1% commitment fee as it would if it applied for bank financing, and the SBA reserves that amount out of its current budget. That commitment is good for four years plus the stub period remaining in the year drawn. This timeframe has generally corresponded with the investment period of most funds. When drawn (for investments and payment of quarterly management fees) under the commitment, the rate at that time is locked in for a period of 10 years. Think about it – 3.192% money is available for ten (10) years!

(vii) Sophisticated Fund Managers and Investors Join the SBIC Program – SBICs have been formed by experienced mezzanine funds, private equity funds, funds organized by banks, insurance companies, Business Development Companies, midsize merchant and investment banks (Brown Brothers Harriman, Wasserstein, Piper Jaffray, Jefferies and Needham), family offices, loan officers, and professional investors with successful track records in investing/lending. First time funds are still acceptable provided that at least two (2) members of the investment committee have the requisite track record which includes a minimum of ten (10) realizations and, if previously a principal in a fund, that fund was in the top fifty (50%) percent in performance of comparable funds (manufacturing to manufacturing) formed in the same year. What the

SBA is looking for two (2) or more managers who have a successful track record outside the SBIC Program to continue investing as a licensee within the SBIC Program provided that prior investments were SBIC-eligible, e.g. no foreign investments, no re-lenders (banks, factors), no real estate unless part of an operating business, no publicly traded securities except for private investments in public entities ("PIPS") etc. In addition, significant institutional investors have provided equity capital to SBICs as limited partners (Prudential, Calpers, Caisse de Depot, Wells Fargo, etc.) Please note that banks subject to the Community Reinvestment Act ("CRA") are presumed to receive CRA credit with respect to the investment test applicable thereto if the SBIC they control or in which they are a limited partner invest within the bank's assessment area.

(viii) Management Fees – SBICs that have private capital of more than \$20 million are permitted to charge an annual 2.0% management fee (quarterly in advance) on committed capital from qualified investors. These percentages are generally based upon capital managed and include the leverage amounts committed to the SBIC by the SBA. Thus, by way of example, if an SBIC raises \$25 million of private capital and receives a commitment of \$50 million of leverage from the SBA, the management fee is 2.0% of \$75 million for the first 5 years of the life of the SBIC; thereafter (when most if not all of the SBICs loans/investments have been made), the management fee is based upon the cost of its loans and investments for all active portfolio companies. Thus, in many circumstances, the SBICs management company has the potential to become a profit center irrespective of the success of the investments.

#### **Minimum Private Capital Required – Portfolio Concentration**

It is rare that the SBA will grant a license to an applicant with less than \$25 million of committed private capital. The SBA wants its licensees to be economically viable and one size does not fit all. The specific amount required will be determined by whatever the SBA determines will enable the applicant to be viable considering, for example, the track record of the applicant and the size of intended investments in or loans to any one portfolio company. Similar to the requirements of many institutional investors the SBA has a safety rule known as an "overline limitation" pursuant to which no more than 10% of an SBIC's total capital (private plus leverage) can be loaned/invested in any one portfolio company. So, for example, if \$25 million is raised privately and \$50 million is provided by the SBA, the SBIC may only loan/invest up to \$7.5 million in any one company. This rule forces the SBIC to make more investments and thus diversify. If necessary to preserve or protect the investment, the SBA may grant permission to exceed such limits.

#### **Drop Down Funds**

The SBIC Program has made a good faith attempt to adhere to current practices in place for the private equity community consistent with the SBA's obligation as a fiduciary for the public's capital. It has, by way of illustration, tried to be flexible enough to allow drop-down funds to become licensed. For example, an existing private equity fund, mezzanine fund, BDC, bank, insurance or finance company, traditional or other lender can form an SBIC Fund as a wholly-owned subsidiary by committing capital to the SBIC with the consent of its limited partners, shareholders, etc. A side-by-side fund is also acceptable except that standard conflicts rules will apply – e.g., investments with affiliates at the same time on the same terms are acceptable; however, an SBIC cannot be disadvantaged as to the rate granted to its affiliate. For newly formed funds, the SBA prefers a side-by-side fund. Drop down funds are generally permitted in order to enable the existing parent to continue investing in non-SBIC eligible companies, e.g., foreign investments, real estate, publicly traded securities (other than PIPES, which are permitted). In the above scenario, the parent fund can continue to operate as previously and the parent will not be subject to SBIC rules and regulations (except that limited partners or shareholders in non-public parent entities must stand behind the commitment of the parent (by becoming a Class B limited partner of the SBIC) to drop funds down into the SBIC. If called upon to honor that commitment the amount funded will be an offset to the commitment to the parent fund).

#### **LBO's – One Stop Shopping**

The SBA has for many years allowed SBICs to control their portfolio companies for up to seven (7) years, which period may be extended in order to preserve or protect the investment. As a result, leveraged buyouts by SBICs are also permitted under the circumstances described

below. The SBA generally requires loans to cash-flowing entities such that the SBIC is not required to utilize its seed capital to pay the semi-annual interest payments on the SBA-guaranteed debentures. If it can demonstrate to the SBA that interest payments on the debenture leverage can be serviced, the SBIC may be permitted to invest up to one-third (1/3) of its total capital in straight equity investments because two-thirds (2/3) of its capital is debt requiring a semi-annual interest payment and one-third (1/3) is the equity from the SBIC entity. Should the SBIC only request one to one (1-1) leverage it may invest up to 50% of its total capital as straight equity. What this means is that an SBIC can effect a leveraged buy-out (assuming at least one of the principals has the requisite lending, credit/investment committee background and track record) without seeking outside financing. The viability of this approach depends upon the size of the transaction which, in turn, is dependent upon the amount of capital raised by the SBIC. By way of example, assume an SBIC has raised \$75 million of private capital and receives two to one (2-1) leverage. As a result of the SBA's overline limitation (as described above) it can only invest 10% of total capital (private plus SBA-committed leverage), or \$22.5 million, in any one company. Assume further that an attractive buyout candidate has \$4.5 million of EBITDA that is available for a 5x multiple (or \$22.5 million, which under this scenario, is the maximum an SBIC can invest in any one company). Of the \$22.5 million necessary to effect the LBO \$7.5 million or less can be used as equity and \$15 million or more can be allocated among senior debt and mezzanine debt at varying rates as the SBIC may choose and negotiate with the Seller. As a result, the SBIC is more attractive to the Seller than competing prospective buyers because it can provide all the cash necessary to effect the buyout absent a financing contingency and it avoids the time and expense of negotiating a subordination and inter-creditor agreement with third party lenders.

#### Miscellaneous

There are numerous other rules and regulations applicable to SBICs which affect the SBA's licensing criteria and process, accessing leverage, operating an SBIC and making distributions to its limited partners. They are not intended to be within the scope of this article. Suffice it to say that those fund managers with positive track records who are seeking to raise private capital owe it to themselves to closely examine whether the two to one (2-1) matching SBIC Program is right for them.

For more information concerning the matters discussed in this publication, please contact the author,  
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