

Office of Investment and Innovation
SBIC Early Stage Innovation Program

The SBIC Program

The Small Business Investment Company 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)
- ▶ 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)

The SBIC Public-Private Partnership at Work

The Early Stage SBIC Program leverages the full faith and credit of the U.S. government to increase the pool of investment capital available to small businesses.



Role of Private Investors:

- ▶ Participate as “Limited Partners” in the SBIC
- ▶ Negotiate the fund structure and management fees with the SBIC manager
- ▶ Invest the matching funds needed for the fund to access SBA-guaranteed leverage

Role of SBA:

- ▶ Assesses fund manager qualifications and licenses funds as Early Stage SBICs
- ▶ Provides up to \$1 of government-guaranteed debt for every \$1 of private capital, up to a maximum of \$50 million
- ▶ Regulates and monitors SBICs for compliance and performance

Role of Early Stage SBIC Fund Managers:

- ▶ Manages all aspects of the fund, including LP relations and compliance with SBA regulations
- ▶ Establishes investment strategy
- ▶ Identifies small business investment opportunities
- ▶ Monitors and exits investments

The SBIC Investment Opportunity

Benefits of Leverage

- ▶ **Flexible Terms:** The duration of SBA's financing instruments can be easily matched up with short or long term investments.
- ▶ **Rapid Deployment of Funds:** The potential to capitalize as much as one-half of a fund with SBA leverage means managers spend less time fundraising and more time investing.
- ▶ **Increased Financial Scale:** SBA leverage allows funds to scale up their strategies and extend their financings to more businesses.
- ▶ **Potential for Enhanced Returns:** SBA-guaranteed capital is low cost and does not participate in profit.

Organizational Benefits

- ▶ **Flexible Fund Structure:** SBICs can utilize a variety of fund structures, including “drop-down” or “side-car” structures.
- ▶ **Exemption from SEC Registration:** SBICs are exempt from SEC registration, yet LPs benefit from SBA's careful monitoring of each fund's performance and regulatory compliance.

Friendly to Bank Investors

- ▶ **Exemption from the Volcker Rule:** Bank investments in SBICs are exempt from the 3% cap set forth by the “Volcker Rule” under the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL-111-203)
- ▶ **Community Reinvestment Act (CRA):** Investments in SBICs are presumed qualified for CRA credit.

Small Business Investment Criteria

SBA has established a basic set of investment criteria to which all SBICs must adhere. These rules ensure the SBIC Program achieves its public policy goals without imposing undue restrictions on fund operations.

- ✓ SBICs **must** invest in “small” businesses, which are defined as those with less than \$19.5 million in tangible net worth AND average after-tax income for the preceding two years of less than \$6.5 million; OR, businesses qualifying as “small” under SBA’s N.A.I.C.S. Industry Code standards (generally based on annual sale or number of employees)
- ✓ SBICs **may** invest in businesses located anywhere in the U.S. or its territories
- ✓ SBICs **may** control a small business for up to seven years, or longer with SBA approval
- ✓ SBICs **may** invest using loans, equity securities or debt securities with equity features such as warrants
- ✗ SBICs **may not** invest in businesses with over 49% of their employees located outside the U.S. or its territories
- ✗ SBICs **may not** invest in project finance, real estate, farmland, financial intermediaries or passive businesses
- ✗ SBICs **may not** invest more than 10% of the total fund in a single portfolio company

Introduction to the Early State Initiative



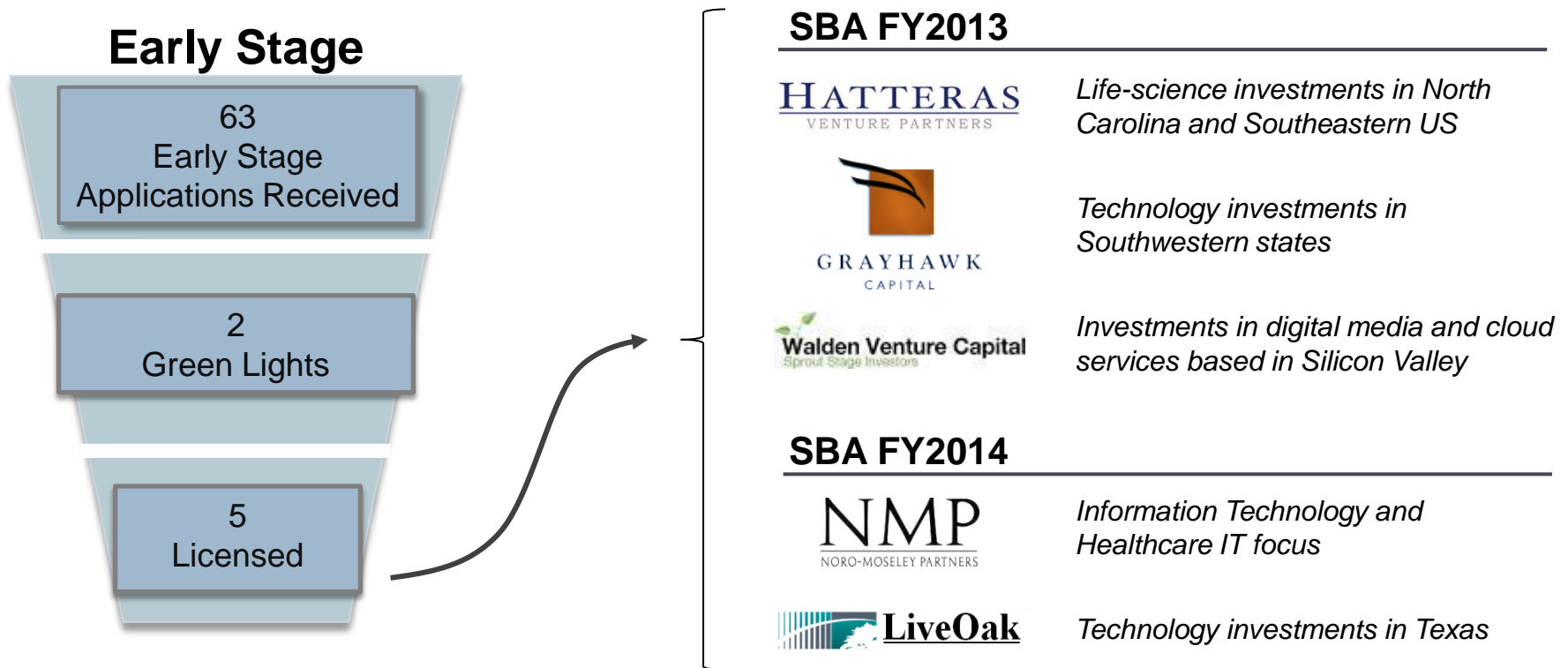
The Early Stage Investment Initiative launched in 2011 as part of President Obama's Startup America Initiative. The program is in the final year of a five year plan to commit \$200M annually to venture capital firms investing in high growth US small businesses.

SBA is currently exploring ways to enhance the Early Stage program (within statutory limitations) and make it a permanent part of the SBIC program.

Subject to leverage availability, SBA will honor leverage commitments to all Licensed Early Stage funds.

Progress to-date

The five funds SBA has licensed to date are geographically diverse and target different industries.



Early Stage SBIC Key Terms

Terms	Early Stage Debenture
Licensing	<ul style="list-style-type: none"> Funds have 12 months from issuance of a Green Light to submit their license application Applications considered as they are received SBA has right to diversify across vintage years & geography
Private Capital	<ul style="list-style-type: none"> \$20 million minimum
Investments	<ul style="list-style-type: none"> 50% of investment dollars into early stage companies (not yet achieved positive operating cash flow in any fiscal year prior to 1st financing)
Maximum Leverage	<ul style="list-style-type: none"> Up to one (1) tier of leverage, no greater than \$50 million Half tier of leverage (or less) encouraged
Term	<ul style="list-style-type: none"> Ten year maturity that may be repaid in full at any time without penalty
SBA Fees	<ul style="list-style-type: none"> 1% Commitment Fee 2% Draw Fee Annual Fee paid quarterly with interest payments Licensing Fee: \$25,000 Examination Fees: Per 107.692

Early Stage SBIC Key Terms (continued)

Terms	Early Stage Debenture
Leverage Description	<ul style="list-style-type: none"> • Standard Early Stage Debenture: • Interest & charges due and payable quarterly • Requires 5 years interest reserve (may be held as unfunded private capital commitments or in restricted cash) • SBA leverage may used to pay quarterly interest and charges and/or fund the 5 year interest reserve <p>OR</p> <ul style="list-style-type: none"> • Discounted Debenture: • Interest & charges discounted for first 5 years (If paid within the first 5 years, SBIC only pays what is accrued.) • Quarterly interest & charges payable after first 5 years
Distributions	<ul style="list-style-type: none"> • Per § 107.1180, but in general: • Interest & charges must be paid prior to distribution • Below 50% Capital Impairment Percentage ("CIP" – see Appendix for examples): pro rata on cumulative basis • At or above 50% CIP and above half a tier of leverage or Above Maximum CIP (generally 70% CIP): SBA gets distribution priority
Other Key Terms	<ul style="list-style-type: none"> • Annual Examinations • Above 50% CIP: <ul style="list-style-type: none"> • SBA has specific right to require valuations on your investments. • SBA takes all distribution priority if over half a tier of leverage • Above Maximum CIP (Generally 70% CIP): <ul style="list-style-type: none"> • SBA has right to promptly transfer SBIC to Office of Liquidation

Important Dates

Milestones	Dates/Times
INITIAL REVIEW	
Management Assessment Questionnaires (“MAQs”) Acceptance Period	5 p.m. EST—April 1, 2016 – September 30, 2016
LICENSING	
All funds have 12 months from receipt of a Greenlight to submit their license application	Rolling Process

Early Stage Small Business Investment Requirements

**50% in Early Stage companies –
not yet profitable as of the
investment date**

- Subsequent investments count toward 50% Early Stage requirement – even after the company becomes profitable

**Remaining 50% in US Small
Businesses, defined as:**

- Businesses with a tangible net worth < \$19.5 million AND average after-tax income for prior two years of < \$6.5 million. OR
- Businesses that qualify as “small” under SBA’s N.A.I.C.S. Industry Code standards (generally under 500 employees)

SBA Low Cost of Capital

▶ Early Stage SBA leverage can be a low cost option for non-dilutive capital

- ▶ As funds draw leverage, they pay:
 - ▶ a 2% draw down fee
 - ▶ an Annual Charge (currently 0.672%) on drawn capital
 - ▶ additional nominal fees
 - ▶ either discounted or current quarterly interest on drawn capital
- ▶ The interest rate is set quarterly by the FHLBC. Please refer to the interest rate calculator at <http://www.fhlbc.com/Documents/sbacalculatorpage.htm> for a more specific estimate of applicable rates. The rate is currently around 4%.

- ▶ Example:
 - ▶ Private Capital: \$100M
 - ▶ Half Tier of Leverage: \$50M
 - ▶ Fees:
 - Licensing Fee: \$25K
 - ▶ Option:
 - Pay \$25K for a \$50M, low cost, line of credit
 - 1% commitment fee – i.e., \$500K – due if and when you request a commitment from SBA
- ▶ Low Cost
 - ▶ Cost of capital, including all fees and interest, is currently around 4%

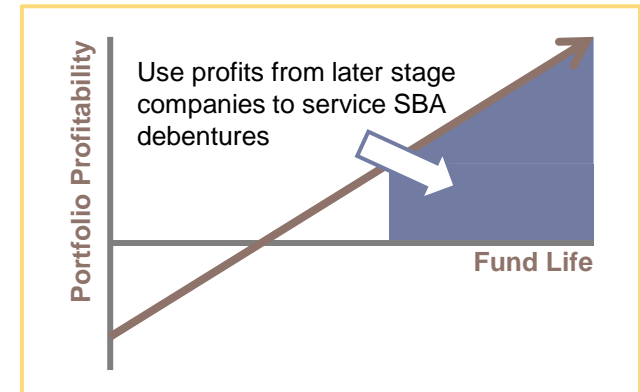
Strategic Application of SBA Leverage

▶ Structure some investments with a current pay component

- ▶ Current pay investments reduce J-curve depth, and provide yield to service SBA leverage.

▶ Draw on debenture leverage prudently

- ▶ For the 50% of total capital that must be invested in Early Stage companies, consider drawing SBA leverage later in your fund's life to invest in companies at a positive inflection point – e.g., about to turn the corner to profitability or achieve an exit.



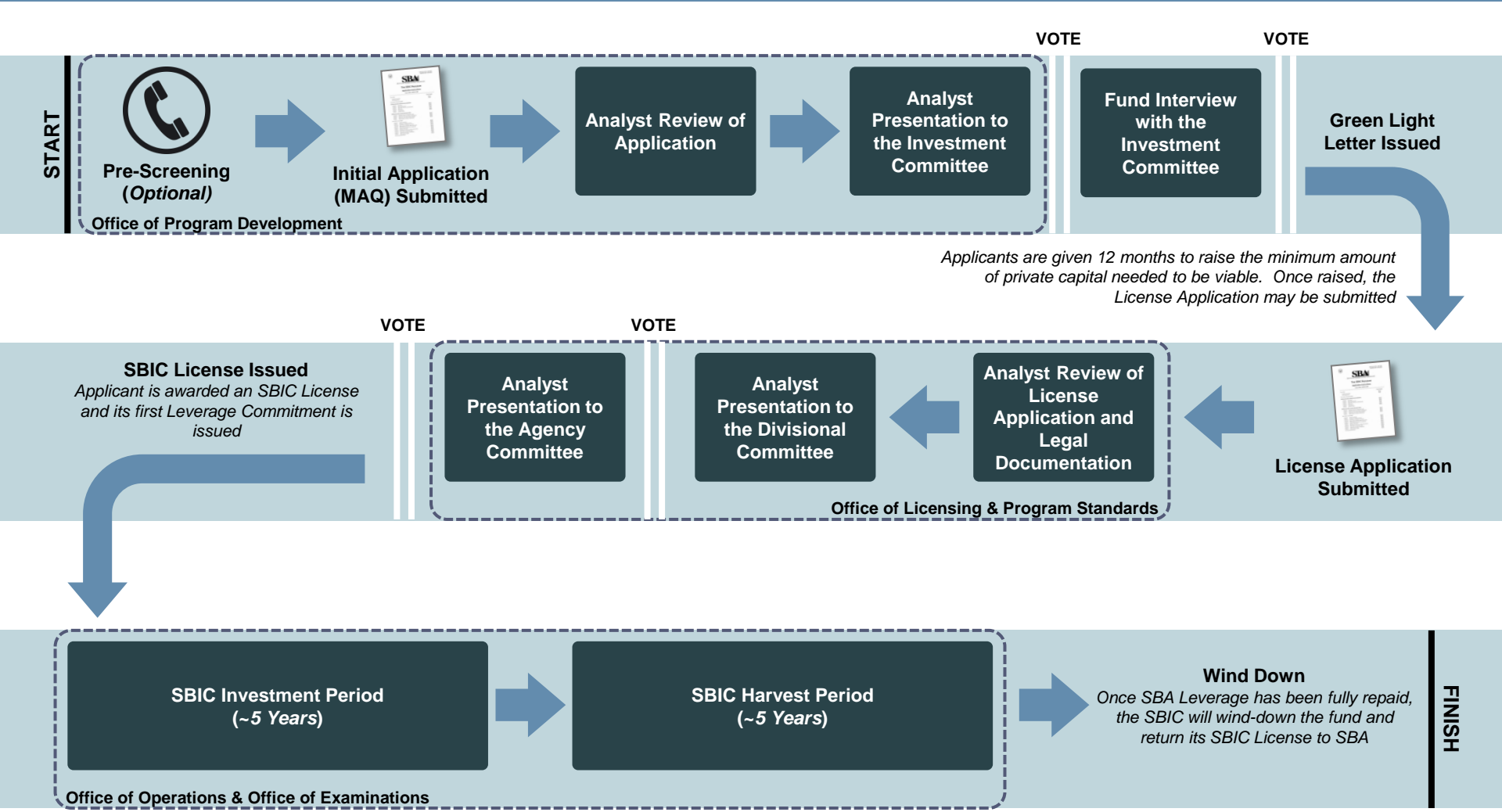
- ▶ For the remaining 50% of total capital that must be invested in US Small Businesses, consider drawing SBA leverage to make follow-on investments in proven winners at or near a liquidity event – and use LP capital typically reserved for follow ons to make more bets.

Strategic Application of SBA Leverage (cont.)

- ▶ **Applicants may request less than a full tier of leverage**
 - ▶ SBA will not take distribution priority if your Capital Impairment (“CIP”) is above 50%, but below the maximum allowable CIP of 70% (See CIP example in the Appendix below). The lower your leverage, the harder it is to trip the CIP threshold.

- ▶ **Charge a management fee on Regulatory Capital only**
 - ▶ To address concerns by LPs about management fees being charged in addition to SBA fees, funds may lower management expenses by only charging a management fee on Regulatory Capital.

SBICs from Start to Finish



Rigorous Underwriting Criteria



Key Criteria Analysts Use to Assess an Applicant’s Qualifications:

Manager Assessment

- ▶ Proven investment experience
- ▶ Balanced track record among principals
- ▶ Evidence indicating a cohesive and effective team
- ▶ Principals with strong, positive reputations
- ▶ Robust investment and due diligence process

Performance Analysis

- ▶ High quality track record of transactions analogous to those proposed for the SBIC
- ▶ Record of positive realizations
- ▶ 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

- ▶ 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”
- ▶ Compatibility of the proposed strategy with manager experience

Fund Structure & Economics

- ▶ 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 responsibility
- ▶ Adequate fund infrastructure
- ▶ Evidence of fundraising traction

Time Frame:

- ▶ Pre-screening call with Investment Officer – 15-30min
- ▶ Analyst Review of Application & Presentation to the Investment Committee – 4-6 weeks

Thorough Legal Review

Licensing:

- ▶ Prior to the submission of the Licensing Application, applicants must have secured private capital commitments in an amount sufficient to ensure the fund's financial viability
- ▶ Analysts review the application, business plan, ownership diversity and coordinate a legal review with SBA's Office of General Counsel
- ▶ Licensing is contingent on the approval of the SBA's Divisional Committee and Agency Committee



Selected Legal Documentation Reviewed in the Licensing Process:

- ▶ Limited Partnership Agreement (LPA): Applicants are encouraged to use the SBA-approved Model LPA
- ▶ Capital Certificate: Compendium of signed commitment letters from the prospective limited partners
- ▶ Fingerprint cards: Each principal of a proposed SBIC must undergo an FBI background check

Time Frame:

- ▶ Analyst and Office of General Counsel Review – 3-6 months

Regulatory & Financial Oversight

Office of Operations & Office of Examinations:

- ▶ The Office of Operations serves as the primary point of contact for SBIC fund managers
- ▶ Analysts in the Office of Operations perform a variety of tasks:
 - Assist SBICs with the draw down of SBA-guaranteed leverage
 - Review and approve potential conflicts-of-interest
 - Process requests for the transfer of LP interests
 - Monitor financial health of SBICs

Key Reports:

- ▶ Financing Reports (Form 1031): SBIC managers must report information to SBA about the companies they finance
- ▶ Quarterly & Annual Financial Statements (Form 468): SBICs use an online system to report their financial results

Examinations:

- ▶ SBA's Office of Examinations assesses the regulatory compliance of SBICs with leverage once a year
- ▶ Examinations are conducted for SBICs without leverage once every other year



Contact Us

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Visit Us Online:

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For Questions about the Early Stage SBIC Program:

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Appendix to Early Stage SBIC Presentation

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.

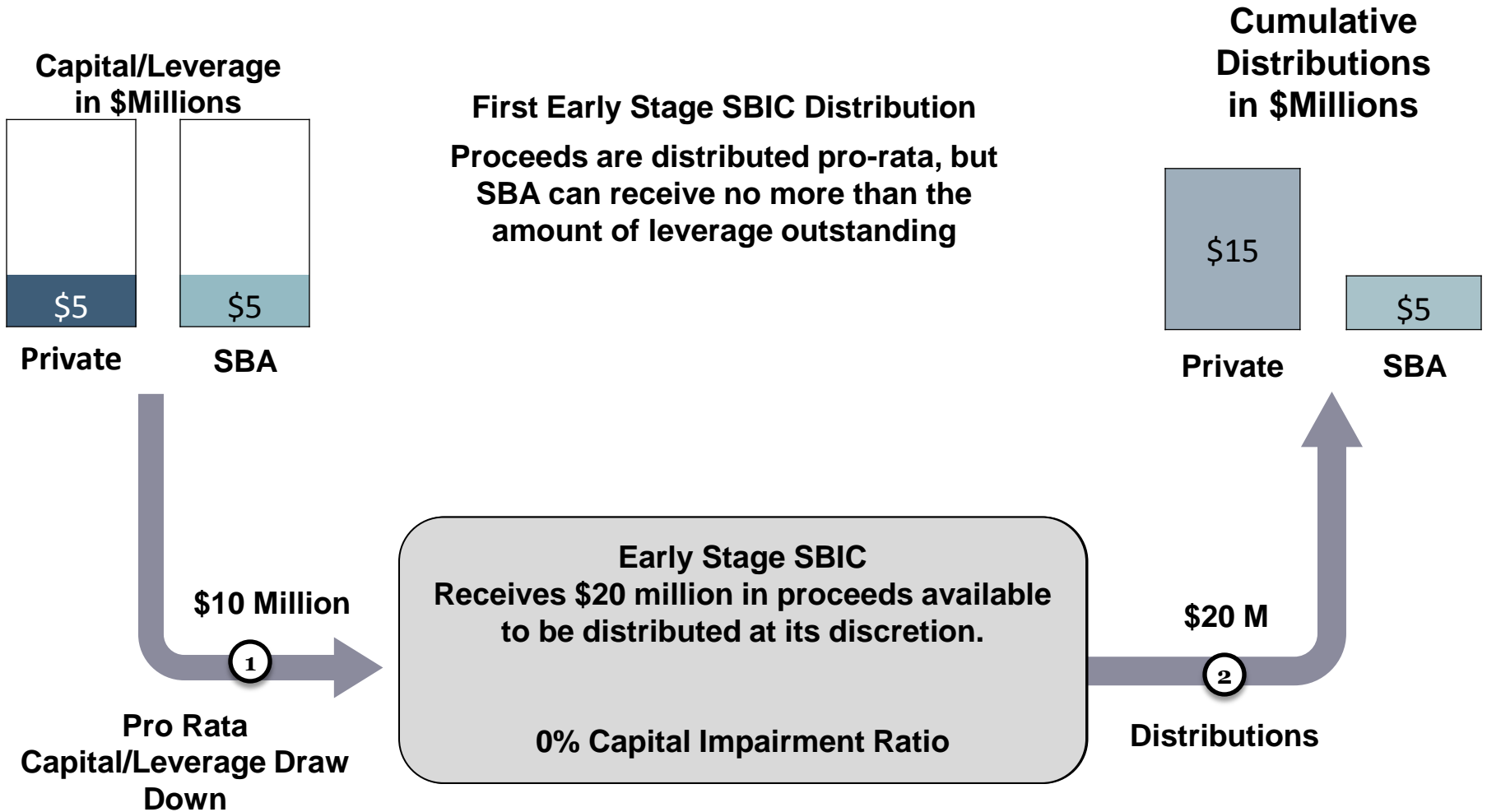
$$\text{CIP} = \left[\frac{-\$10 \text{ million} + 80\% \times \$1 \text{ million} + 50\% \times \$2 \text{ million}}{\$25 \text{ million}} \right] \times 100$$

= 32.8%

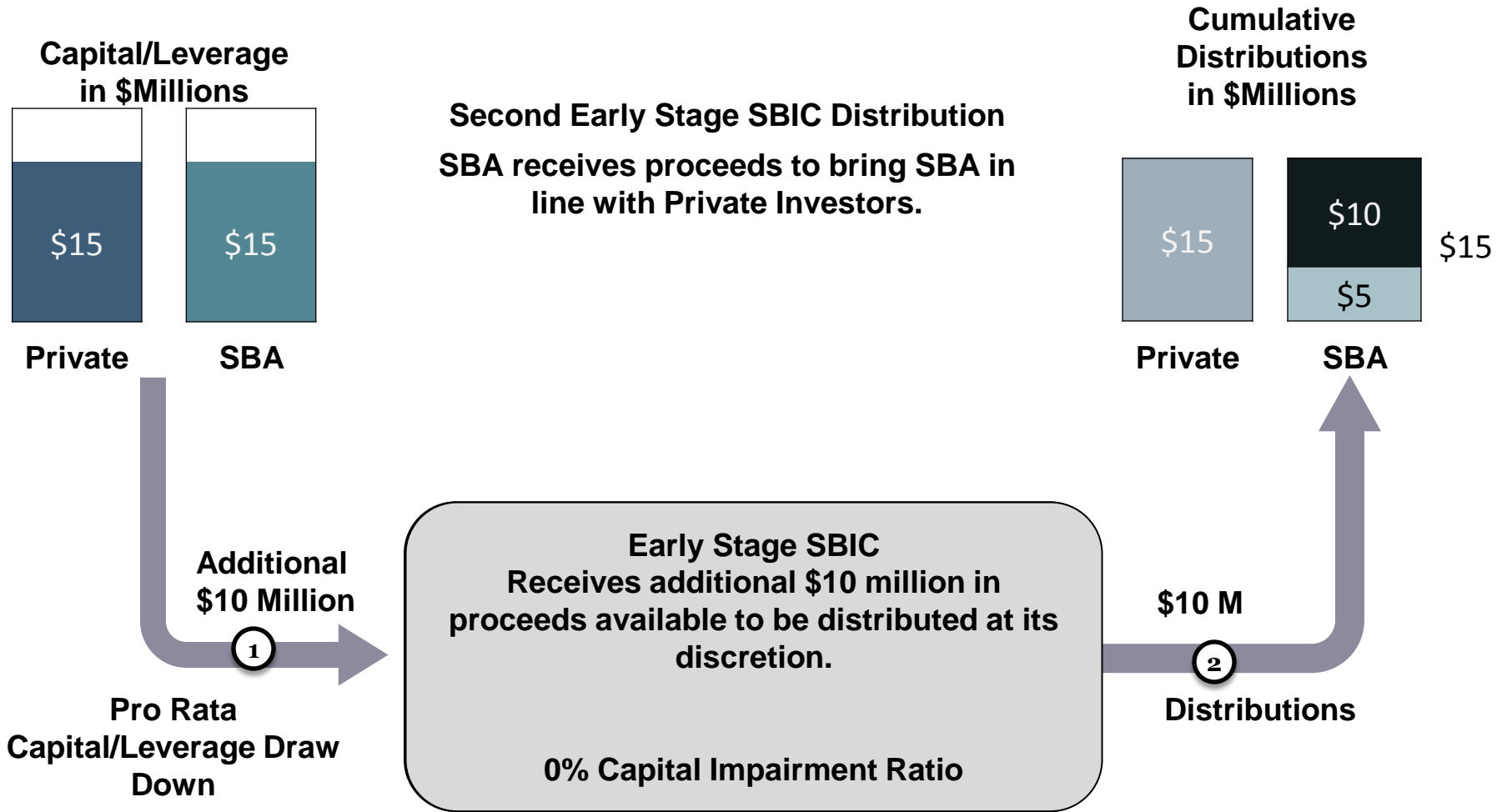
Key SBA Rights if SBIC's CIP Over Maximum Allowable

- ▶ 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

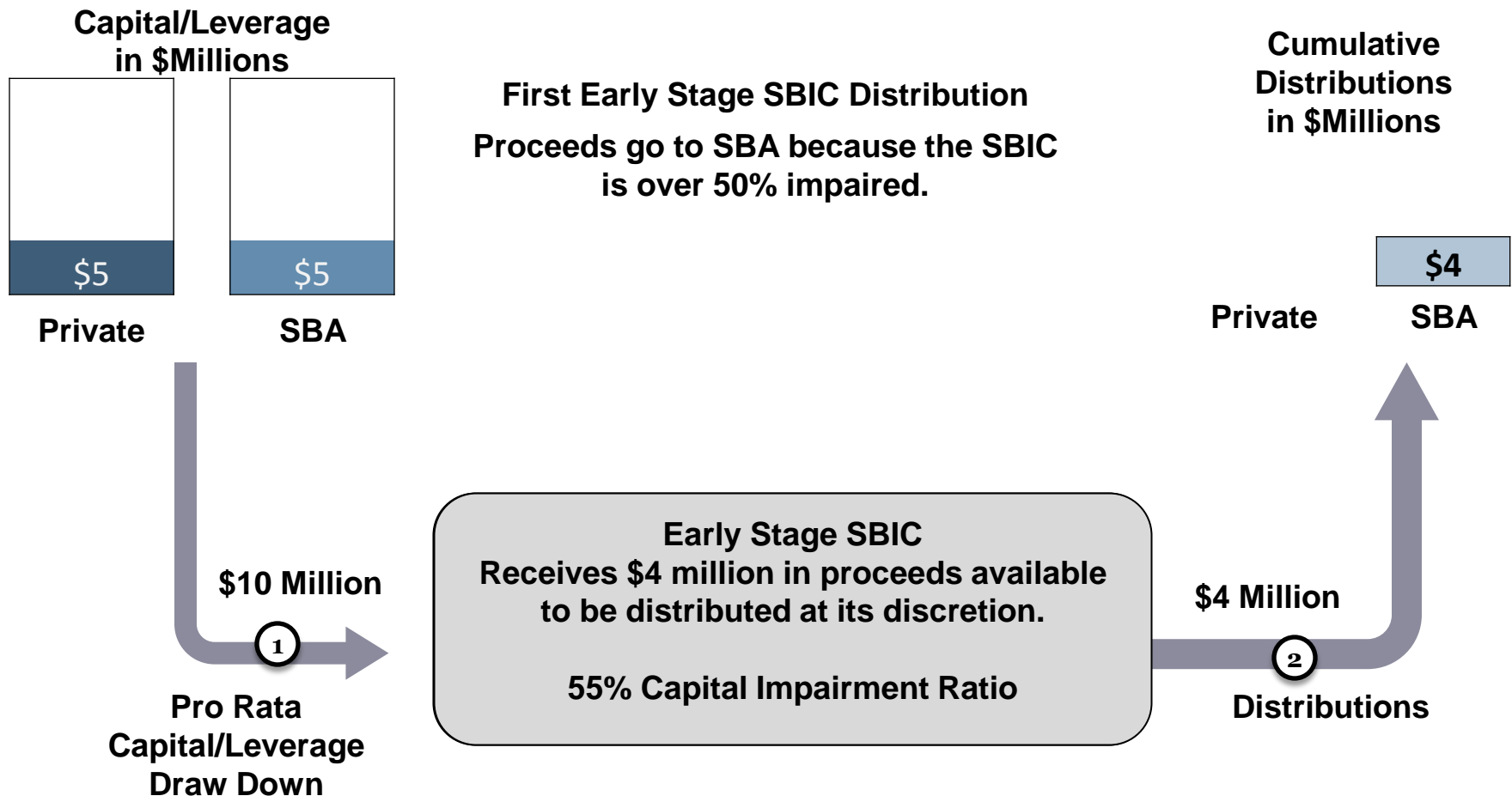
Early Stage Distribution Example 1: SBA Catch-Up First Distribution



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

