

Early Stage Small Business
Investment Companies

January 2012



Table of Contents



SBIC Program Introduction*:

- *Program Overview*
- *Advantages of an SBIC*
- *SBIC Life Cycle*

**This section will not be covered in the January 11, 2012 Webinar .*



Early Stage SBIC Program



Questions and Answers

The SBIC Program in Brief

- ▶ The SBIC Program is a multi-billion dollar, government-sponsored investment fund created in 1958 to bridge the gap between entrepreneurs' need for capital and traditional sources of financing:
 - SBA invests long-term capital in privately-owned and managed investment firms licensed as Small Business Investment Companies (SBICs)
 - For every \$1 an SBIC raises from a private investor, the SBA will typically provide \$2* of debt capital, subject to a cap of \$150 million
 - Once capitalized, SBICs make debt and equity investments in some of America's most promising small businesses, helping them grow

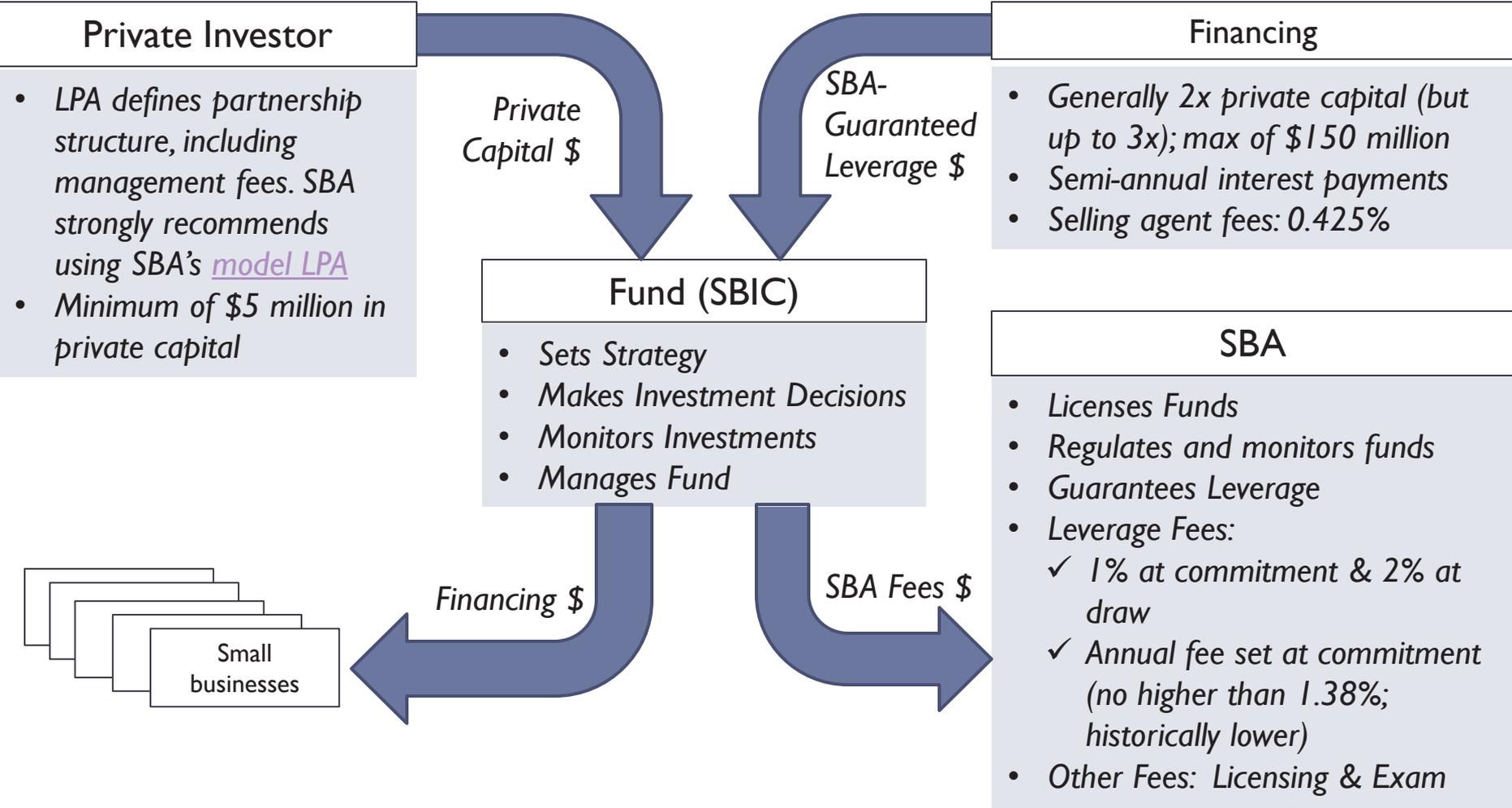
SBIC Success Stories

Costco	Amgen	Staples
Apple	Quiznos	Sun
Callaway	Adaptec	AOL
HP	Cutter & Buck	Intel
FedEx	Jenny Craig	Build-a-Bear
Outback Steakhouse	Nutri-systems	Adam's Respiratory (Mucinex)

* SBA provides leverage up to 3x private capital, but typically 2x.



How SBIC Leverage Works



Small Business Investment Requirements

- ▶ **SBICs *must* invest in Small Businesses, defined as:**
 - Businesses with a tangible net worth < \$18 million **AND** average after-tax income for prior two years of < \$6 million
 - **OR** Businesses that qualify as “small” under SBA’s N.A.I.C.S. Industry Code standards (generally under 500 employees)

- ▶ **SBICs *must* make 25% of their financings in “Smaller Businesses”, defined as:**
 - Businesses with a tangible net worth < \$6 million
 - **AND** average after-tax income for prior two years < \$2 million



Other Major SBIC Investment Requirements

Area	SBICs May Invest	SBICs May NOT Invest
Investments	<ul style="list-style-type: none"> • Loans • Debt with Equity features • Equity 	<ul style="list-style-type: none"> • More than 10% of the proposed total fund size in a single company without SBA approval
Use of Proceeds	<ul style="list-style-type: none"> • Small businesses in non-prohibited areas 	<ul style="list-style-type: none"> • Project Finance • Real Estate • Financial Intermediaries
Geography	<ul style="list-style-type: none"> • In businesses located anywhere in the U.S. or its territories 	<ul style="list-style-type: none"> • In businesses with over 49% of their employees located outside the U.S.
Control	<ul style="list-style-type: none"> • Control small businesses for up to seven years, a limit that may be extended with SBA approval 	



Typical SBIC Life Cycle



Step 1: Licensing

Licensing Decision



Licensing Application & Minimum Capital

Licensing

- Submit Licensing Application
- Due Diligence
- Legal Review
- FBI Background Check
- Committees:
 - Divisional
 - Agency
- Administrator approves.

• Target Time Frame: 6 months

Green Light Letter

Raise Capital

- Must raise \$5 million minimum prior to submitting Licensing application. (Applicants must raise sufficient capital to execute business plan prior to licensing decision.)

• Time: Up to 18 months

Management Assessment Questionnaire ("MAQ")

Initial Review

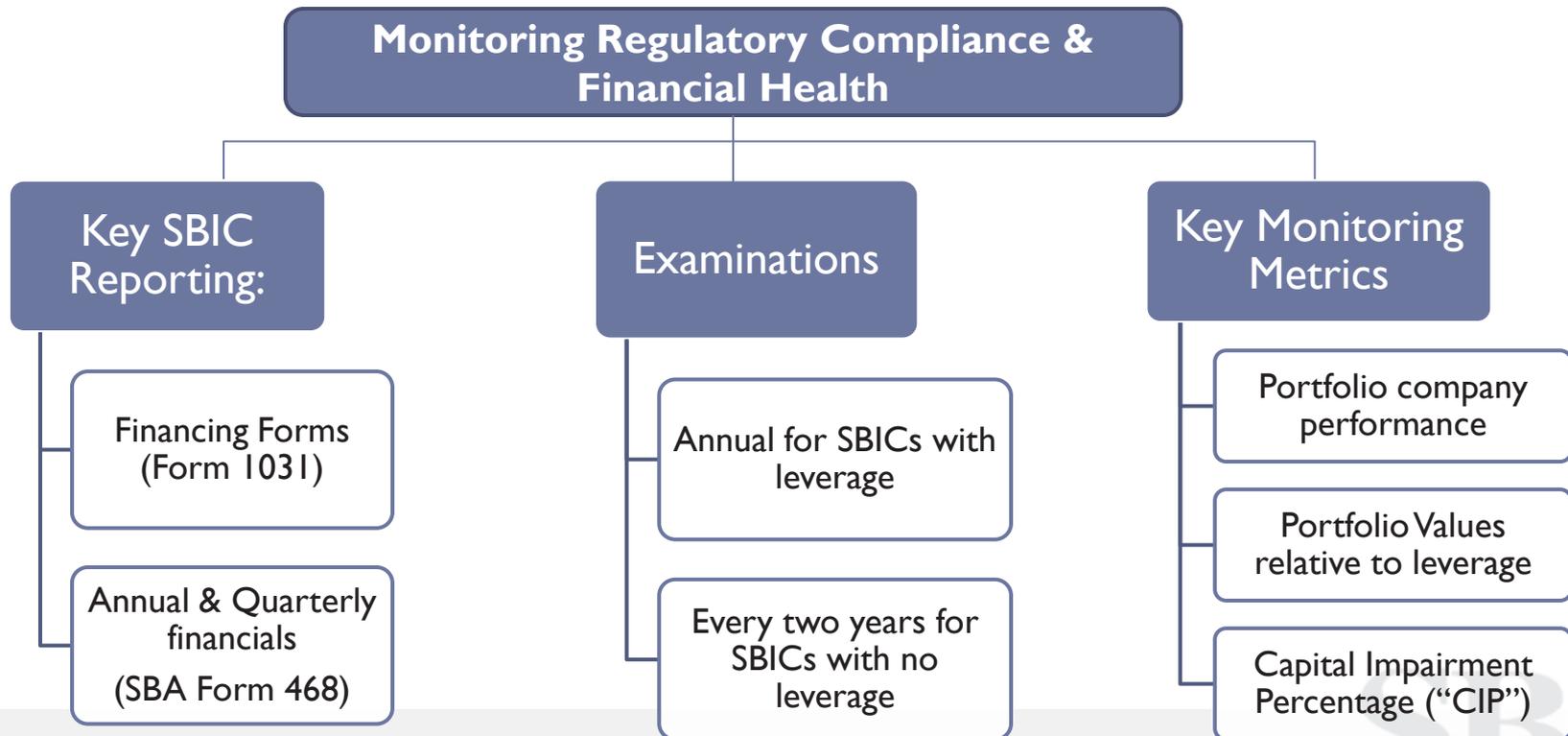
- Submit MAQ
- Fund Strategy
- Track Record
- Review track record
- Due Diligence
- Investment Committee Decision

• Target Time Frame: 8 weeks



Step 2: Operating as SBIC

- The Office of Operations acts as the primary point of contact for licensed SBICs.
 - Process leverage commitments & draws
 - Process requests (conflicts of interests, transfer of LP interests, etc...)
 - Monitor regulatory compliance and financial health.



What is CIP?

- ▶ Key regulatory metric SBA uses to determine an SBIC's financial health, defined by [13 CFR 107.1840](#), but *in general*
 - ▶ Represents operating & investment losses as % of private regulatory capital.
 - ▶ Realized losses can typically be offset by unrealized appreciation only in qualifying securities. (Public securities or securities that received a substantial investment by outside investor within past 24 months.)

- ▶ Maximum allowable CIP
 - ▶ Depends on leverage ratio (leverage to Private Regulatory Capital) and the percentage of equity , but typically 40 to 50%

- ▶ Key SBA rights if SBIC goes above maximum allowable CIP:
 - ▶ May deny leverage commitments and draws
 - ▶ May transfer to the Office of Liquidation
 - ▶ If settlement cannot be reached in Liquidation, SBA may utilize receivership.



Advantages of an SBIC

- **Leverage Benefits**

- ✓ **Flexible terms:** *Ten year debenture term with semi-annual interest payments avoids problem of duration mismatch.*
- ✓ **Rapid Deployment of Funds:** *Ability to raise typically two-thirds of a fund's capital from SBA, thereby minimizing the time they spend fundraising and focusing their efforts on investing.*
- ✓ **Increased Financial Scale:** *SBA leverage provides increased capital from which SBICs may fund more investments or increase funding to portfolio companies.*
- ✓ **Low cost of capital:** *SBA Debenture leverage interest rates based on 10 year treasury plus a market-based spread for liquidity and prepayment risk. See [website](#) for historic rates.*
- ✓ **Enhanced Returns to Private Investors:** *The low cost of capital increases returns to private investors in good performing funds. See appendix for historic SBIC Debenture performance.*

More Advantages of an SBIC

- **Organizational:**
 - ✓ **Flexible Fund Structure:** *The SBA licenses a variety of fund structures, including SBICs established as “drop-down” or “side-car” funds attached to an existing investment fund.*
 - ✓ **SEC Registration Exemption Benefits:** *SBICs are exempt from SEC registration requirements. Yet, LPs benefit from the careful monitoring done by the SBA, greatly reducing the risk for fraud and abuse.*
- **Friendly to Bank Investors:**
 - ✓ **Volcker Rule Exemption Benefits:** *Bank investments into SBICs are exempt from the 3% cap set forth by the Volcker Rule enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL-111-203)”*
 - ✓ **Community Reinvestment Act:** *Investments in Small Business Investment Companies are presumed qualified for Community Reinvestment Act credits.*
- **The Opportunity of “Small Business”:**
 - ✓ *Despite being the bedrock of the American economy, the small business community is underserved and represents a value opportunity for investors.*

Table of Contents



SBIC Program Introduction



Early Stage SBIC Program

- Introduction
- Terms
- Proposed Licensing Process



Questions and Answers

Early Stage SBIC Initiative Introduction

Introduction

- ▶ Purpose: To Address Seed/Early Stage Investment Gap
 - ▶ Over last 5 years less than 10% of all U.S. Venture Capital dollars went to seed investments*
 - ▶ Almost 70% went to three states: California, Massachusetts, and New York*
- ▶ As part of Start-Up America, SBA will commit
 - ▶ Up to \$1 billion of Debenture leverage over 5 year period
 - ▶ To Early Stage SBICs
- ▶ Early Stage SBIC Proposed Regulations
 - ▶ Posted on December 9, 2011 at www.regulations.gov
 - ▶ Comment closing period on February 7, 2012

*Source: Thomson

Small Business Administration



Early Stage SBIC Proposed Key Terms

Terms

Terms	Early Stage Debenture
Licensing	Annual Call Commitments limited to \$200 million per year up to \$1 billion total SBA has right to diversify across vintage years & geography
Private Capital	\$20 million minimum
Investments	50% of investment dollars into early stage (not yet achieved positive operating cash flow in any fiscal year prior to 1 st financing)
Maximum Leverage	Up to 1 tier of leverage, no greater than \$50 million
Term	Ten year maturity that may be repaid in full at any time without penalty
SBA Fees	1% Commitment Fee 2% Draw Fee Annual Fee paid quarterly with interest payments Licensing Fee: \$25,000 Examination Fees: Per 107.692 of proposed rule

Proposed Key Terms (continued)

Terms	Early Stage Debenture
Leverage Description	<p>Standard Early Stage Debenture:</p> <ul style="list-style-type: none"> • Interest & charges due and payable Quarterly • Requires 5 years interest reserve (may be held as unfunded private capital commitments or in restricted cash) <p>Or</p> <p>Discounted Debenture:</p> <ul style="list-style-type: none"> • Interest & charges discounted for first 5 years • Quarterly interest & charges payable after first 5 years
Distributions	<p>Per § 107.1180 of Proposed Rule, but in general:</p> <ul style="list-style-type: none"> • Interest & charges must be paid prior to distribution • Below 50% Capital Impairment Percentage (“CIP”): Pro Rata on <i>cumulative</i> basis • At or above 50% CIP: SBA gets distribution priority
Other Key Terms	<p>Annual Examinations</p> <p>Above 50% CIP</p> <ul style="list-style-type: none"> • SBA has specific right to require valuations on your investments. • SBA takes all distribution priority <p>Above 70% CIP</p> <ul style="list-style-type: none"> • SBA has right to promptly transfer SBIC to Office of Liquidation

Example Early Stage Distribution

Amounts in \$ Millions

	<i>Draws: \$10 - Private \$10 - SBA Lev.</i>	<i>No additional draws prior to next distribution.</i>	<i>Additional Draws: \$10 - Private \$10 - SBA Lev.</i>	
	<u>Distribution 1</u>	<u>Distribution 2</u>	<u>Distribution 3</u>	
Capital & leverage draws				
Distribution Amount	\$10.0	\$15.0	\$10.0	
<i>CIP</i>	<i>10%</i>	<i>0%</i>	<i>15%</i>	
<i>Distribution</i>				
SBA Share	\$5.0	\$5.0	\$7.5	
Private Share	\$5.0	\$10.0	\$2.5	
<i>Cum. Distributions</i>				
SBA	\$5.0	\$10.0	\$17.5	} <i>Cumulative basis allows “catch-up” by SBA and LPs. (See appendix for more examples.)</i>
Private	\$5.0	\$15.0	\$17.5	
	<u><i>Why?</i></u>	<u><i>Why?</i></u>	<u><i>Why?</i></u>	
	<i>Pro rata distribution</i>	<i>SBA can receive no more than its outstanding leverage.</i>	<i>Allows SBA to catch up.</i>	



Key Differences Between Standard Debenture, Participating & Early Stage

Term	Standard Debenture SBIC	Participating Sec. (not available)	Early Stage
Licensing	<ul style="list-style-type: none"> Rolling 	<ul style="list-style-type: none"> Rolling 	<ul style="list-style-type: none"> Annual
Leverage	2 tiers up to \$150 million max	2 tiers up to legislated max	1 tier up to \$50 million max
Priv. Capital	\$5 million minimum	\$10 million minimum	\$20 million minimum
Investments	Broad range, but generally later stage and mezzanine	Broad range of equity investments	At least 50% in early stage
Leverage Description	Standard with semi-annual interest and annual charges Or 5 or 10 Year Discounted if LMI or Energy Saving Investment (pending final regulations)	SBA paid Interest (known as prioritized payments) to bond holders; SBICs only owed and repaid SBA out of profits.	Standard with 5 year interest reserve and quarterly interest and annual charges OR 10 Year Discounted
Profit Participation	None	SBA typically received about 8% of any profits	None
Distributions	SBICs may distribute profits without SBA approval. Return of capital more than 2% in any year must be approved by SBA	Complicated, but in general, prioritized payments to the extent of profits, profits, return of capital.	<ul style="list-style-type: none"> Below 50% CIP: Pro Rata on cumulative basis At or above 50% CIP: SBA gets distribution priority
Surrender	Repay all leverage	Generally needs to repay leverage & realize all earmarked assets prior.	Repay all leverage

Unleveraged Opportunity

Term	Non-Leveraged SBIC
Licensing	Rolling
Private Capital	\$5 million minimum
Investments	Broad range, including early stage
Financial Reporting	Annual Only
Distributions	No distribution restrictions.
Other	<ul style="list-style-type: none"> • Examinations every other year • Exempt from various regulatory rules that only apply to leveraged funds
Regulatory Advantages	<ul style="list-style-type: none"> • Volcker Rule • SEC Registration Exemption • CRA Credit
Timing	<ul style="list-style-type: none"> • Accepting application now



Proposed Licensing Process

Proposed Licensing Step	Remarks
1. SBA Accepts Management Assessment Questionnaires	<ul style="list-style-type: none"> • SBA will announce call through Federal Register Notice • Applications submitted to SBA by deadline • Same application as standard SBIC Program
2. SBA Performs Initial Review / Investment Committee	<ul style="list-style-type: none"> • Applicants preliminarily determined based on criteria • Applicants notified if qualified or not.
3. Selected Applicants Submit Licensing Application	<ul style="list-style-type: none"> • Selected applicants will submit additional licensing material, including the proposed non-refundable \$25,000 licensing fee.
4. SBA Due Diligence / Licensing Phase	<ul style="list-style-type: none"> • SBA will perform due diligence and license qualified applicants.

- **SBA reserves right to not license if none found qualified.**
- **SBA may diversify across geography and vintage years.**



SBA Evaluation Criteria

Same as in Standard SBIC Program

Manager Assessment	Performance Analysis
<ul style="list-style-type: none"> • Proven investment experience • Balanced track record among principals • Evidence indicating a cohesive & effective team • Principals with strong, positive reputations • Robust investment and due diligence process 	<ul style="list-style-type: none"> • High quality track record with transactions analogous to those proposed for the SBIC strategy • Evidence past returns could have supported SBIC cost of leverage and met or exceeded targets • Analysis of fund performance measured against peer funds
Strategy Evaluation	Fund Structure & Economics
<ul style="list-style-type: none"> • Clearly articulated focus and investment thesis • Evaluation of targeted transaction size, investment themes and type instruments to be used • Clear indications proposed investments will fund eligible “small businesses” 	<ul style="list-style-type: none"> • Structure of LP preferred return • GP carry, management fees and vesting schedules in line with industry norms • Alignment of carry distribution with time dedication and level of responsibilities • Investment and reserve strategy; strategy to make SBA interest payments



Historical U.S. Venture Performance

U.S. Venture Funds Vintage Years 1986 - 2005
 Median Net Multiples by Quartile
 As of June 30, 2011

Quartile	Median Net Multiples		May Benefit from leverage
	Venture	Seed and Start-up (Fund Size = \$40 to \$100 million)	
1	2.60	3.66	Likely
2	1.65	1.96	Likely
3	1.08	1.39	Unlikely
4	0.66	0.69	No

Only Quartile 1 and 2 funds are likely to benefit from this program.

Sample Size 953

128

Source: Thomson One

Seed and start-up funds with fund sizes between \$40 to 100 million have performed similar to the rest of venture.

Timing

- ▶ February 7, 2012: Regulations closed for comments
- ▶ Spring 2012 Goal:
 - ▶ Issue final regulations
 - ▶ Call for Early Stage SBICs
- ▶ 2012 Goal:
 - ▶ License Early Stage SBICs that have raised Private Capital
- ▶ If you are NOT seeking leverage
 - ▶ SBA is accepting applications **now**.
 - ▶ Applicants may apply as a non-leveraged SBIC anytime.
 - ▶ Please contact Program Development at sbic@sba.gov for further information.



Table of Contents



SBIC Program Introduction



Early Stage SBIC Program

Questions and Answers

- Questions
- How to Comment on the Proposed Rule

Questions

- ▶ Frequently Asked Questions (“FAQs”) will be posted at
 - ▶ www.sba.gov/content/early-stage-small-business-investment-company-sbic-initiative-0
- ▶ Questions from Participants?



How to Comment

- ▶ Regulations posted at:
www.regulations.gov/#!documentDetail;D=SBA-2011-0023-0001.
- ▶ To post a comment, click on “Submit a Comment”
- ▶ Regulations closed for comments on February 7, 2012
- ▶ More information may be found at www.sba.gov/inv



Appendix to Early Stage SBIC
Presentation



Standard SBIC Leverage Products

Standard Debenture

Discounted Debenture

Amount:	Typically 2x (but up to a maximum of 3x) the capital raised from private investors
Term:	10 years with principal payment due at maturity NO prepayment penalty
Interest:	Semi-annual payment based on a spread above the 10-year Treasury note
Fees:	1% commitment fee; 2% drawdown fee Annual fee payable semi-annually
Uses:	Investments in small businesses as defined by the SBA Office of Size Standards and federal regulations, generally in later stage and “buyout” transactions. Real estate and project finance generally prohibited.

Standard SBIC Leverage Products

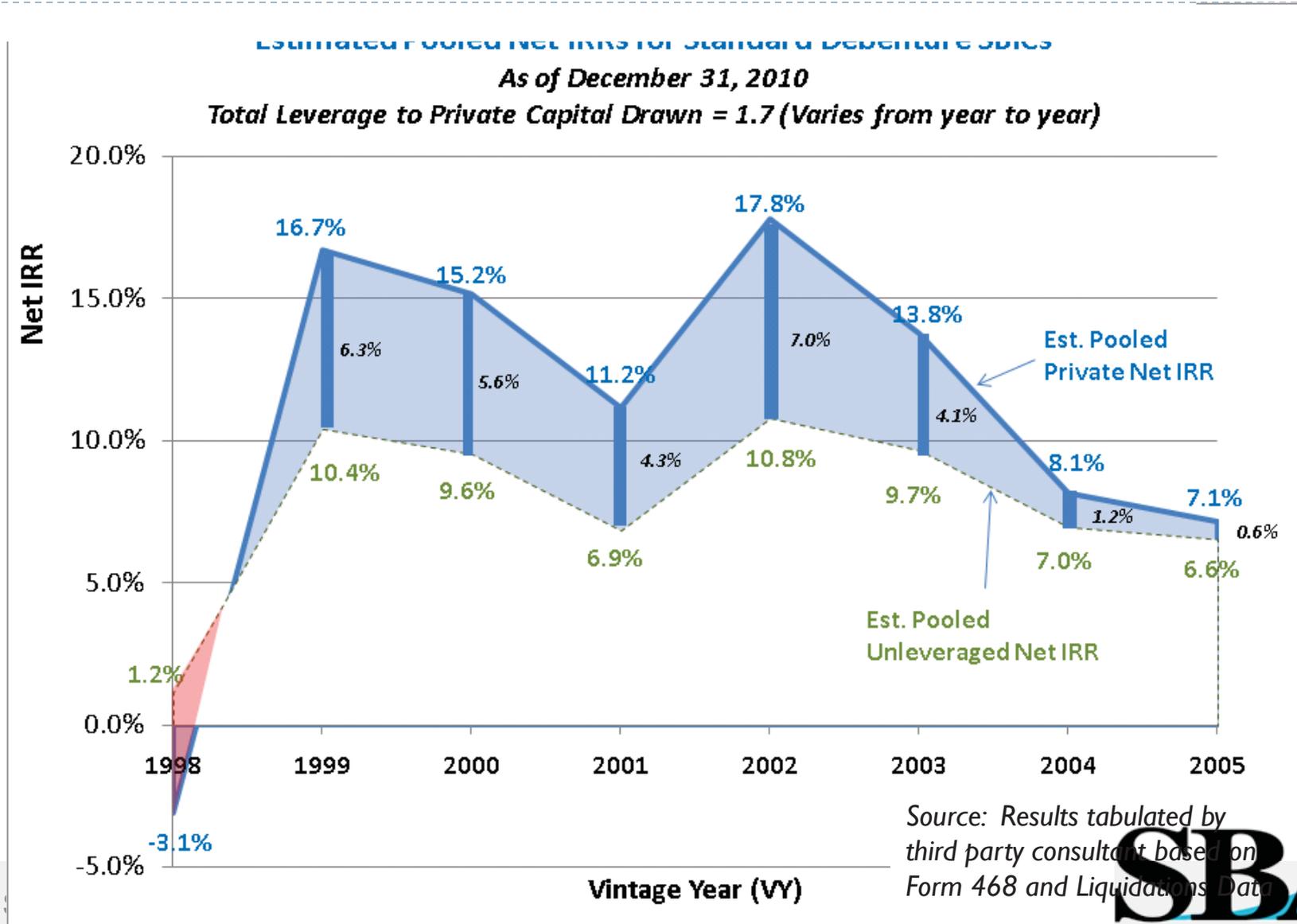
Regular Debenture

Amount:	Typically 2x (but up to a maximum of 3x) the capital raised from private investors
Term:	5 or 10 years with principal payment due at maturity NO prepayment penalty
Interest:	Semi-annual payment for last five years of 10 year note only; based on spread above 10 year Treasury note
Fees:	1% commitment fee; 2% drawdown fee Annual fee payable semi-annually for 10 year bond only
Uses:	The discounted debenture is appropriate for debt and equity funds with an investment focus on small businesses in low-to-moderate income areas OR (pending regulations in 2012) energy saving investments .

Discounted Debenture

Historical Impact of SBA Leverage for Standard SBICs

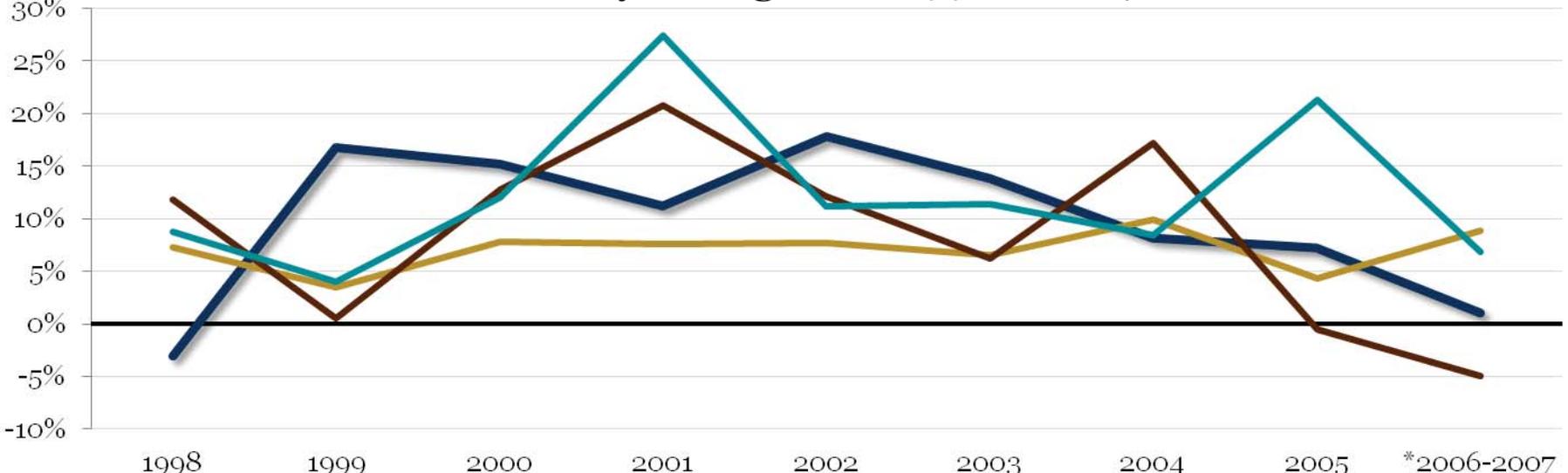
Advantages of an SBIC



Historical Returns for Standard Debenture SBICs

(Avg. Leverage to Private Capital Drawn = 1.7x)

Returns by Vintage Year 1998 – 2007



- SBIC Debenture Funds Pooled IRR (1)
- Preqin US Mezzanine Pooled IRR (2)
- Thomson Sm. & Med. Buyout & Mezzanine Pooled (3)
- Preqin US Sm. Buyout Pooled IRR (2)

* 2006 – 2007 data is presented as an arithmetic mean of the pooled IRRs for those years

(1) SBIC Vintage Year determined by date of license. Data as of 12/31/10; Returns calculated based on information collected as part of annual financial statement submissions to SBA; Returns include an assumed 20% carried interest payment to the GP after LPs have received distributions equal to paid-in capital.

(2) Source: Preqin Ltd. www.preqin.com. Data includes “Most up-to-date” figures and was accessed 8/04/10; Benchmark may include some funds licensed as SBICs

(3) Source: Thomson Reuters. www.thomsonone.com. Data as of 12/31/10. Data includes US funds from \$5M to \$500M categorized as Small Buyout, Medium Buyout, or Mezzanine.



What is CIP?

- ▶ CIP is the key regulatory metric SBA uses to determine an SBIC's financial health.
- ▶ CIP is defined by [13 CFR 107.1840](#), but *in general*
 - ▶ Represents operating and investment losses as a percentage of private regulatory capital.
 - ▶ Realized losses can typically be offset by unrealized appreciation only in qualifying securities:
 - ▶ 80% of Class I (Publicly traded and marketable securities)
 - ▶ 50% of Class II (Privately held securities that received a substantial investment by outside investor within past 24 months).
 - ▶ Other securities (not qualifying as Class I or Class II) cannot offset realized losses, but can offset unrealized losses.
- ▶ Maximum allowable CIP
 - ▶ Depends on leverage ratio (leverage to Private Regulatory Capital) and the percentage of equity
 - ▶ Typically 40 to 50% for most SBICs issuing Debentures



CIP Example

- ▶ Private Regulatory Capital = \$25 million
- ▶ Operating & Investment Realized Losses = \$10 million
- ▶ Net Appreciation = \$5 million
 - ▶ Depreciation = \$3 million
 - ▶ Appreciation = \$8 million as follows:
 - ▶ Class I - \$1 million
 - ▶ Class II - \$2 million
 - ▶ Other - \$6 million

Note: This equation changes based on amounts of Class I and II relative to Net Appreciation.

$$\text{CIP} = \left[\frac{-\$10 \text{ million} + 80\% \times \$1 \text{ million} + 50\% \times \$2 \text{ million}}{\$25 \text{ million}} \right] \times 100$$

= 32.8%

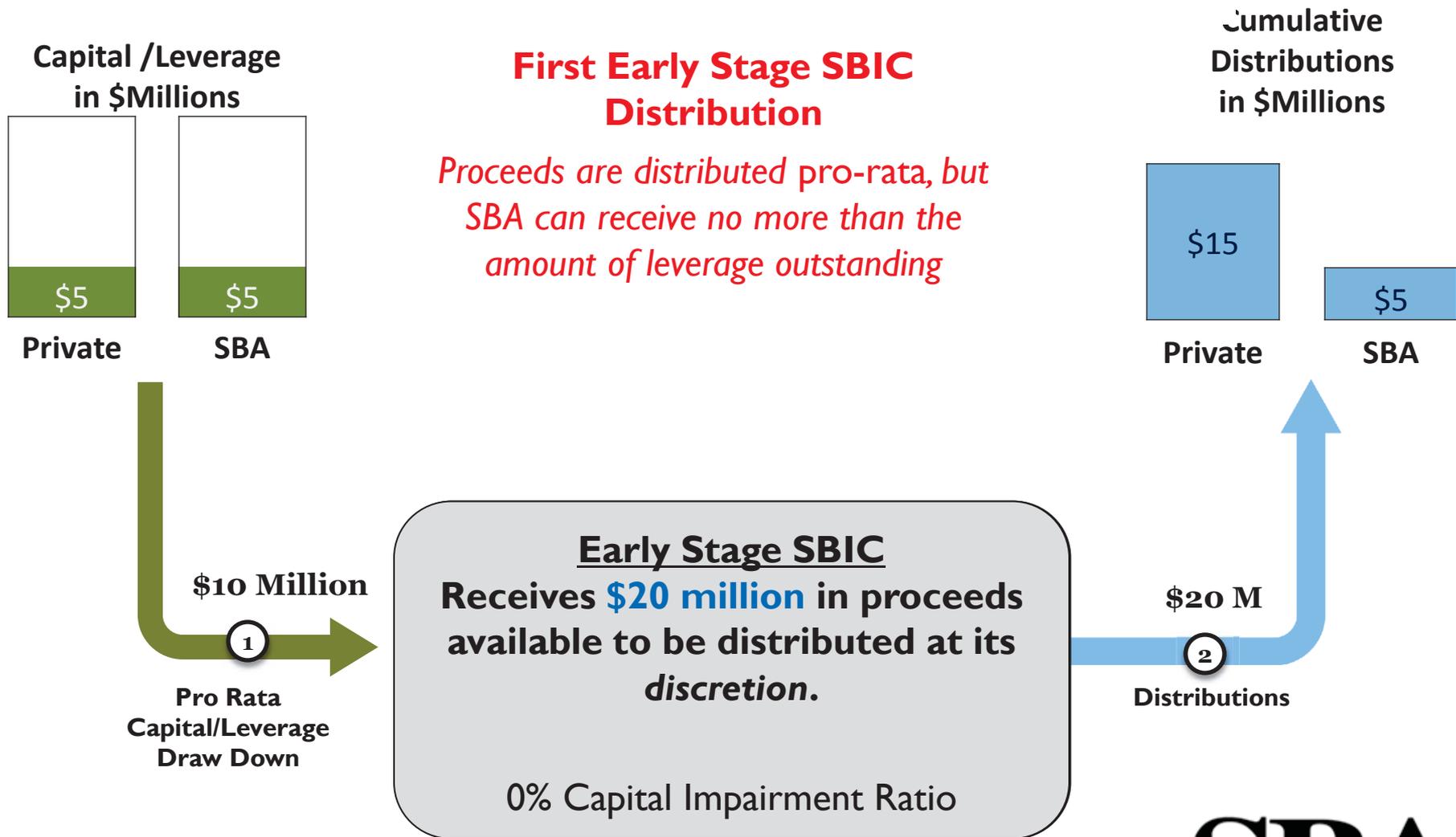


Key SBA Rights if SBIC's CIP Over Maximum Allowable

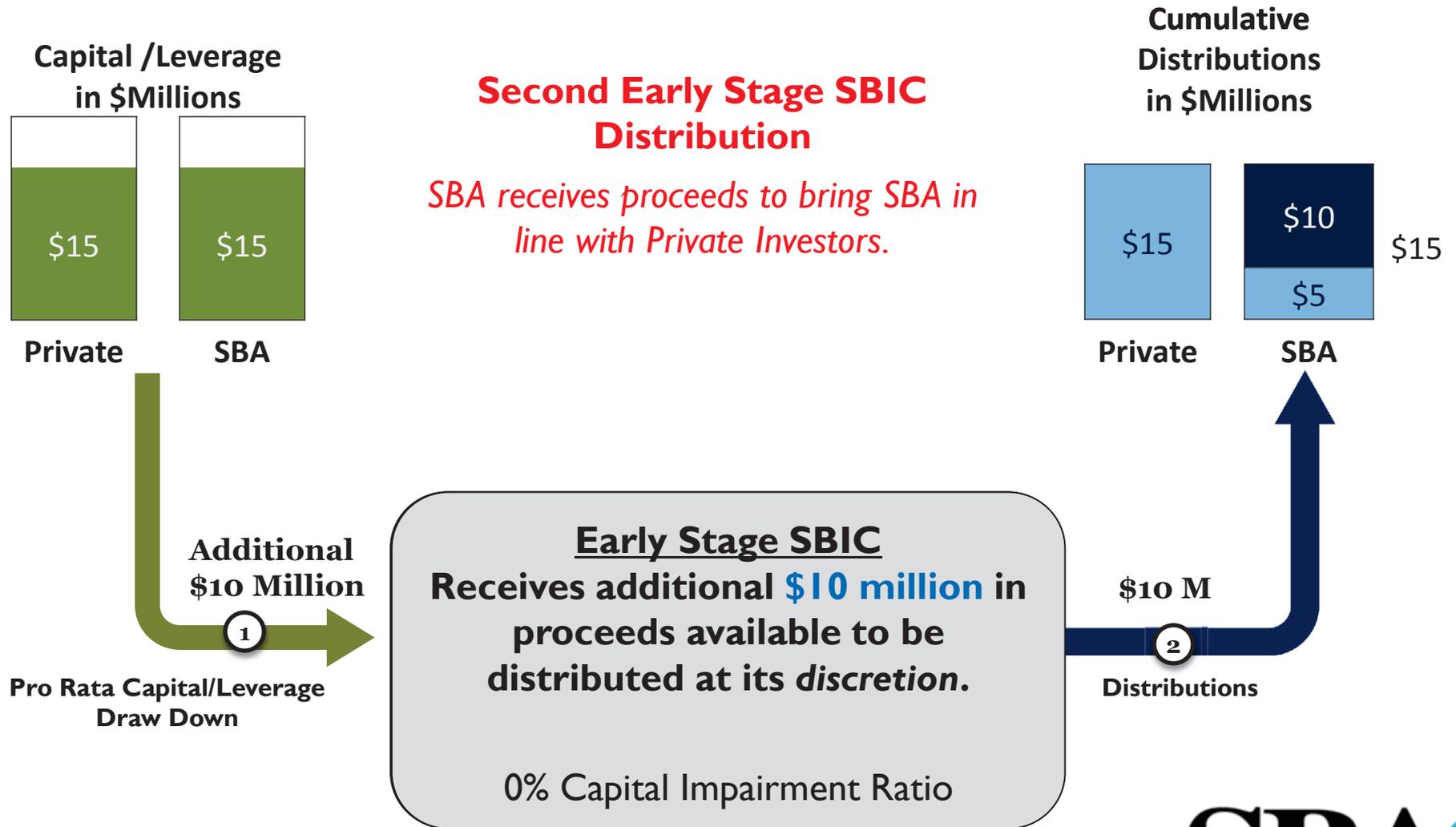
- ▶ Deny leverage commitments and draws
- ▶ Transfer to the Office of Liquidation
- ▶ If settlement cannot be reached in Liquidation, SBA may utilize receivership.
- ▶ [13 CFR Part 107, Subpart J](#) discusses SBA's rights in conjunction with a Licensee's Noncompliance With Terms of Leverage



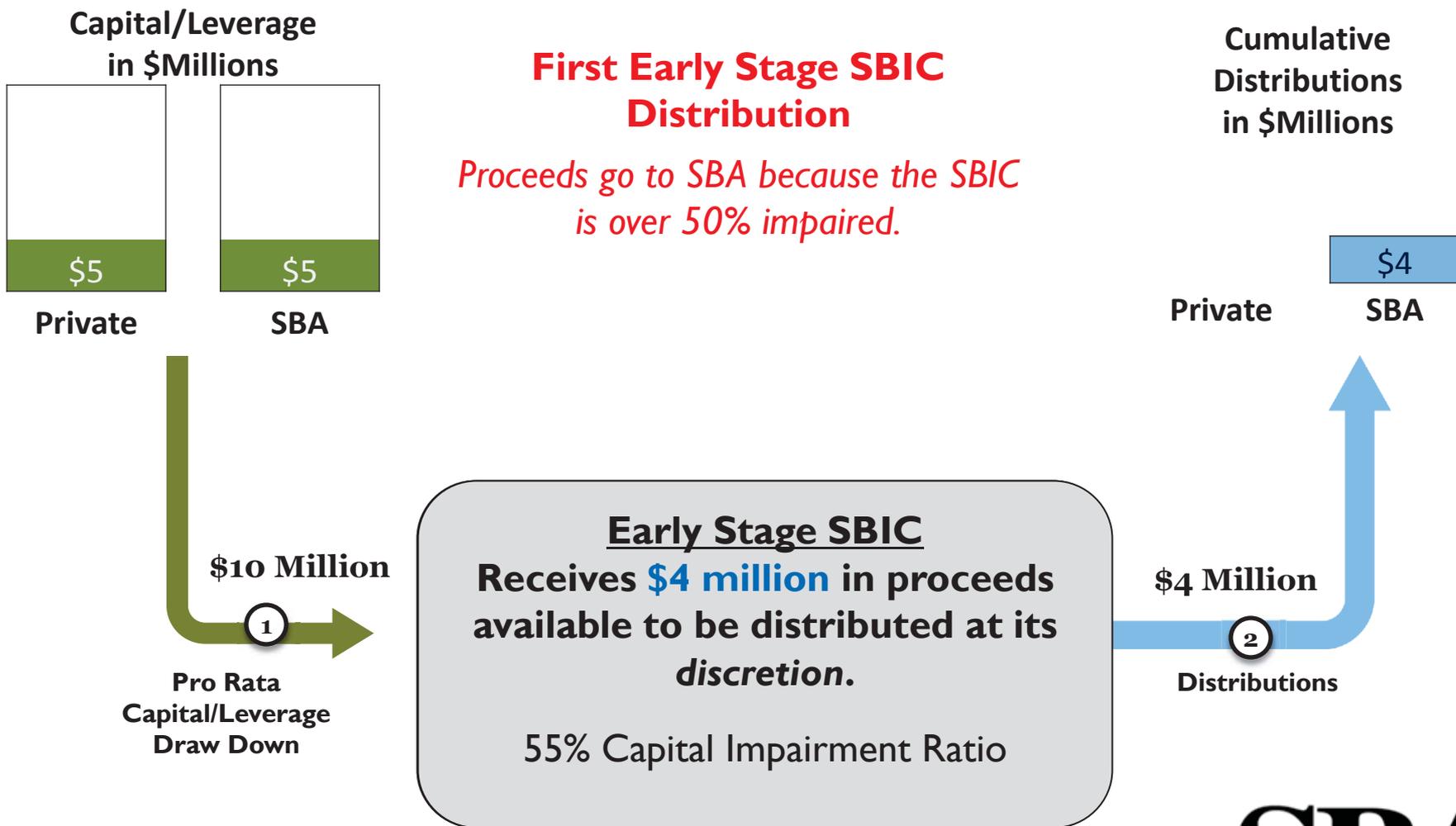
Early Stage Distribution Example 1: SBA Catch-Up First Distribution



Early Stage Distribution Example 1: SBA Catch-Up Second Distribution



Early Stage Distribution Example 2: LP Catch-Up First Distribution



Early Stage Distribution Example 2: LP Catch-Up Second Distribution

