

1. Letter from the Associate Administrator for Investment

Dear Reader,

Welcome to this “Special Report” on the State of the Small Business Investment Company (“SBIC”) program. After forty-five years of being in business to support America’s entrepreneurs, we thought it was time you knew more about the SBIC program and where it is headed.

SBICs – privately-owned and managed venture capital funds – are the building blocks of long-term economic prosperity. At the end of FY 2002, SBIC investments supported over 10,800 entrepreneurial companies in 441 funds, with over \$11.8 billion in private venture capital and another \$5.1 billion in SBA matching funds.¹ As this report shows, SBIC financings work to fill the gap in private equity markets, especially at the earliest stages of a company’s growth.

The program is a unique way for the federal government to help U.S. small businesses. It is structured so that the government itself does not make direct investments or target specific industries. Essentially a “fund of funds,” the SBIC program outsources the portfolio management and investment decisions to qualified private fund managers, who invest in entrepreneurial companies based on their specialized knowledge of venture capital investing.

Alongside private equity, the government acts as a limited partner, seeking a return on its investment. In the broadest sense, those returns are in the form of major contributions to U.S. economic productivity, employment, and innovation:

SBICs – both leveraged and non-leveraged funds – are part of a legacy of early investing in some of the world’s most successful companies – America Online, Apple Computer, Callaway Golf, Costco, Federal Express, Intel, Outback Steakhouse, PeopleSoft, Staples, and others.

Of course, even with the program’s success stories, there is no way to sugarcoat the fact that anyone who has invested in venture capital has felt the pain associated with the decline in private equity markets over the last three years. SBICs are not immune to that decline. The SBIC program is a “zero-subsidy” program, supported by fees paid by the SBICs. As such, the program must be able to operate in a manner that ensures the return of SBA’s capital – and provides the federal government with a fair share in the profits of successful funds – to keep the program self-financing over the long term.

We view the current market environment as an opportunity for SBICs to prove their worth like never before. At a time when private investors are questioning their commitment to the venture capital asset class, SBA leverage – government-guaranteed matching investment funds – attracted \$800 million in private capital in FY 2002 alone. By encouraging private risk-taking, the program is capable of supporting thousands of entrepreneurs through the slow economic period, with the prospect of growing leading-edge businesses out of the down cycle.

¹ Figures obtained from SBIC Data Management.

Business Activities of the Investment Division

The Investment Division is running more like the business it is. We are executing an ambitious plan that puts into action several elements of the President's Management Agenda, the Administration's Agenda for Small Business, and the SBA's Strategic Plan. We are meeting or exceeding our performance objectives with respect to SBIC licensing, financings, examinations, and restructurings. With guiding principles, performance goals, and program priorities firmly in place, the Investment Division is continually reassessing its business plan to ensure that it produces measurable results.

Special Report. This Special Report is part of our new orientation – a starting point for reviewing SBIC portfolio performance while managing risk, fostering accountability, and demonstrating program results. In this report, we seek to describe the potential risks and rewards of taxpayers' participation in the SBIC program.

As this report shows, SBICs have helped generate billions of dollars in corporate revenues and income taxes, while creating over one million jobs and countless improvements to our health, safety, and way of life. These benefits continue to pay America many times over for the costs of running the program.

SBIC Licenses. The licensing process for new SBICs is the most critical element of our risk management strategy. Important measures are being implemented to increase the percentage of profitable funds in the future and to protect against the risk of financial loss to SBA and private investors. We are striving for a high degree of customer service, a rigorous approach to due diligence, a high level of coordination and teamwork, and strong consistency in our decision-making. We are excited about the teams of venture fund managers we are licensing today from across America.

Of course, the day we license a fund is the day we assume the risk that some or even all of SBA's investment may not be recovered. That is why we are focused on licensing qualified funds *and* rejecting applications that do not meet our licensing criteria. We respect the specialized nature of venture investing. SBIC application denials or dismissals are critical contributions to program risk management.

Annual SBIC Examinations. In FY 2002, the Office of SBIC Examinations performed a record 326 annual examinations. At the same time, the number of reports with compliance issues has declined from seventy-six in FY 2001 to seventy-one in FY 2002. We remain vigilant in our efforts to guard against fraud and other wrongdoing in the SBIC portfolio. We are seeing fewer improper financings, inappropriate distributions, conflicts of interest, and portfolio valuations that did not follow our guidelines.

In line with the President's Management Agenda for federal agencies, we have competitively outsourced a portion of these exams, starting with the non-leveraged SBICs that present no financial risk to the government.

Portfolio Oversight and Risk Assessment. The Office of SBIC Operations is undergoing change to dedicate more internal resources to risk management, better define portfolio company value, and establish clear policies and procedures for managing our portfolio. We believe we have an opportunity to play a prominent role in encouraging best practices in venture capital fund management, which is important not only to the integrity of the program but to the industry overall.

With the assistance of private fund managers, the Investment Division has built a new portfolio risk rating model to replace the current system of monitoring SBICs for regulatory and financial warning signs. When this tool is fully integrated into day-to-day oversight later in FY 2003, the program will benefit by having a more standardized system for assessing and managing risk at various stages of an SBIC's life. Over time it will also provide us with more information regarding total prospective portfolio losses, including where they fall in the range of SBIC program assumptions.

Underserved Markets

The days when venture capital consisted of financing companies only in Boston, or New York, or Silicon Valley, are long since over. Great companies can be found in every corner of this country. SBICs recognize that opportunity.

The economic impact of SBIC financings is felt in all 50 states, plus the District of Columbia, Puerto Rico and the Virgin Islands. In FY 2002 alone, over 1000 SBIC investments – with a value of over \$725 million – were reported in low and moderate income (LMI) areas.²

We are encouraging geographic diversity and investment in underserved markets through the use of available financial tools and aggressive outreach efforts. Fund management teams are using LMI Debentures (low-interest debt with no interest payment due for the first five years) to invest in LMI areas. SBICs, both leveraged and non-leveraged, remain excellent vehicles for investors to receive Community Reinvestment Act (CRA) credit for their investments.

Our long-term vision is to expand the reach of venture capital into every nook and cranny of America. American communities that are currently overlooked or underserved by venture capital can offer huge rewards to investors. We are dedicated to licensing qualified fund managers who seek to take advantage of those opportunities – managers who, with their venture investing experience and networks, can create lasting economic development and employment in urban, rural and struggling communities throughout America.

We hope this Special Report provides a better picture of what one of SBA's premier programs has contributed to the spirit and success of U.S. entrepreneurship. SBICs are unique public-private partnerships that, through the highs and lows of the market, help fuel the engines of growth in our economy – America's small businesses.

Sincerely,

Jeffrey D. Pierson
Associate Administrator for Investment

² Figures from Data Management using figures reported in FY 2002, not when financings actually occurred.