

## **SBIC TechNotes**

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### **Post-Licensing SBIC Risk Management Procedures**

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A rigorous and effective risk management and oversight program is essential to protect the Agency's financial interests in Small Business Investment Companies (SBICs) and to ensure that the objectives of the Small Business Investment Act of 1958, as amended (the Act), are being met.

Such a program includes, first and foremost, the licensing of qualified private fund management teams. This TechNote describes SBA's risk management and oversight procedures *after* an SBIC receives its license, draws SBA leverage, and begins fund operations.

***This TechNote does not in any way limit SBA's rights and remedies as contained in the Small Business Investment Act and the regulations at 13 CFR Part 107. These rights and remedies include, but are not limited to, SBA's rights to (a) place an SBIC into Restricted Operations, (b) restrict or deny Leverage availability, and (c) take appropriate legal action to protect its interest.***

Three new elements of SBA's post-licensing risk management and oversight are also described herein: (1) a new Risk Assessment Model; (2) a set of day-to-day oversight activities and procedures to help prioritize and standardize oversight responsibilities among the Investment Division personnel; and (3) Portfolio Review Meetings that may be held with certain SBICs.

Although SBA's risk management program is comprehensive, it cannot anticipate all contingencies nor can it provide a template for all decisions. Thus, decisions on a case-by-case basis are a necessary part of the overall policy and procedures.

The objectives of SBA's risk management program are as follows:

1. Promote highest standards of integrity and best fund management practices among SBICs.
2. Strengthen existing "early warning" procedures to assess financial and regulatory issues affecting fund performance.
3. Ensure consistency and continuity of day-to-day oversight activities of Investment Division personnel.
4. Collect operational data and analysis to assist in efforts to estimate total prospective portfolio losses over time.

## **Risk Assessment Model**

The Risk Assessment Model is one component of the Investment Division's overall risk management procedures for both Participating Security and Debenture Licensees. The Model is a means for assessing risk and encouraging best fund management practices at the SBIC level.

The Risk Assessment Model is the primary tool used by the SBA to determine the relative intensity and degree of oversight for a particular SBIC (see below). While the Risk Assessment Model captures a number of factors that are critical to the success or failure of a private equity fund, it does not prescribe action. SBA also considers other factors, including regulatory compliance, in deciding whether to exercise the rights and remedies prescribed by the Act and the Regulations with respect to particular SBICs.

The Model uses both quantitative and qualitative factors to assign a Risk Rating for each SBIC. Quantitative factors use Form 468 financial data and valuation reports and involve simple spreadsheet inputs. Qualitative factors include an analysis of a Licensee's management team and adherence to business plan.

The Model incorporates specific factors and point weightings for both Debenture and Participating Securities licensees. The factor weightings change as a fund transitions from the immature stage to mature status.<sup>1</sup>

### **Risk Model Factors**

1. Fund status – Immature vs. Mature
2. Capital Impairment
3. Accumulated Prioritized Payments (Participating Security)
4. Debenture Fixed Charge Coverage (Debenture)
5. Adherence to Business Plan
6. Portfolio Company Valuations
7. Management & internal controls (regulatory compliance history)
8. Liquidity Needs

The risk rating factors provide a risk rating score. In general, as the score increases, the level of SBA oversight increases.

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<sup>1</sup> The change in classification to mature status occurs when a Licensee reports investments at cost (including realizations and write-offs) totaling 65% or more of its Combined Capital plus outstanding SBA Commitments. An Appendix to this TechNote contains a copy of the Risk Assessment Model spreadsheet and more detailed information about each risk rating factor and trigger points.

## **Trigger Points**

Trigger Points identify critical aspects of a licensee's operations that automatically place it into the Intensive oversight category (notwithstanding the risk rating score). The Model currently uses three Trigger Points:

1. Licensees with serious outstanding regulatory violations require Intensive oversight until these violations are resolved. (See "Explanation of Risk Rating Factors" in Appendix A.)
2. Licensees with excessive realized losses (i.e., an Undistributed Net Realized Earnings deficit equal to 100% of Regulatory Capital) and no anticipated liquidity events within the next twelve months.
3. (a) For Participating Securities issuers: Licensees that have a Capital Impairment percentage of 100% or more regardless of the age of the fund.  
(b) For Debenture issuers: Licensees that have a condition of Capital Impairment under SBA regulations.

## **Levels of SBIC Oversight**

The Office of SBIC Operations handles the day-to-day oversight of active SBICs. Three general levels of oversight have been established: Normal, Enhanced, and Intensive. The new risk assessment model, as discussed above, influences the process in which SBICs are placed in one of three oversight categories.

Many factors determine an SBIC's level of oversight, most of which are components of the risk model score. These factors include the SBIC's financial condition (using standard mathematical formulas), regulatory compliance history (based on SBIC examinations), and management integrity and experience (both qualitative and quantitative assessments).

Investment Division personnel are responsible for specific activities related to each level of oversight. Importantly, placement of an SBIC into an oversight category does not presuppose or prescribe any regulatory or other action to protect the Agency's position in the fund, nor does it limit SBA's ability or authority to pursue any remedies available to it under the Act or the Regulations.

The point ranges indicative of the level of oversight are as follows: Normal – 0 to 40 points; Enhanced – 41 to 65; and Intensive – greater than 65 points.

### **1. Normal**

A Licensee in good financial standing and regulatory compliance receives Normal oversight. At this level, the analyst/portfolio manager assigned to monitor the SBIC serves as the primary point of contact. Normal oversight activities include:

- Analysis of annual and quarterly SBIC financial statements, valuation reports, and other supporting documentation
- SBIC portfolio review 1-2 times per year
- Review Commitment and Draw requests
- Review Capital Certificates
- Review any Regulatory issues requiring SBA's prior approval, such as Conflict of Interest investments and Overline investments
- Review Examination reports for any Regulatory violations
- Attend annual SBIC partner's meetings and/or visit fund managers

## 2. **Enhanced**

Licensees experiencing some financial difficulties (e.g., a significant number or amount of portfolio company write-offs) or Regulatory issues are placed into the Enhanced oversight category. At this level, the Area Chief takes a more active role in the oversight of a Licensee.

The oversight activities for a Licensee in the Enhanced category include:

- All monitoring and oversight activities under the Normal category
- Credit Committee may meet to discuss the SBIC's ability to receive additional Commitments and draw against existing commitments
- Increased interaction with fund managers and review of the portfolio at Area Chief and/or Director level
- Site visits to portfolio companies to assess fund managers' views of potential performance
- As needed, face-to-face Portfolio Review Meeting(s) with SBA officials (see Portfolio Review Meeting section for more detail)

## 3. **Intensive**

SBICs with severe financial problems or serious Regulatory violations receive Intensive oversight. Specific oversight activities at the Intensive level include:

- All monitoring activities previously listed
- Face-to-face Portfolio Review Meeting(s) with SBA officials
- More frequent and enhanced SBIC reporting (quarterly or monthly)
- Increased monitoring of portfolio companies (e.g., review of financial statements) with an emphasis on cash needs relative to the SBIC's position in the company

***Placement of a Licensee in any oversight category does not in any way limit SBA's ability to take whatever action it deems appropriate, including but not limited to, placing an SBIC into Restricted Operations, transferring an SBIC to the Office of Liquidation, and exercising other rights and remedies under the Act and the Regulations.***

## **Portfolio Review Meetings**

When a Licensee is placed in the Intensive oversight category, SBA may give the management of the Licensee an opportunity to meet with the Agency, through a Portfolio Review Meeting. This meeting may also occur when the Licensee is in the Enhanced category. SBA may take whatever administrative or remedial action it deems appropriate either before or after the Portfolio Review Meeting.

The primary purpose of the meeting is to review all remaining portfolio companies in which the SBIC has a financial interest. Meetings are held at SBA headquarters in Washington and last approximately half a business day, possibly longer if the SBIC has a large remaining investment portfolio or a complicated structure. All the SBIC principals are expected to attend.

SBA does not require a pre-determined format, but specific information must be included in the presentation as follows:

### **I. Portfolio Company Information**

1. Description of the portfolio company's business
2. Description of where the company stands against plan
3. Summary financial statements (i.e., income statement, cash flow statement, and balance sheet) including projections for two years
4. Current Cash Balance
5. Burn Rate
6. Estimated months of cash on hand
7. Next major milestone for this company
8. Justification for the latest valuation based on SBA Regulations
9. History of financing rounds and valuations (pre-money and post-money), including the dates and amounts of investments by the SBIC
10. Follow-on rounds of financing required by the portfolio company and the impact of pricing on the values of existing investments
11. A list of other significant investors in the portfolio company and an assessment of their ability and desire to provide additional financing to the company
12. Anticipated exit options, timing, values and proceeds to the licensee
13. Changes in portfolio company management
14. Litigation, or adverse legal or regulatory decisions and/or proposals

### **II. SBIC's Financial Position**

A review of the financial position of the SBIC is required using the most current data available. Specific comments are requested on:

1. Current cash balance and available liquid assets
2. Expense structure of the SBIC, especially the components of the management fee (e.g., rent, overhead, etc.)

3. Unfunded commitments from Private Limited Partners
4. Review of current Capital Impairment calculation, including:
  - a. Calculation as of the most recent fiscal quarter
  - b. Details of Class 1 and Class 2 Appreciation
  - c. Expectations of changes in Capital Impairment over the next 12 months
5. All commitments made by the SBIC to invest in portfolio companies, including estimated dates of funding.
6. A three year forecast of the operations and financial position of the SBIC, tied to the Form 468.<sup>2</sup>

### **III. Post-Portfolio Review Meeting Activities**

The financial analyst responsible for oversight of the SBIC will present the data and analysis in summary form to decision-makers, including:

1. Age of fund
2. Adherence to business plan
3. Percent of capital drawn down
4. Cumulative returns to date on all related funds
5. GP's investment in the fund
6. Portfolio company-specific information
  - a. Valuation & exit potential
  - b. Cash burn rate
  - c. Quality of co-investors (syndicate)
7. Fund recapitalization prospects
8. Regulatory compliance
9. Risk Rating worksheet (including trends)
10. Capital Impairment worksheet (including trends)

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<sup>2</sup> The forecast should reflect the anticipated amounts and timing of exits described above. For Participating Securities licensees, the forecast should reflect the distribution regulations and include, as applicable, accumulated prioritized payments balances, payments of prioritized payments, profit participation, redemption of leverage, and distributions to limited partners. For Debenture licensees, the forecast should include a schedule of debenture interest payments and debenture redemptions, including any planned prepayment of debentures. A Form 468 balance sheet should be prepared as of the end of each year of the three-year forecast period.

## **APPENDIX A: RISK ASSESSMENT MODEL**

The risk assessment models may be accessed by clicking on the following links:

- [Risk Assessment Worksheet: Participating Security Funds](#) [Microsoft Excel]
- [Risk Assessment Worksheet: Debenture Funds](#) [Microsoft Excel]

### **EXPLANATION OF RISK RATING FACTORS**

This Appendix describes the risk model factors and calculations of the various factor components. Individual factor points and risk rating scale are presented in the tables at the end of this section.

**TRIGGER POINTS** identify critical aspects of an SBIC's operations that automatically qualify a Licensee for Intensive oversight. The Risk Assessment Model currently uses three trigger points: Excessive Realized Losses, Serious Regulatory Violations, and Capital Impairment.

1. Excessive Realized Losses means an Undistributed Net Realized Earnings deficit equal to or greater than 100% of Regulatory Capital. This calculation excludes the impact of any Unrealized Gain or Loss. Any permanently impaired asset that has not been written off should be added to Realized Losses when calculating Excessive Realized Losses.
2. Serious Regulatory violations include, but are not limited to, Conflicts of Interest, unapproved Overline investments or transfers of control, and use of fund assets for ineligible purposes. A pattern of repeated regulatory abuses could also qualify as a trigger.
3. (a) For Participating Securities issuers: Licensees that have a Capital Impairment percentage of 100% or more, regardless of the age of the fund.  
  
(b) For Debenture issuers: Licensees that have a condition of Capital Impairment under SBA regulations.

**RISK FACTORS** are individual elements used to determine an SBIC's Risk Rating. Points are assigned based on an analysis of the individual factors, then summed to determine the overall risk score.

1. **Fund Maturity:** The worksheet weights several factors differently depending on the maturity of a fund. SBA classifies a fund as mature at the earliest of (a) the new investment phase is complete, (b) total investments at cost (including the cost of assets sold and written-off) equal or exceed 65% of Combined Capital plus outstanding SBA commitments, or (c) a Licensee's partnership agreement prohibits new investments or allows fund managers to begin raising a new fund.

The Risk Model eliminates the Adherence to Business Plan factor for a mature fund because this factor becomes less important once a Licensee completes the new investment phase. These points are assigned to Capital Impairment and Valuations for a Participating Securities Licensee, and to Fixed Charge Coverage and Valuations for a Debenture Licensee.

2. **Capital Impairment:** Points are assigned based on the ratio of a Licensee's Capital Impairment (see Sections 107.1830 thru 107.1850) to its Permissible Impairment. A fund scores the maximum points if the ratio exceeds 1. A ratio less than 1 is multiplied by the appropriate maximum point level for this factor based on fund maturity and type of Licensee.
3. **Adherence to business plan (Immature funds only):** A Licensee receives either 0 or 20 points during the new investment phase based on its adherence to the business plan presented at the time of Licensing or to any SBA approved changes. Business plan components such as investment pace, target industries, mix of debt and equity, stage of investments, and other relevant factors are assessed. Material deviations from the Licensee's business plan result in the maximum points.
4. **Accumulated Prioritized Payments (Participating Securities issuers only):** Interest payments made by SBA on behalf of Licensees to the Trust Certificate holders represent actual cash outlays that expose the Agency to loss. The factor uses the ratio of a Licensee's Prioritized Payments balance to Regulatory Capital. A ratio of .5 or more earns the maximum points. For a ratio below .5, divide by .5 and multiply the result by 10.
5. **Fixed Coverage Charge (Debenture SBICs only):** A Debenture Licensee should generate current cash income to cover fixed charges.

a. 
$$\frac{\text{Gross Investment Income}}{\text{Total interest on SBA Debentures}}$$

Scale: Immature fund: <1 = 5 points  
 Mature Fund: <1 = 10 points; 1.0-2.0 = 5 points, >2.0 = 0

b. 
$$\frac{\text{Gross Investment Income}}{\text{Total interest on SBA Debentures + Management Fees}}$$

Scale: Immature fund: <1 = 5 points; Mature Fund <1 = 10 points

6. **Valuations:** The first subcomponent is worth 5 points and the second scores either 5 points for an immature fund or 15 points for a mature fund.
  - a. **Non-compliance with SBA's Valuation Guidelines:** A Licensee receives 5 points for failure to maintain valuations in accordance with SBA's valuation policy or for an outstanding Examination violation citing the Licensee for not following its valuation policy.
  - b. **Breakeven ratio:** For an Immature fund, a ratio above 1.0 scores no points while a ratio below 1.0 scores the maximum points. For a Mature fund, a ratio > 2.0 = 0 points, 1.5-2.0 = 5 points, 1.0-1.49=10 points, and below 1.0 scores the maximum 15 points.

**Participating Securities breakeven calculation:**

$$\frac{\text{Value of loans and investments (as reported on Form 468) + Cash}}{\text{Outstanding Leverage + Accumulated Prioritized Payments}}$$

**Debenture breakeven calculation:**

$$\frac{\text{Value of loans and investments (as reported on Form 468) + Cash}}{\text{Total Debentures Outstanding}}$$

7. **Fund Management & Internal Controls:** If the original management team at the time of licensing remains unchanged, then this factor rates zero points unless other problems exist with the management of the Licensee. A Licensee operated by a single Principal or one that has experienced a major change in the management team receives the maximum points. Other factors considered in the assessment include the experience and track record of management, depth and stability of the team, quality and use of internal controls, Regulatory compliance history, and an active board of advisors. Based on a review and assessment of all relevant factors, a Licensee is assigned 0, 5, or 10 points.
8. **Liquidity:** This factor assesses the level of financing risk within the portfolio. If more than 30% of a Licensee's investments will require funding within the next 12 months, the Licensee receives 10 points. Funding requirements include investments to support operating losses & working capital, as well as financings for growth and expansion activities. SBA will also evaluate a Licensee's ability to support portfolio company investment requirements and the ability of a small concern to access funding from other investors and bank lines of credit.

## FACTOR POINT SCALE

### Participating Securities

Risk Assessment Factors	Immature	Mature
<b>1. Capital Impairment</b>	<b>40</b>	<b>50</b>
<b>2. Adherence to Business Plan</b>	<b>20</b>	<b>0</b>
<b>3. Accumulated Prioritized Payments</b>	<b>10</b>	<b>10</b>
4. Fixed Charge Coverage	N/A	N/A
<b>5. Valuations</b>	<b>10</b>	<b>20</b>
1. Non-compliance with Valuation policy	5	5
2. Breakeven ratio	5	15
<b>6. Management / Internal Controls</b>	<b>10</b>	<b>10</b>
<b>7. Liquidity</b>	<b>10</b>	<b>10</b>
<b>Total Points</b>	<b>100</b>	<b>100</b>

### Debenture

Risk Assessment Factors	Immature	Mature
<b>1. Capital Impairment</b>	<b>40</b>	<b>40</b>
<b>2. Adherence to Business Plan</b>	<b>20</b>	<b>0</b>
3. Accumulated Prioritized Payments	N/A	N/A
<b>4. Fixed Charge Coverage</b>	<b>10</b>	<b>20</b>
1. Investment Income / SBA interest	5	10
2. Investment income (Interest + Management Fees)	5	10
<b>5. Valuations</b>	<b>10</b>	<b>20</b>
1. Non-compliance with Valuation policy	5	5
2. Breakeven ratio	5	15
<b>6. Management / Internal Controls</b>	<b>10</b>	<b>10</b>
<b>7. Liquidity</b>	<b>10</b>	<b>10</b>
<b>Total Points</b>	<b>100</b>	<b>100</b>

## RISK RATING SCALE

Risk Rating Points	Level of Oversight
0-40	Normal
41-64	Enhanced
65 or higher	Intensive