SBIC TechNotes
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SBIC TechNote 10: SBIC Risk Management

A. Introduction

A rigorous and effective risk management and oversight program is essential to protect the Agency's financial interests and to ensure that the objectives of the Small Business Investment Act of 1958, as amended (the Act), are being met. This TechNote describes SBA's risk management and oversight practices and procedures for Small Business Investment Companies (SBICs) with outstanding Leverage and/or commitments.

This TechNote supersedes the original TechNote 10 published in December 2003. This edition reflects changes and enhancements to SBA's risk management practices and oversight procedures.

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.

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

1. Identify SBICs and/or investments that may require closer monitoring.
2. Maintain a set of procedures and standards by which the Agency initiates administrative actions to protect its interests.
3. Assess SBIC performance to assist in efforts to estimate total prospective portfolio losses over time.

B. References & Definitions

The following definitions are provided to clarify terms used in this TechNote.

Term	Definition
§107.xxxx	Regulatory citations refer to 13 CFR Part 107
Capitalized words and terms	Unless otherwise defined in this TechNote, capitalized words and terms have the meaning set forth at 13 CFR 107.50

The following regulations apply to the information in this TechNote:

- §107.503(c) Responsibility for valuations
- §107.1120 General eligibility requirements for Leverage
- §107.1182 Valuation requirements for Early Stage SBICs based on Capital Impairment Percentage
- §107.1810 Events of default and SBA's rights and remedies

- §107.1820 Conditions affecting issuers of Preferred Securities and/or Participating Securities
- §107.1830-1840 Capital Impairment, computation, and general requirements
- §107.1845 Determination of Capital Impairment Percentage for Early Stage SBICs

TechNote #5 describes SBA's credit management policies and practices.

TechNote #12 provides guidance on valuation issues.

SOP 10 08 provides instructions and guidance for the examination of SBICs.

The Valuations Guidelines for Small Business Investment Companies describes the policies and procedures to which SBICs must conform in valuing their Loans and Investments and provides guidance as to the techniques and standards which are generally applicable to such valuations.

C. Risk Review and Assessment

SBA conducts comprehensive quarterly risk reviews and assessments of each SBIC with outstanding Leverage and/or commitments. In addition to meeting the program objective noted in the introduction, SBA also uses risk analysis in its credit management procedures and the licensing process for subsequent funds. SBA evaluates a number of quantitative and qualitative factors in assessing the financial and regulatory risks associated with each SBIC, including (but not limited to) the following:

1. Capital Impairment Percentage

   The Capital Impairment Percentage ("CIP") is SBA's primary regulatory tool for determining the financial health of an SBIC. When an SBIC exceeds its maximum permitted CIP, SBA may take certain actions to minimize potential losses to the Agency. This is explained further in *Section F. Capital Impairment*.

   The CIP calculation applies to SBICs with outstanding Leverage. The computation of an SBIC's CIP and maximum permitted CIP is explained in §107.1840. Also refer to TechNote #5 for additional guidance.

   SBA has the right pursuant to §107.1830(f) to make its own determination of an SBIC's CIP. For example, if SBA determines that you overvalued an investment or incorrectly recognized income, SBA may determine that your CIP is higher than your calculation.

   The calculation of maximum permitted CIP results in higher maximum CIPs for funds with greater percentages of Equity Capital Investments (ECI) in their portfolios. This reflects the expectation that SBICs that make more equity investments will have a greater degree of volatility. In making its determination of an SBIC's CIP, SBA may exclude an investment from total ECI if the original investment did not qualify as ECI, but was converted to ECI due to a distressed restructuring or for the purposes of increasing the SBIC's maximum permitted CIP.

Additional rules for determination of CIP for Early Stage SBICs are in §107.1845.

2. Leverage and interest coverage ratios

The leverage and interest coverage ratios, calculated from figures reported in the SBA Form 468, help SBA evaluate an SBIC's ability to repay and service its outstanding Leverage.

The standard leverage coverage ratio calculation is:

$$\textbf{Leverage Coverage Ratio} = \frac{(\text{Total Assets} - \text{Liabilities Excluding SBA Leverage} - \text{Other Assets}) + \text{Unfunded Private Commitments}}{\text{Outstanding Leverage}}$$

The standard interest coverage ratio calculation is:

$$\textbf{Interest Coverage Ratio} = \frac{\text{Operating Activities Cash Inflows}}{\text{Interest Expense on SBA Debentures}}$$

SBA may make adjustments to the ratios based on an analysis of the inputs, as well as perform other analytical calculations as necessary. For example, a questionable valuation could result in an adjustment to total assets and change the leverage coverage ratio.

3. Portfolio assessment

SBA assesses the performance of each company in the SBIC's investment portfolio. SBA uses several sources of data to reach conclusions, which typically includes: the Form 468 and Schedule 8, the SBIC's semi-annual valuation reports, communication with the SBIC, third party valuation reports as needed, any other documents submitted by the SBIC, and SBA's own research. See *Section D* below for more detail on valuation reports.

SBA may consider a number of factors such as delinquencies, investment restructurings, top line and bottom line trends, financial ratios, ability to reach milestones and/or meet budget targets, ability to attract additional capital, strength of management and governance, industry trends, and market position.

4. SBIC Performance

SBA assesses the performance of the SBIC. In addition to the factors noted in items 1 through 3 above, SBA may also look at your profitability, cash flows, financial trends, reasonableness of valuations, and history of and outlook for Leverage pay downs. SBA will monitor the SBIC's adherence to its approved investment plan. Benchmarks may also be considered.

5. <u>SBIC Unique Characteristics</u>

   An SBIC may have certain unique characteristics unrelated to performance that cause it to have a higher risk profile. One such characteristic is the riskiness of an SBIC's investment strategy. For example, an SBIC that primarily makes equity investments will usually pose a greater credit risk to SBA than an SBIC that primarily makes senior secured loans. Another characteristic is the amount of Leverage an SBIC has since the more Leverage that an SBIC has the higher potential risk of loss to the Agency.

6. <u>Regulatory compliance and SBA examinations</u>

   SBA reviews regulatory risk primarily through an SBIC's examination history. The severity, frequency, and trends of regulatory violations are considered. For more information on the examination process, refer to SOP 10 08.

D. Valuations

Valuations play a significant role in SBA's determination of the financial health of an SBIC and the performance of its investment portfolio. SBA reviews your valuations to ensure that they conform to your adopted valuation policy and the Valuation Guidelines for Small Business Investment Companies. TechNote #12 provides detailed guidance on valuation issues.

A part of SBA's risk management practices is the use of a third party firm to value one or more of an SBIC's portfolio investments. Pursuant to §107.503(c), SBA may require an SBIC to engage, at its own expense, an independent third party to substantiate the SBIC's valuations. The regulation states that the valuation professional must be acceptable to SBA. TechNote #12 outlines SBA's requirements.

SBA also has the option of using its valuation contractor, at the Agency's expense, to conduct third party valuations of your portfolio investments.

E. Portfolio Review Meetings

If SBA determines that an SBIC's risk profile is high or has the strong potential to become high, SBA increases its monitoring of the SBIC by requesting more frequent information from the SBIC and communicating more frequently with the SBIC about the SBIC's performance.

SBA may give the management of the SBIC an opportunity to meet with the Agency through a Portfolio Review Meeting. The purpose of the meeting is for you to provide SBA with the most recent information on your investments and to discuss management expectations for the investments and the fund.

In such situations, SBA may also take whatever administrative or remedial action it deems necessary either before or after the Portfolio Review Meeting, pursuant to the rights and remedies afforded to it in the Act and the regulations.

Preparation for Portfolio Review Meeting

The primary functions of the meeting are to review all remaining portfolio companies in which the SBIC has a financial interest and to review the current financial status of the SBIC and its outlook for the future. Meetings are usually held at SBA headquarters in Washington, but circumstances may dictate that a meeting can be accomplished via teleconference. You should consult with your SBA financial analyst for guidance. Meetings last approximately one to two hours, 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

For a selected number of portfolio companies, as determined by you in cooperation with your SBA financial analyst, provide the following:

All Investment Types
1. Description of the portfolio company's business
2. Historical financial statements (i.e., income statement, cash flow statement, and balance sheet) including projections for two years
3. Description of where the company stands against the approved business plan
4. Next major milestone for this company
5. Justification for the latest valuation based on SBA Regulations
6. Changes in portfolio company management, if any
7. Litigation or adverse legal or regulatory decisions and/or proposals, if any

Loans/Debt Investments	**Equity Investments**
8. List of creditors senior to SBIC and outstanding loan/debt balances	8. History of financing rounds and valuations (pre-money and post-money), including the dates and amounts of investments by the SBIC
9. Covenant status with all creditors, including SBIC	9. Follow-on rounds of financing required by the portfolio company and the impact of pricing on the values of existing investments
10. Explanation of restructurings of company debt, including	10. A list of other significant investors in the portfolio company and an assessment

SBIC's investment, if any	of their ability and desire to provide additional financing to the company
11. Description of collateral, if any	11. Anticipated exit options, timing, values and proceeds to the SBIC
12. Anticipated nature of payoff, payoff timing and proceeds to the SBIC	

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 and beyond
5. All commitments made by the SBIC to invest in portfolio companies, including potential follow-on investments and estimated dates of funding
6. A three year forecast of the operations and financial position of the SBIC, tied to the Form 468
7. Disclosure of all third party debt

<u>Post-Portfolio Review Meeting Expectations</u>

The information provided in the meeting will enable SBA to make an informed decision on any credit matter (e.g. commitment application) or a transfer of the SBIC to the Office of Liquidation that may be pending or under consideration. In addition, the meeting provides SBA greater detail in SBA's continued monitoring of the SBIC and its investments going forward. Material deviations in performance from the materials and information presented in the meeting will necessitate follow up discussions with SBA.

F. <u>Capital Impairment</u>

This section only applies to SBICs with outstanding Debenture Leverage and does not apply to SBICs with outstanding Participating Securities Leverage. §107.1820 outlines the remedies that SBA may take with impaired SBICs with outstanding Participating Securities Leverage. SBICs may consult with their assigned SBA financial analyst for further guidance.

The condition of Capital Impairment is defined in §107.1830(c). When an SBIC has a condition of Capital Impairment, or SBA determines that an SBIC has a condition of capital impairment pursuant to §107.1830(f), SBA may take the remedies described in §107.1810. There are separate procedures, described later in this section, for SBICs licensed as Early Stage SBICs.

When SBA determines that you have a condition of Capital Impairment, the Agency takes the following steps:

1. SBA will send you a notice of default letter upon the Agency's determination that the SBIC has a condition of Capital Impairment. Capital Impairment is listed in the regulations under §107.1810(f)(5) as an "event of default with opportunity to cure." The letter provides you with at least 15 calendar days from the date of the letter to cure the impairment.

2. If the SBIC is unable to cure the impairment by the expiration of the given timeframe or submit an acceptable plan to cure the impairment, SBA may immediately transfer the SBIC to the Office of Liquidation pursuant to the rights granted to the Agency in §107.1810(g). At that time, SBA may also exercise any or all of the other rights noted in that section of the Regulations.

   Though the circumstances of each SBIC's impairment may be different, SBA's general requirements for a cure plan are:

   a. Cash flow forecast for the next two years, including anticipated Leverage draw downs, Leverage interest payments, and any voluntary expense reductions
   b. Exit forecast for each of the remaining investments in your portfolio
   c. Capital Impairment forecast for the next two years
   d. Leverage repayment plan
   e. Plan, if any, to raise additional Regulatory Capital

   The cure plan should note specific milestones for each component of the plan. You should highlight any anticipated event or action that would cure impairment.

3. If SBA determines that the cure plan is reasonable, SBA will allow the SBIC to remain under the oversight of the Office of SBIC Operations. SBA will require you to submit monthly written status reports until the SBIC cures its condition of Capital Impairment. There is no standard reporting format, but the reports should convey how the SBIC and its investments are performing against the cure plan.

4. Based on the SBIC's monthly reports and other communication with the SBIC, SBA will evaluate how you are progressing against the milestones established in the cure plan. SBA will consider the SBIC's financial performance, the status of its portfolio companies, and any deviations from the cure plan. SBA may transfer the SBIC to the Office of Liquidation at any time if it remains impaired, if it is not performing in accordance with the cure plan, or if there is another reason to transfer the SBIC.

Other Implications of Capital Impairment

If the impaired SBIC is part of a fund family under Common Control with combined outstanding Leverage of $150 million or more, then pursuant to §107.1120(d), the impaired SBIC **and its affiliated SBICs** are ineligible for additional Leverage draws.

If §107.1120(d) is not applicable to the impaired SBIC, then it may continue to submit Leverage draw applications. However, SBA expects an impaired SBIC to utilize its own funds first prior to seeking additional Leverage. This includes calling all remaining private investor commitments. SBA does not routinely approve Leverage draw applications from impaired SBICs. SBA will consider each Leverage draw application based on the circumstances and merits of the request. The SBIC should provide supporting justification with each Leverage draw application until it is able to cure impairment.

Early Stage SBICs

§107.1845 contains additional provisions for the determination of the CIP of Early Stage SBICs.

Early Stage SBICs are required under §107.1182(b) to promptly notify SBA in writing if CIP is 50% or higher. A 50% or higher CIP triggers certain valuation requirements, which are explained in §107.1182(c).

When SBA determines that an Early Stage SBIC has a condition of Capital Impairment, the Agency takes the following steps:

1. SBA will send a notice of default letter to the SBIC upon the Agency's determination that the SBIC has a condition of Capital Impairment. The letter provides the SBIC at least 15 calendar days from the date of the letter to cure the impairment.

2. If the SBIC is unable to cure the impairment by the expiration of the given timeframe, SBA may immediately transfer the SBIC to the Office of Liquidation pursuant to the rights granted to the Agency in §107.1810(g) and (j). At that time, SBA may also exercise any or all of the other rights noted in those sections of the Regulations.

For Early Stage SBICs, the opportunity to cure the impairment is limited to the cure period. SBA is not required to consider a plan to cure the impairment that takes longer than the cure period.

G. Maturing Leverage

Failure to make the final payment due on maturing leverage could result in immediate transfer to the Office of Liquidation.

In order to ensure that SBIC managers are aware of and adequately addressing upcoming Leverage maturities, SBA may request that an SBIC submit its plan to repay Leverage that matures within the next two interest payment dates for Debenture SBICs or within the next four Payment Dates for Early Stage or Participating Securities SBICs.