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Report to the Ranking Republican, Committee on Armed Services, House of Representatives

July 1994

DEFENSE CONVERSION

Capital Conditions Have Improved for Small- and Medium-Sized Firms

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GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

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July 21, 1994

The Honorable Floyd Spence
Ranking Republican, Committee
on Armed Services
House of Representatives

Dear Mr. Spence:

The Fiscal Year 1994 National Defense Authorization Act authorized the Secretary of Defense to allocate up to $15 million for guaranteed loans to assist small firms in the defense industry convert to commercial applications. In response to your request, we are providing information on general trends in the availability of capital for small and medium-sized firms and on certain federal and nonfederal initiatives to improve access to capital for these firms. On April 29, 1994, we briefed your office on the results of our work. This report updates the information presented in that briefing.

Background

The largest cuts in the Department of Defense's (DOD) declining budgets have been in the purchases of goods and services. By 1995, real budget authority for these purchases will have declined a projected 67 percent from its peak in 1985. Cuts in DOD's procurement budget are forcing a consolidation of the defense industrial base and job loss for many defense industry workers, leading to initiatives to help defense firms, particularly small firms, convert defense-related technology to commercial use.

Several state, regional, and federal groups interested in defense conversion have conducted surveys to identify problems faced by defense firms in making that conversion. Respondents to these surveys, most of which were conducted in 1991 and 1992, generally rated capital assistance programs as among more needed forms of help.

Results in Brief

Available evidence indicated that business capital was tight in general at the time most of the surveys of defense firms were conducted, but it has since eased. During the recession of the early 1990s, investment declined throughout the economy. The decline partly reflected an expected decline in demand for capital during a recession. Changes in bank regulation, however, tended to constrain the supply of financing. Recent evidence from the banking industry, the venture capital industry, and small business industry associations indicated that the availability of capital was improving.

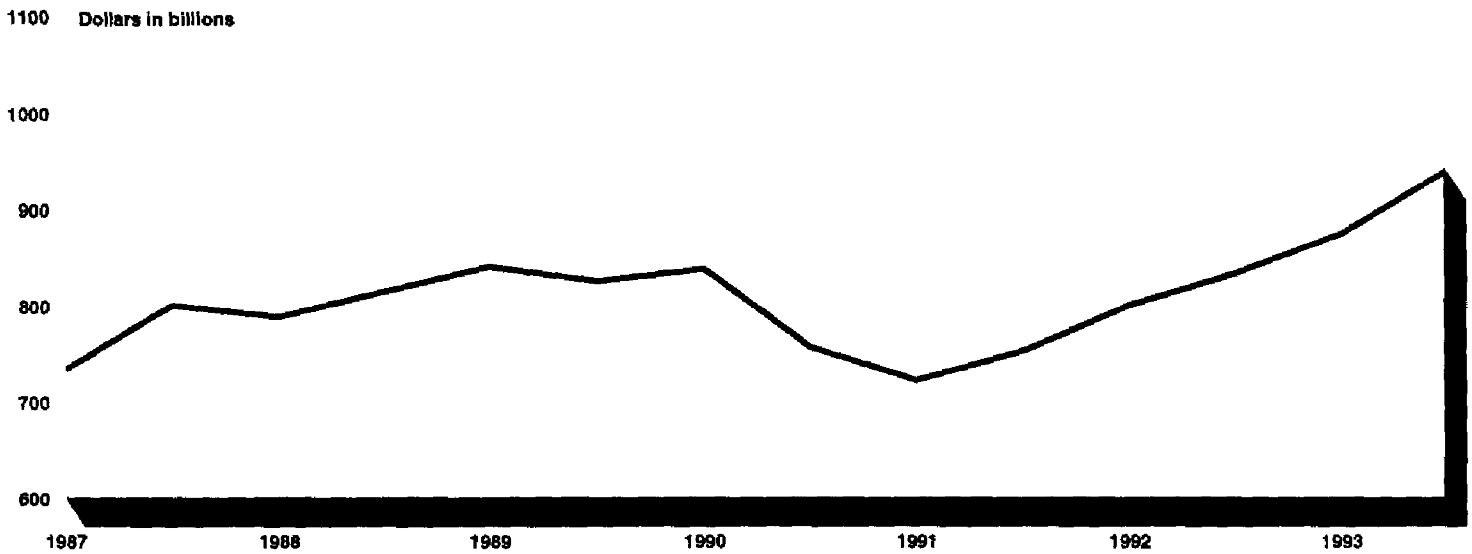
A number of initiatives are underway, or are being considered, to address the capital needs of small- and medium-sized businesses. The Small Business Administration's (SBA) guaranteed loan program is expanding rapidly. Congress is considering additional proposals to create programs that will help businesses obtain financing. In addition, a number of states have established loan or venture capital funds to assist local businesses.

Small- and medium-sized defense firms face fundamental challenges as they attempt to enter commercial markets, including lack of experience preparing business plans, difficulty in identifying commercial markets, and uncertainties in making pricing decisions. A guaranteed loan program would not address these challenges.

Capital Access Tightened During the Early 1990s

Although no clear measure exists of the availability of capital to small- and medium-sized firms, gross private direct investment does provide a measure of overall investment in the economy. This measure shows a decline in investment beginning in 1990 that reached a low point during the recession of the early 1990s and recovered to previous levels by 1993 (see fig. 1). Both the availability of investment funds and the demand for capital affect total investment. The investment decline of the early 1990s partly reflected an expected reduction in demand for capital during periods of recession. There is, however, evidence of constraints on the supply of capital during this period as well.

Figure 1: Gross Private Direct Investment, 1987-93



During the early 1990s, banks were subjected to new capital standards. Requirements adopted under an international accord known as the Basel Agreement linked bank capital to credit risk. Banks were required to maintain more capital for risky investments, such as commercial loans, but no capital for low-risk government securities. Consequently, replacing risky commercial loans with government securities could help a bank meet its capital requirements. Other approaches to meeting the capital requirements were raising more capital or reducing investments. Weak banks especially faced difficulty raising new capital, so reducing loans and other investments was the more feasible approach.

The impact of the new bank capital standards varied markedly by region and was greatest in regions that had experienced real estate market declines. In New England, for example, a drop in real estate values required banks to increase loss reserves held against real estate loans, which, in turn, reduced bank capital. Research sponsored by the Federal Reserve Bank of Boston indicated that meeting the new capital standards led the region's weakest banks to reduce loans and investments substantially. Other regions that were less affected by real estate market declines would have experienced a lesser constraint on the supply of bank lending.

During the early 1990s, changes in bank regulation intended to address the causes of widespread bank and savings and loan failures were implemented. Representatives of the banking industry believe that these regulations, although well-intended, constrain their ability to lend to smaller businesses. For example, the requirements concerning formal appraisals for real estate securing loans, implemented pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, are widely considered to be an impediment to small business lending. Some evidence also suggests that bank regulators adopted a more conservative approach to applying bank regulations in light of the 1980s banking crisis.

The lax lending standards of the 1980s were an aberration, according to both banking industry and small business association representatives we contacted. Lending standards tightened considerably during the early 1990s, meaning that banks were no longer making loans they might have made during the 1980s. Even though the current tighter standards may reflect historically normal lending practices, firms unable to obtain financing as a result of the tighter standards are likely to perceive that an ongoing "credit crunch" exists.

Capital Access Appears to Be Easing

The Federal Reserve Board's 1993 annual report on loan availability for small businesses states that bank financing is more available for such firms. Although the volume of commercial and industrial loans changed very little through 1993, the Board cites evidence that large firms are paying down bank debt and replacing bank debt with financing obtained from the public debt market. This decline in commercial and industrial loans to large firms, the Board reports, contrasts with significant increases in small loans, which are typically made to small- and medium-sized firms. Further, senior loan officers responding to the Board's quarterly survey reported an easing of lending standards for companies of all sizes during 1993 and significant increases in loan demand.

Small business surveys also reflect improved access to financing. For example, the Small Business Economic Survey, conducted by the National Federation of Independent Business (NFIB), found that 30 to 40 percent of respondents with over 40 employees reported during 1990 that loans were harder to obtain.[1] In its survey at the end of 1993, just 8.7 percent of respondents reported loans were harder to obtain—a level typical of the late 1980s—and just 1.9 percent reported that financing was their single most important problem. In addition, a special survey NFIB conducted in 1991 found that respondents ranked "obtaining long-term (over 5 years) loans" number 46 in importance on a list of 75 potential business problems; 40 percent of respondents reported obtaining such loans was not a problem. "Obtaining short-term (under 12 months) loans" and "obtaining equity financing" were ranked numbers 53 and 69 in importance, respectively.[2] Table 1 shows the results of NFIB's survey for the second and fourth quarters of 1989 through 1993.

Table 1: Results of NFIB's Small Business Economic Survey

Figures in percents

	All firms		Firms with over 40 employees	
Period	**Financing single most important problem**	**Loans harder to obtain**	**Financing single most important problem**	**Loans harder to obtain**
2nd Qtr. 1989	1.5	18.7	5.0	9.0
4th Qtr. 1989	1.1	15.1	5.1	5.3
2nd Qtr. 1990	1.1	26.2	5.6	30.2
4th Qtr. 1990	1.1	31.6	7.4	43.3
2nd Qtr. 1991	0.7	30.3	2.5	23.5
4th Qtr. 1991	0.4	24.7	1.3	26.0
2nd Qtr. 1992	0.5	24.1	2.5	24.7
4th Qtr. 1992	0.4	19.2	2.4	12.1
2nd Qtr. 1993	0.5	14.4	1.7	9.9
4th Qtr. 1993	0.4	14.3	1.9	8.7

Along with improved availability of debt financing, venture capital funds are making more equity financing available. Disbursements by venture capital funds peaked at about $4 billion in 1987 and declined steadily to a low of $1.4 billion in 1991. On the basis of data from the first half of 1993 (the latest data available as of May 1994), disbursements may have reached a total of $3.3 billion for 1993.

[1]NFIB has conducted its small business survey quarterly since 1973. It represents about 600,000 small businesses; the median size of member firms is 7 employees.

[2]Generally about 30 percent of firms surveyed respond to NFIB's quarterly surveys, and 33.5 percent responded to its 1991 special survey. In both cases, NFIB's analysis of responses indicated that firms responding were representative of all firms surveyed.

Several Initiatives Address Capital Access Issue

SBA's guaranteed lending authority is expanding rapidly, and SBA is taking steps to simplify its processes. SBA's guarantee authority totals $7.2 billion for fiscal year 1994, up from $3.8 billion in 1990. SBA projects an increase in lending authority to $13.5 billion by 1996. SBA's Certified and Preferred Lender programs are intended to make loan guarantees quicker and easier for small businesses to obtain. Under the Certified Lender program, lenders that meet certain criteria are promised a decision on an application for a loan guarantee within 3 days. Under the Preferred Lender program, SBA delegates authority to approve applications for loan guarantees from high-quality borrowers to lenders that meet certain criteria.

Congress is considering legislation that would improve access to financing for small- and medium-sized businesses. The National Competitiveness Act of 1994 (H.R. 820) includes provisions for a pilot program to support organizations that provide loans or venture capital investments to high-technology businesses. The Community Development, Credit Enhancement, and Regulatory Improvement Act of 1994 (H.R. 3474) includes provisions to support community development financial institutions that would make loans to businesses and other organizations in economically depressed areas. The bill also includes provisions to simplify and streamline bank regulation and improve access to financing for smaller businesses. Finally, the Economic Development Reauthorization Act of 1994 (H.R. 2442) includes provisions to create a clearinghouse to help firms commercializing federal technology obtain financing from federal, state, local, and private sources. The bill also requires the Secretary of Commerce to report to Congress on whether programs to support innovative economic development financing tools should be authorized.

A number of states have established loan and venture capital funds to promote local economic development. For example, Pennsylvania has established a network of loan funds generally offering subsidized interest rates to help businesses finance acquisition of land, buildings, machinery, and equipment. Similarly, New York State's Science and Technology Foundation manages a $7.9 million fund that provides loans and equity investments to high technology companies. The state has also provided loans to defense companies through the New York State Urban Development Corporation and Job Development Authority.

In addition, the Technology Capital Network is a program that seeks to improve communication about opportunities to make direct investments in start-up companies. Information on such investments, made outside of organized venture capital funds, generally travels by "word of mouth" among friends and business associates. Consequently, the number of individuals aware of a particular investment opportunity can be limited. The Network maintains databases of wealthy individuals interested in making direct investments and entrepreneurs seeking financing and matches investors and entrepreneurs with complementary interests. The Network is currently housed at the Massachusetts Institute of Technology, but its creator envisions a national network of such centers.

The Network concept may have significant potential for expanding the supply of equity funding for start-up companies. Organized venture capital funds supply approximately $3 billion in equity annually. Academic research on venture capital investments made outside organized funds suggests that the informal market may be up to 10 times as large as the organized market. The research also suggests that as few as 10 to 20 percent of the wealthy individuals who could participate in the informal market actually do so. The Network's creators believe that, by improving communication about investment opportunities in the informal market, a greater share of the market's potential could be tapped.

Unique Issues Hamper Defense Conversion Efforts

Firms attempting to convert from defense to commercial production face several unique issues, even though access to financing appears to be improving and a number of initiatives address the financing needs of small- and medium-sized businesses. First, defense firms have historically depended on progress payments for financing and lacked experience preparing business plans needed to obtain financing from banks or venture capital firms. Second, venture capital firms, in particular, seek companies that have a unique product or service that has near-term potential for high growth. According to one venture capital industry representative, a venture capital firm is likely to invest in just 5 of every 1,000 business proposals presented to it. Finally, defense firms—both large and small—often lack certain skills needed for success in the commercial market. Defense contractors we met with, state economic development officials, and researchers familiar with the defense industry cited a lack of experience identifying potential markets, making commercial pricing judgments, and developing products rapidly to capitalize on market opportunities as challenges facing defense firms.

Scope and Methodology

Because no comprehensive list of defense firms exists, we focused on examining trends in the supply of capital to small- and medium-sized firms in general. To accomplish our objective, we contacted representatives of the banking industry, the venture capital industry, SBA, small business trade associations, and selected firms in the defense industry to obtain their views on the availability of capital for small- and medium-sized businesses (see app. I). We also reviewed studies and reports addressing access to capital issues prepared by the Federal Reserve System and other organizations.

We performed our work between April and May 1994 in accordance with generally accepted government auditing standards. We did not obtain written agency comments on this report. However, we discussed the results of our work with officials of the Department of Defense, the National Economic Council, and other staff in the Executive Office of the President and incorporated their changes where appropriate.

As arranged with your office, unless you publicly announce this report's contents earlier, we plan no further distribution until 15 days from its issue date. At that time, we will send copies to the Chairmen of the Senate and House Committees on Armed Services and on Appropriations, the Secretary of Defense, and the Director of the Office of Management and Budget. Copies will also be made available to others on request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix II.

Sincerely yours,

David E. Cooper

David E. Cooper
Director, Acquisition Policy,
Technology, and Competitiveness Issues

Organizations Contacted

Banking Industry

Federal Reserve System
American Bankers Association
Shawmut Bank

Venture Capital Industry

National Venture Capital Association
Quarterdeck Investment Partners
Center for Venture Research

Industry Associations

National Federation of Independent Business
National Small Business United
American Business Conference

Small Business Administration

Office of Financial Assistance
Office of Small Business Development
Office of Government Contracts

Defense Industry Firms

Frisby Airborne Hydraulics, Inc.
Hughes Aircraft Company
Lockheed Corporation
Logistics Management Institute
Northrop Corporation
Raytheon Company
United Technologies Corporation

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