

BDC ROUNDTABLE

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SBIC Workshop The Advantages of SBICs

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Overview

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Overview

- A Small Business Investment Company (“**SBIC**”) is a privately owned and operated company that makes long-term investments in U.S.-based small businesses and is licensed by the U.S. Small Business Administration (“**SBA**”).
- The SBIC program was created in 1958 to fill the gap between the availability of venture capital and the needs of small businesses in start-up and growth situations.
- At the end of fiscal year 2008, the SBA had over \$8.5 billion invested in 348 funds, including outstanding commitments.
- Together with private capital of approximately \$9 billion, the program totaled over \$17.5 billion in capital resources at the end of fiscal year 2008. As of September 9, 2009, the program totaled over \$16.8 billion in capital resources.
- 5 new SBIC licenses granted in fiscal year 2008; 8 new SBIC licenses granted as of September 9, 2009.

American Recovery and Reinvestment Act of 2009

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- Section 505 of the Recovery Act raises the maximum amount of leverage that an SBIC may receive (leverage limits), increases the amount an SBIC may invest in a single qualifying small business and streamlines reporting requirements.
- Sets maximum SBA funding levels to SBICs at up to three times the private capital raised by the SBIC, or \$150 million, whichever is less and \$225 million for multiple licensees under common control.
- Maximum leverage limits are \$175 million for single funds and \$250 million for multiple funds under common control which are licensed after September 30, 2009, and invest 50% of their dollars in low-income geographic areas.
- Raises the percentage an SBIC can invest in a single small business or group of affiliated companies (the “overline” limit) to 10% of “total capital.”
 - Total capital is the sum of private capital and “the total amount of leverage projected by the SBIC in its business plan that was approved by SBA at the time of the grant of the company’s license.”
 - Since most SBICs project the use of two tiers of leverage (i.e., leverage equal to two times their private capital), this calculation is generally equivalent to raising the overline limit to 30% of private capital.
- Simplifies the percentage of any licensee’s dollar investments that must be made in “smaller” businesses by removing the current tier structure and delineating a flat 25%.

Guidance for Business Development Companies

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SBIC TechNote Number 13

- In March 2009, the Investment Division of the SBA issued guidance regarding the issuance of SBIC debenture licenses to publicly held investment companies that have elected to be regulated as BDCs
- With respect to SBIC subsidiaries of BDCs, the SBA will count a parent BDC's unfunded capital commitment as Regulatory Capital if:
 - The parent's funded net worth is at least ten times its total capital commitment to the SBIC; and
 - SBA is comfortable that sufficient liquidity exists to fund the commitment, taking in account such factors as cash on hand, access to additional equity capital and non-SBA credit facilities, operating income and expenses, historical and expected portfolio cash projections, and current and long-term liabilities.

- With respect to the calculation of the leverage commitment available to the SBIC of a BDC applicant, the SBA will consider the SBIC eligible to obtain a leverage commitment up to two times its Regulatory Capital if:
 - The parent BDC has funded net worth at least six times its total capital commitment to the SBIC; and
 - SBA is comfortable that sufficient liquidity exists to fund the commitment.
- The SBIC's leverage draw downs will initially be limited to a single tier and a 1:1 leverage ratio until Regulatory Capital is fully paid-in.
- If a parent BDC has funded net worth less than six times its total capital commitment to the SBIC and/or if the Investment Division determines that liquidity is insufficient, its commitment will only be counted as Regulatory Capital to the extent that it is paid-in.

Guidance for BDCs

- The SBA also issued the following guidance to BDC applicants:
 - SBICs may apply for leverage commitments a maximum of two times per calendar year;
 - BDC applicants are encouraged to carefully consider the appropriate Regulatory Capital amount in light of their investment strategy and typical investment size when determining whether or not an SBIC license is a good fit for their business;
 - SBICs that have a planned 10-15 year lifespan, rather than an evergreen or indefinite life structure, are preferred; and
 - As a general rule, SBA will only license funds that satisfactorily link, either directly or indirectly, incentive compensation of the principals responsible for the SBIC portfolio to the performance of the SBIC.

BDC/SBIC Structure

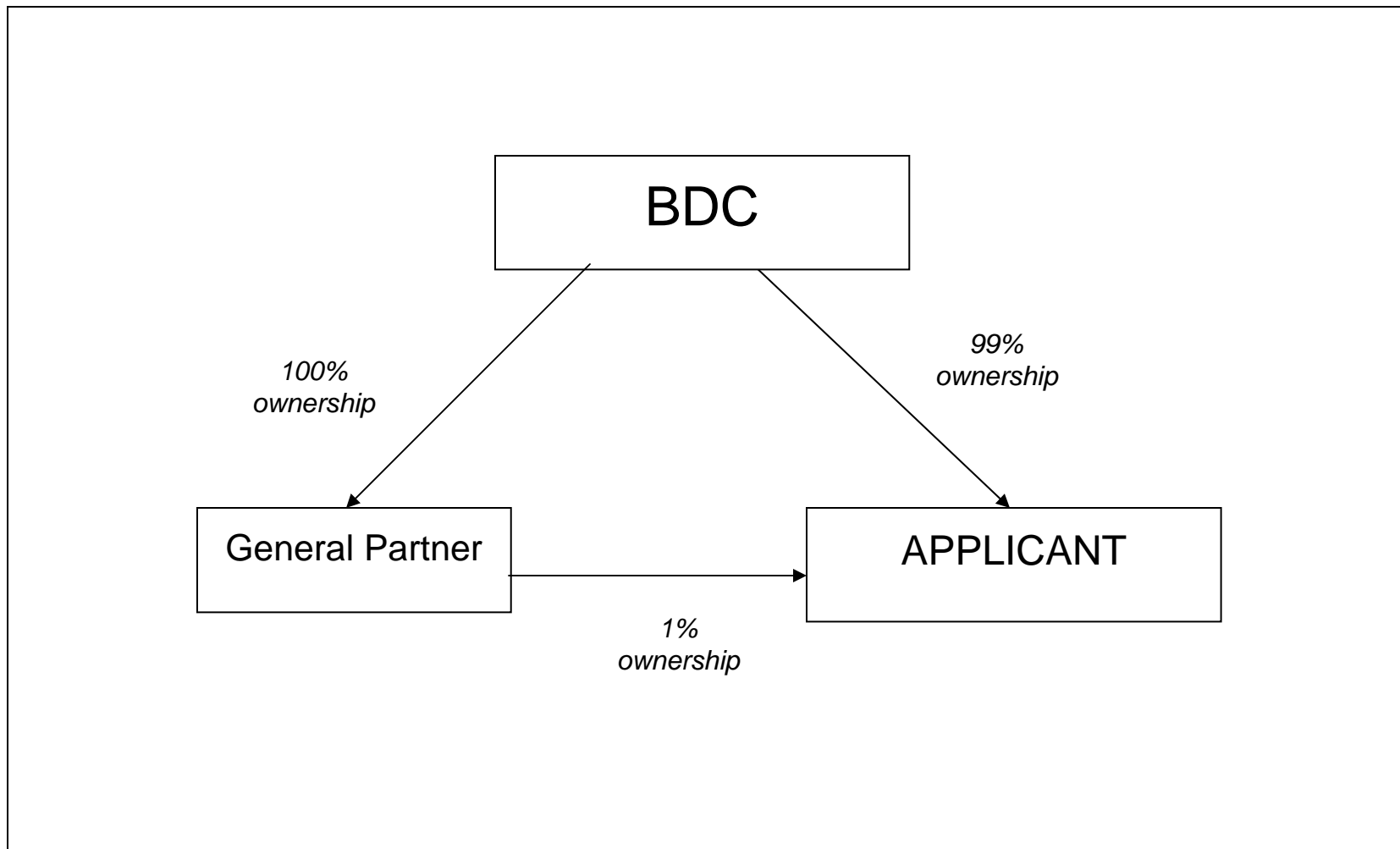
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BDC/SBIC Structure



BDC/SBIC Structure

BDCs that have SBIC subsidiaries:

- Hercules Technology Growth Capital, Inc.
- Medallion Financial Corp.
- MCG Capital Corporation
- Main Street Capital Corporation
- Rand Capital Corporation
- Triangle Capital Corporation

Exemptive Relief

- Relief to get SBIC leverage treatment at BDC level
- Section 18(a)
 - Question of whether BDC with an SBIC Subsidiary must comply with the asset coverage requirements of Section 18(a) (as modified by Section 61(a) for BDCs) on a consolidated basis
 - The senior securities issued by the SBIC Subsidiary would be excluded from the SBIC Subsidiary's individual asset coverage ratio by Section 18(k) if the SBIC Subsidiary were a BDC
 - Exemption requested-senior securities representing indebtedness issued by the SBIC Subsidiary may be excluded from the BDC's consolidated asset coverage ratio

Licensing Factors

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Licensing Factors

Suitability of Management

- In order to be licensed, an applicant's managers must generally meet the following criteria:
 - **senior-level decision-making experience in a private equity/mezzanine fund;**
 - **demonstrate evidence of strong deal flow in the investment area for the proposed fund;**
 - **investment experience as a principal rather than as an agent;**
 - **realized track record of superior returns benchmarked against funds of vintage year and style;**
 - **hands-on experience adding value at the portfolio company level; and**
 - **the management team must be cohesive, with complementary skills, history and strong chemistry.**
- During the licensing process, the SBA seeks to confirm that there is a qualified management team and that the SBIC has a good chance of operating profitably.

Suitability and Viability of Operating Plan

- Suitability of intended portfolio mix and plan of operations with the SBIC Program
 - For example: No project finance or investments in real estate speculation, motion pictures or wild-cat oil drilling
 - Need for licensee in operating area
- Economic feasibility of projected returns on investments with the amount of capital being raised and the plan of investment
- To be Licensed:
 - Debenture / Non-Leveraged: \$5 Million
- “Regulatory Capital” defined:
 - Either paid-in investments or unfunded but binding commitments from “Institutional Investors”
- “Institutional Investor” generally defined:
 - Entity or individual with at least \$10 million net worth
 - Individual with at least \$2 million net worth without residence and max commitment of 10% net worth
 - Banks or savings and loan associations or their holding companies, or insurance companies

Licensing Factors Management and Ownership Diversity

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To be Licensed:

- At least 30% of Regulatory Capital from sources unrelated to the management team
- The sources must qualify as suitable “Diversity Investors” per SBA Regulations at 13 C.F.R. 107.150
- Diversity Investors include either three or more unrelated investors or one or more “Regulated Institutional Investors”
- Publicly owned - look through to public owners

Licensing Process and Procedures

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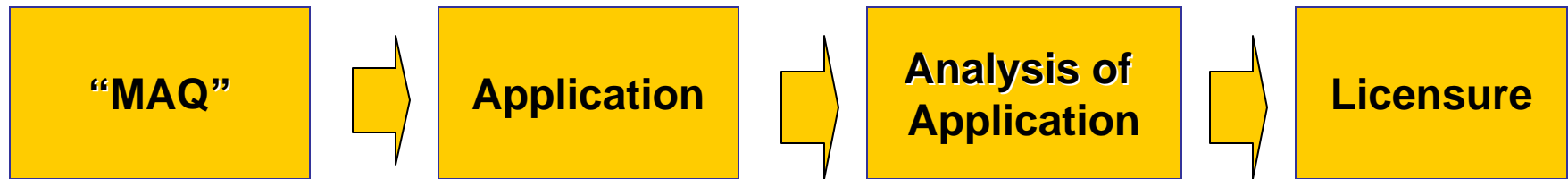


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SBIC Licensing Process

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- Initial Review
- Meeting with Investment Committee
- “Green Light”

- Minimum Regulatory Capital Committed
- “Pre-Licensing Investments”
- SBIC Class

- Due Diligence
- Analysis (Financial and Legal)
- Comment Letters
- Meeting with Investment Division

- 3 Levels of Decision Makers
- Timing: 6 to 8 Months
- Fees (SBA, Legal)

Licensing Procedures

Management Assessment Questionnaire

- Submission of “MAQ”
 - Managers’ backgrounds, track records and references
 - Investment and operating plan
- Invitation to meet with “Investment Committee”
 - Only if managers meet criteria and plan is suitable
 - At meeting, prospective applicants discuss and defend:
 - Venture capital and financial experience
 - Investment plan; proposed capital and legal structure
- “Green Light” or “Go Forth and Capitalize” Letter
- Timing: 2 to 3 months (if no issues arise)

Submission of Formal Application

- Application Fee - \$15,000 base filing fee is \$10,000, plus an additional \$5,000 for a partnership or limited liability company applicant.
- Certification by managers and significant investors
- Capital Certificate evidencing Regulatory Capital
 - Investor names and addresses; amounts committed or paid-in
 - Designation of “Institutional Investors”

“Pre-Licensing Investments”

- Only after application filed and formally accepted
 - SBIC program allows only “new money” and not existing investments to be included in Regulatory Capital
- Pre-approval by SBA required
 - Assures eligibility with SBIC regulations and policy
 - Submission of term sheet and portfolio company background
 - Timing: Must be submitted at least 10 business days prior to the proposed closing
- Attendance at Regulation Class (1 day) required

Licensing Procedures

Due Diligence Checks

- Background checks of managers by SBA
 - Reference Checks (ten professional references)
 - Examination of previous deals in track record
 - Lexis / Nexis database searches
- Background checks of managers by FBI
 - Vetting of all managers and significant investors through FBI Fingerprint and Name-check Divisions
- Determination of each manager's suitability

Licensing Procedures

Financial and Legal Analysis

- Plan of operations
 - Investment focus: Industry / Geographic / Stage / Size
 - Investment plan: Opportunistic vs. thematic
- Capital and legal structure
 - Stand Alone / Drop-down / Side-by-Side
- Legal documents
 - Operating Agreement
 - Corporate, LP, LLC
 - Management Agreement

Licensing Procedures

Comment Letters

- “Comment Letter”
 - Material issues: regulatory, financial and legal
 - Corrections and discussion points
 - Notices
- Response by Applicant in a timely manner maintains Applicant’s place in the queue (including changes in legal documents)
- Follow-up Comment Letter where needed

Three Levels of Decision-Makers

- Investment Division License Committee
 - Associate Administrator and Deputy; Directors of Investment Division Offices of Development, Operations, Examinations and Liquidation; Chief Counsel; Senior Policy Advisor
- Agency SBIC License Committee
 - Deputy Administrator; Associate Deputy Administrator for Capital Access; General Counsel and Deputy; Associate Administrator for Investment and Deputy; Directors, Investment Division Offices of Development, Operations
- SBA Administrator for Final Approval

Operations

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Accessing Leverage

- The SBA has implemented an accelerated commitment process for up to one tier of leverage.
- Applicant may apply for up to one tier of leverage prior to obtaining a license or up to 30 days after licensure.
- To apply:
 - Submit a standard commitment package, omit certain forms and replace one of the required statements

Just in Time Financing

- The SBIC Program permits the funds of investors and SBA leverage to be taken down by the Partnership in “lock step,” thereby delaying investor capital calls and increasing investor returns.
- SBIC is required to have a total Regulatory Capital of at least \$5 million.
- Only \$2.5 million of the SBIC’s Regulatory Capital needs to be paid-in prior to issuance of the SBIC license; once at least one-half of the \$2.5 million is invested, the SBIC will be eligible to use the SBA-issued leverage

Investment Size

- At least 25% of investments will be in Smaller Enterprises with a net worth of \$6 million (max) and a net income after taxes of \$2 million (max)
- No more than 75% of investments will be in Small Businesses with a net worth of \$18 million (max) and a net income after taxes of \$6 million (max)
- Maximum investment in any 1 company or group of affiliated companies (the “overline” limit”) is 10% of total capital
 - Total capital is the sum of private capital and “the total amount of leverage projected by the SBIC in its business plan that was approved by SBA at the time of the grant of the company’s license.”
 - Since most SBICs project the use of two tiers of leverage (i.e., leverage equal to two times their private capital), this calculation is generally equivalent to raising the overline limit to 30% of private capital.

Affiliate/Associate Issues

- SBICs are precluded from making investments in a Small Business if the investment would give rise to a conflict of interest.
- Generally, a conflict of interest may arise if an associate of the SBIC has or makes an investment in the Small Business or serves as one of its officers or directors or would otherwise benefit from the financing.
- Joint investing with an associate of the SBIC, such as another fund controlled by affiliates of the SBIC's general partner, may be made on identical terms or on terms which are fair to the SBIC.

Other Regulatory Requirements

- The General Partner or Board of Directors is required to value the SBIC's assets annually (semi-annually, if leverage is used) pursuant to valuation guidelines approved by the SBA.
- An SBIC using leverage must invest its "idle funds" not invested in Small Businesses in liquid, safe, short-term investments specified in the regulations (principally, U.S. government obligations, repurchase obligations, federally insured deposits, and deposits in "well-capitalized" federally insured financial institutions).
- If an SBIC issues leverage, it will be required to avoid "Capital Impairment" which will be considered to exist if the SBIC's "Capital Impairment Ratio" (calculated by adding the SBIC's realized losses and net unrealized depreciation and dividing the result by the SBIC's private capital) exceeds permitted levels detailed in the regulations and which vary depending on the proportion of equity investments made by the SBIC.
- An SBIC's ability to borrow funds from third parties is subject to SBA regulation. SBICs only may incur unsecured debt.

Regulatory Overview

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Capital Commitment:

- Commitment Fee: 1.0%
- Debenture Rate (semi-annual payment): most recently ten-year Treasuries + 200-225 basis points and is fixed at the time that the SBIC draws down the leverage.
- SBICs may draw down leverage from an existing leverage commitment upon one day's notice through an interim credit facility provided by the Federal Home Loan Bank of Chicago.
- A 2% "user" fee payable to the SBA and 37.5 basis points of underwriting fees are deducted from each disbursement under the credit facility.
- The SBIC pays an interim interest rate on each Debenture at the time of issuance.
- Every six months, all Debentures issued during the prior six-month period are pooled by the SBA and a new interest rate is established.
- Prepayment penalty charged to small business equal to 5% of the outstanding balance during the first year of any financing, declining by one percentage point per year through the fifth year, is considered reasonable.