Small Business Investment Companies 101

Cynthia Krus, Sutherland
Lisa Morgan, Sutherland
Kristi Craig, Small Business Investor Alliance
Beth Manzi, PEF Services LLC

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Agenda

• SBIC Program Overview
• Application Process
• SBIC Subsidiaries of BDCs
• Management Diversity and Operations
• SBIC Investments
• SBIC Accounting and Reporting
• Second Licenses
• Legislative Update
SBIC PROGRAM OVERVIEW
SBIC Program – 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 SBA

• Maximum SBA funding levels
  - $150 million, for fully funded SBICs (at $75 million)
  - $225 million, for multiple licensees under common control
  - $350 million, for multiple licensees under common control (legislation pending)
SBIC Program – FY 2012 Stats

• SBA licensed 30 new SBICs that have raised approximately $1 billion in private capital
  ▪ 27 debenture licenses
  ▪ 3 non-leveraged licenses awarded
• Approximately $1.9 billion in SBA commitments
• Approximately $3.1 billion into financing more than 1,000 small businesses
• Private and SBA capital under active management reached more than $18 billion, distributed across 301 operating SBICs
SBIC Program – Debentures

- SBA debentures have the following features:
  - Semi-annual interest-only payment
  - Coupon rate is 0.412% over the 10-year Treasury rate
    - Last pooling in March 2013 priced at 2.351%
  - 10-year maturity
  - No prepayment penalties
  - Unsecured
  - Non-recourse to managers
  - Debentures are pooled in March and September of each year
SBIC Program – Debentures

• **Debenture fees:**
  - 1.00% leverage fee on issuance of original commitment paid within 30 days of receipt of written commitment
  - 2.00% leverage fee deducted from each draw
  - 0.375% underwriter fee deducted from each draw
  - 0.05% administrative fee deducted from each draw
  - 0.76% annual charge on outstanding leverage on current fiscal year commitments
    - Percentage will vary based on the year commitment is issued

• **Distributions permitted subject to the following limitations:**
  - May distribute net realized, cumulative earnings less unrealized depreciation (READ – retained earnings available for distribution)
  - Distributions may not reduce investor capital by more than 2% in any fiscal year without SBA’s prior written approval
  - READ does not include non-cash income (e.g., PIK, OID, etc.)
APPLICATION PROCESS
## Application Process

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Application Process

• Pre-Screen Interview (2-4 weeks)
  - Executive Summary submitted to SBA Investment Division, which addresses:
    - Investment strategy;
    - Overview of investment criteria and target deal profile, including size, stage, industry and other portfolio company characteristics relevant to your investment strategy;
    - Team biographies and a summary of the principals’ experience working together, if any; and
    - Track record (template available on SBA website)
  - Feedback is non-binding
Application Process

• MAQ (2-3 months)
  ▪ SBA documentation, which includes:
    ▪ Complete Management Assessment Questionnaire ("MAQ") on Form 2181
    ▪ Legal proceeding certifications
    ▪ Track record
  ▪ Focus on management team qualifications
    ▪ Senior level investment experience
    ▪ Investment track record with above average returns
  ▪ Meet with Investment Committee for presentation
  ▪ Issuance of “green light” letter
Application Process

• License application (5-8 months)
  ▪ SBA documentation, which includes:
    ▪ Updated MAQ
    ▪ Fingerprint cards for each principal
    ▪ Legal proceedings certifications from each principal
    ▪ Comprehensive track record for each principal
    ▪ Business model
    ▪ Legal documentation (Form LP Agreement)
  ▪ Pre-licensing investments
  ▪ Committee level approvals
  ▪ Signed by SBA Administrator
SBIC SUBSIDIARIES OF BDCS
SBIC Subsidiaries of BDCs

• BDCs that have SBIC subsidiaries:
  ▪ SBICs that elected to become BDCs and conducted successful IPO:
    ▪ Main Street Capital Corporation
    ▪ Triangle Capital Corporation
    ▪ Fidus Investment Corporation
    ▪ Capitala Finance Corp. (in progress)
  ▪ BDCs that have received an SBIC license for a wholly owned subsidiary:
    ▪ Fifth Street Finance Corp.
    ▪ Golub Capital BDC, Inc.
    ▪ Hercules Technology Growth Capital, Inc.
    ▪ MCG Capital Corporation
    ▪ Medallion Financial Corporation
    ▪ PennantPark Investment Corp.
    ▪ Rand Capital Corporation
    ▪ Saratoga Investment Corporation
    ▪ Medley Capital Corp.
    ▪ Monroe Capital Corp.
  ▪ Additional BDCs are in the process of obtaining SBIC licenses
SBIC Subsidiaries of BDCs

• Options for BDCs interested in an SBIC subsidiary
  ▪ Obtain license through SBA
  ▪ Become minority investor in existing SBIC
  ▪ Convert an existing SBIC platform to a BDC

• How does an SBIC convert to a BDC?
  ▪ Conversion transaction
    ▪ Approval of LPs in advance of valuation and merger
    ▪ Merger of SBIC into subsidiary of BDC
    ▪ Amend limited partnership agreement
    ▪ SBA approval
  ▪ SEC review
    ▪ Registration statement
    ▪ Affiliate transaction issues
    ▪ Compensation issues
    ▪ Disclosure issues
SBIC Subsidiaries of BDCs

• Why are BDCs attractive to SBICs?
  ▪ Ability to access public market
  ▪ Flexibility in funding portfolio investments
  ▪ Permanent capital base
  ▪ Additional compensation incentives

• Why are SBICs attractive to the BDC market?
  ▪ Existing portfolio – not blind pool
  ▪ Existing management team with track record
  ▪ Market niche – lower middle market
  ▪ Additional leverage capacity
## Comparison of SBICs v. BDCs

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## Comparison of SBICs v. BDCs

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SBIC Subsidiaries of BDCs

- Exemptive relief under Section 18 to get SBIC leverage treatment at BDC level

- 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
SBIC Subsidiaries of BDCs

• TechNote 13
  - When will the SBA count a parent BDC’s unfunded capital commitment as regulatory capital?

• Key factors
  - What is the BDC’s funded net worth?
  - Does sufficient liquidity exist at parent BDC?
SBIC Subsidiaries of BDCs

- Assumes $225 million SBIC fund with $75 million BDC commitment:

| BDC’s net worth is in excess of $750 million (10 times capital commitment) | • Eligible to obtain capital commitment for $150 million  
  • Eligible to access full $150 million per SBA regulations  
  • Maintain a 2:1 leverage ratio |
|---|
| BDC’s net worth is in excess of $450 million (6 times capital commitment) | • Eligible to obtain capital commitment for $150 million  
  • Draws initially limited to $75 million (a single tier of leverage)  
  • Maintain a 1:1 leverage ratio  
  • Second $75 million available once $75 million commitment is paid in |
| BDC’s net worth is less than $450 million (less than 6 times capital commitment) | • Eligible to obtain commitment for 2x regulatory capital  
  • Capital commitment will only be counted as regulatory capital to the extent that it is paid in |
SBIC Subsidiaries of 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 (per SBIC TechNote 13)
  - 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
  - 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
MANAGEMENT DIVERSITY AND OPERATIONS
• Management ownership diversity
  ▪ No single investor may own more than 70% of SBIC’s private capital
  ▪ At least 30% of SBIC’s private capital must come from three or more investors who are unrelated to management
  ▪ Exception for traditional investment companies/BDCs
    ▪ BDCs may look through to public investors
    ▪ SBA has indicated that it will be satisfied if the percentage of investors not considered insiders is greater than 40%
SBIC Operations – Leverage Commitments and Draws

• Leverage commitment
  ▪ 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

• Just in time financing
  ▪ SBIC is eligible to draw down off of its leverage commitment
  ▪ These “draw requests” are processed by the SBA twice a month, and the SBIC must provide the SBA with a statement of need for such funds (as well as other required documents) in its draw request application
SBIC INVESTMENTS
SBIC Investments

- Investments
  - Size requirements
  - Conflicts of interest
  - Cost of money
  - Overline limitations
  - Prohibited investments
  - Anatomy of SBIC investment
Investments – Size Requirements

- Size requirements for small businesses and smaller enterprises
  - Defined in 13 CFR 107 and 13 CFR 121.103
- Small businesses (maximum of 75%)
  - All investments must meet the size standards below
    - Net worth of $18 million (maximum) and a net income after taxes of $6 million (maximum)
    - Use of NAICS codes as alternative using number of employees or gross revenues
- Smaller enterprises (at least 25%)
  - Net worth of $6 million (maximum) and a net income after taxes of $2 million (maximum)
  - Use of NAICS codes as alternative using number of employees or gross revenues
Investments – Affiliate Considerations

- A business is aggregated with all of its “affiliates” for size determination purposes
  - An entity/individual is an affiliate of an SBIC if one controls or has the power to control the other, or a third party controls or has the power to control both
  - Certain investors in small businesses are excepted from the definition of “affiliate” and do not impact size determination
    - Employee benefits plans, investment companies (including 3(c)(1) funds), VCOCs
Investments – Conflicts of Interest

- 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.
- Co-investing with associates generally requires prior SBA approval, unless exception is available.
Investments – Conflicts of Interest

• There are several exceptions to the need for prior SBA approval, including:
  ▪ Associate is a lending institution
  ▪ Co-investment on same terms and conditions
• If SBA approval is not required, SBIC must always be prepared to establish that the terms and conditions of the co-investment were fair and equitable to the SBIC
• Major focus of SBA examinations
• When in doubt, seek SBA approval
Investments – Cost of Money

- Cost of money – interest and other consideration that you receive from a small business
- Loans – maximum interest rate of 19%
- Debt – maximum interest rate of 14%
- You may exclude:
  - Discount on loan portion of debt security (OID)
  - Closing and application fees (maximum 3% (loan) or 5% (debt security)
  - Reasonable prepayment
  - Fees for management services (must have proper documentation for time spent)
  - Reasonable board of director fees (must be on par with all other board members)
Investments – Overline Limitation and Prohibited Investments

• Overline limit
  ▪ Maximum investment in any one company or group of affiliated companies 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
    ▪ Goal of the overline limit is portfolio diversification

• Prohibited investments
  ▪ Re-lenders/re-investors
  ▪ Project finance
  ▪ Most real estate projects
  ▪ Most foreign businesses
  ▪ Passive businesses
Investments – Anatomy of an SBIC Investment

- Loans
  - Debt instrument without provision to acquire equity securities
  - Interest rate up to 19%; 2% closing fee; 1% application fee

- Debt securities
  - Instruments evidencing a loan with an option or any other right to acquire equity securities
  - Interest rate up to 14%; 4% closing fee; 1% application fee
  - Consideration must be paid for all options (any nominal value, i.e., penny warrants)
  - Duration of not less than one year/more than 20 years
Investments – Anatomy of an SBIC Investment

• Equity securities
  ▪ Stock, options, warrants, LP interests, etc.
  ▪ 4% closing fee; 1% application fee
  ▪ Equity redemptions not permitted within one year, except:
    ▪ IPO/follow-on offering
    ▪ Change of management or control including payoff
    ▪ Bankruptcy
    ▪ Material breach of financing agreement
  ▪ Redemption price must be (i) fixed amount no higher than the price paid for securities or (ii) amount that cannot be fixed based on:
    ▪ Reasonable formula that reflects performance; or
    ▪ FMV at time of redemption determined by third-party professional appraisal firm
Investments – Anatomy of an SBIC Investment

• Amortization
  ▪ Straight line

• Prepayments
  ▪ “Reasonable” which is defined to be 5% in first year decreasing by 1% each year thereafter

• Default interest
  ▪ Up to 7% above the non-default rate provided that only can be charged for a payment default or a failure to provide information and NOT for a violation of covenants

• Break-up fee
  ▪ Equal to closing fee that would have been permitted
SBIC ACCOUNTING AND REPORTING
SBA Reporting

- **Quarterly and Annual Form 468**
  - SBA financial statement – due 30 days after each interim quarter end and 90 days after each year end
  - Non-leveraged SBICs are only required to submit annual Form 468

- **SBA Capital Certificate**
  - Investor details, regulatory and leverageable capital – filed when there is a change to regulatory or leverageable capital
  - Investor recertification

- **Form 1031**
  - Portfolio Company Financing Report – due 30 days after each investment is financed

- **Form 1031A**
  - Semi-Annual Certification of all Form 1031s filed for the preceding six-month period
New SBA Reporting Application (SBIC Web)

- SBA has mandated the use of SBIC Web by all SBICs going forward
- New system will be used to create and file Forms 468 and 1031
- Planned for use to upload
  - Bank letters - but not capital certificates yet
  - Valuation reports
  - Cap tables/waterfalls
SBA Examinations

• Annual exams
  ▪ Compliance oriented
  ▪ Current focus - deal terms, tracking cash, valuations, management fees
  ▪ Frequency - within first year of receiving license, then annually thereafter for leveraged SBICs

• Common regulatory violations
  ▪ Valuation guidelines not followed
  ▪ Excessive management fees - Section 107.680(a)
  ▪ Ineligible financings - Section 107.720(d)(1)
  ▪ Inactivity - Section 107.590(a) (older fund issue)
  ▪ Conflict of interest financings - Section 107.730(a)
  ▪ Capital impairment - Section 107.1830(e)
  ▪ Unapproved Prepayment Restrictions - Section 107.830(c)(2)

• Violations vs. “other matters”
• Examination planning recommendations
SBA and GAAP Differences

• Unrealized gains (losses)
  ▪ Are reported as direct increases/decreases to partners’ capital for SBA reporting purposes
  ▪ Are not included on the statement of operations (GAAP)

• Financial highlights are not required by the SBA
• SBA valuation policy is not GAAP
• Installment sale reporting
Management Fees

• Fees are generally between 2.0 – 2.5% of regulatory capital plus an assumed two tiers of leverage (see your LPA and the SBA TechNote 7A)

• Fee income from portfolio company services or closing fees subject to 100% offset (must benefit the fund)
  • A management services agreement is needed for consulting services provided to the portfolio company, and the services must be charged at a market hourly rate and fully documented for examiner review

• Fees related to additional LP commitments may only be charged in the quarter in which the SBA is notified (via capital certificate)

• Accounting for waived management fee and impact on Form 468 and capital certificate
Regulatory Requirements – Valuations

- TechNote 4 has recently been revised and addresses the documentation and reporting requirements for valuations
- Frequency of valuations – at least semi-annually
- Minutes documenting valuation approvals
- Dissenting opinions need to be documented in the minutes
- Formal resolution
- Documentation
SBA Valuation Guidelines

- The SBA valuation policy is required to be used for all SBIC funds
- Valuations are the responsibility of the GP
  - “A careful, conservative, yet realistic approach”
- Investment companies report investments at “fair value”
- The equity method is not used for investment companies
  - “The very nature of these investments makes the determination of fair market value problematical”
SBA Valuation Guidelines vs. GAAP

- SBA guidelines require the portfolio company to be self-financing for two years and have positive cash flow from operations for two years.

- For public stock, the SBA guidelines use the average of the last three trading days:
  - GAAP uses the value on the final day of the year.

- SBA guidelines require a discount for thinly traded stock:
  - GAAP prohibits this in most cases.
Capital Impairment

• If an SBIC issues leverage, it will be required to avoid “capital impairment” if the SBIC’s “capital impairment ratio” exceeds permitted levels detailed in the regulations and which vary depending on the proportion of equity investments made by the SBIC
  - Capital impairment ratio is calculated by adding the SBIC’s realized losses and net unrealized depreciation and dividing the result by the SBIC’s private capital
Duration/Expected Fund Life

- SBA prefers planned 10- to 15-year life
- SBA has been “quiet” on the short time to full investment
- Entering into a wind-up plan will be necessary at the end of the investment period
- Could be required earlier if subsequent license request is made
SECOND LICENSES
Second License – Overview

- Maximum amount of SBA leverage available to a “family of funds” is $225 million
  - Current legislation would increase the maximum amount of available SBA leverage to $350 million for two or more SBICs that are commonly controlled and not under capital impairment
- SBA prohibits SBICs under common control to co-invest in small businesses
- SBA developed a “fast track” process for second licenses
- Able to bypass MAQ submission and receive “green light” in approximately two weeks
  - Total time to license via fast track is approximately six months
Second License – Fast Track

• Requirements set forth in TechNote 14
• Process:
  ▪ Notify operations analyst in writing
  ▪ Office of Operations must make positive recommendation to Investment Committee
  ▪ If fast track “green light” letter is issued, then provide required documents under Forms 2181/2183
• Qualifications:
  ▪ Same business plan and management team (licensed within last eight years)
  ▪ At least two exams and three audited Forms 468 and positive portfolio company exits
  ▪ Positive cash flow from operations, no significant issues with capital impairment/compliance
  ▪ Not available to SBIC subsidiaries of BDCs
LEGISLATIVE UPDATE
Legislative Update

• Small Business Investment Company Modernization Act of 2013 – H.R. 1106 and S. 550
  - H.R. 1106 introduced on March 13, 2013, and co-sponsored by Steve Chabot (R-OH), David Cicilline (D-RI) and Renee Ellmers (R-NC)
  - S. 550 introduced on March 12, 2013, and sponsored by James Risch (R-ID)

• Key provisions
  - Increases the maximum leverage amount to the lesser of: (1) 300% of an SBIC’s private capital, or (2) $200 million
  - Increases to $350 million the maximum amount of outstanding leverage that may be made available to two or more SBICs that are commonly controlled and not under capital impairment
  - Proposes authorizing $4 billion in debenture guarantees for 2013
Legislative Update

• Expanding Access to Capital for Entrepreneurial Leaders Act (“EXCEL Act”) – S. 511
  ▪ Introduced on March 11, 2013
  ▪ Sponsored by Mary Landrieu (D-LA) and co-sponsored by Benjamin Cardin (D-MD)
  ▪ On June 17, 2013, the Senate Committee on Small Business voted favorably on the legislation as amended

• Key provisions
  ▪ Similar to the Small Business Investment Company Modernization Act of 2013
  ▪ Increases to $350 million the maximum amount of outstanding leverage that may be made available to two or more SBICs that are commonly controlled and not under capital impairment
  ▪ Proposes authorizing $4 billion in debenture guarantees for 2013
Contact Us

Cynthia Krus  
Partner  
Sutherland Asbill & Brennan LLP  
202.383.0218  
cynthia.krus@sutherland.com

Lisa Morgan  
Counsel  
Sutherland Asbill & Brennan LLP  
202.383.0523  
lisa.morgan@sutherland.com

Kristi Craig  
SVP Business Development  
Small Business Investor Alliance  
202.628.5057  
kcraig@sbia.org

Beth Manzi  
Chief Operating Officer  
PEF Services LLC  
212-203-4685 X118  
beth@pefundservices.com