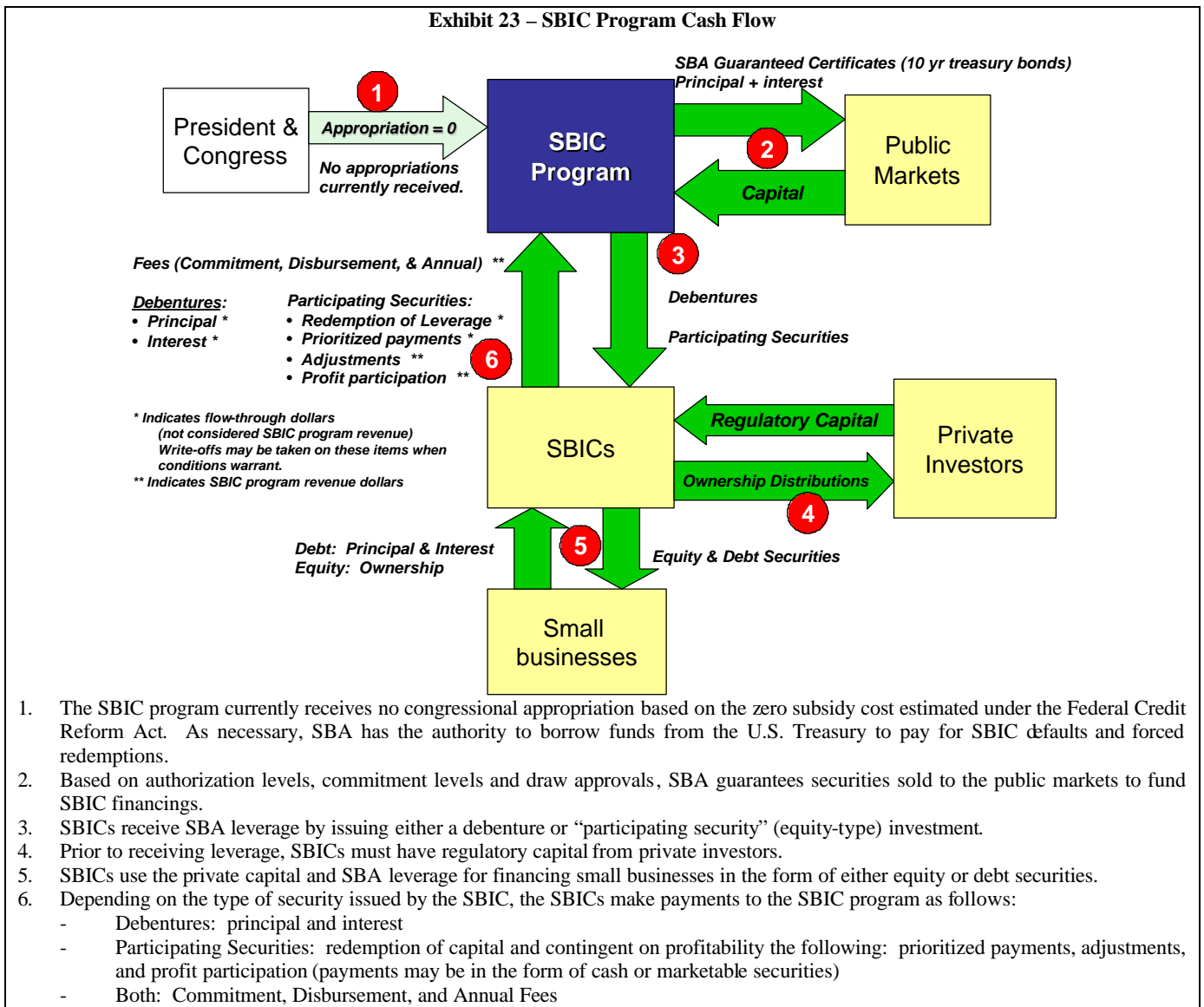


4. SBIC Program Financial Statements

The SBIC program is in many respects a real business with identifiable revenues, expenses, assets, liabilities – and the financial risks that go along with them. We have therefore developed a set of financial statements for the program – a preliminary picture of the financial items driving SBIC program revenues, losses, and cash flow. (Disclaimer: These SBIC financial statements were prepared from the program office data for commercial presentation purposes and may differ from the figures presented in SBA’s audited financial statements.)

SBIC Program Cash Flow. Exhibit 23 below provides a graphic overview of how money flows through the SBIC Program.



Our analysis starts by charting the accounts of the SBIC program, so that they correspond appropriately with typical corporate financial statement items. The table below explains how this has been done using existing program data and new databases created out of all available statistics. Investment Division personnel costs and certain fees associated with the operating of the program (such as Examination Fees and Licensing Fees) are not included in these financial statements, due to the nature of government reporting of these items. Each of the items below is further explained later in this section within the financial notes and discussion.

Financial Statement Item	SBIC Program Item
Profit and Loss Statement	
<ul style="list-style-type: none"> Revenues 	Appropriations (Now at zero) SBIC Commitment, Disbursement, and Annual Charges SBIC Adjustment Payments Net Profit Participation (Profit Participation Payments Made To SBA + Gain (loss) on Sale of Securities Received)
<ul style="list-style-type: none"> Expenses 	Actual and projected losses from leverage invested into SBICs
<ul style="list-style-type: none"> Net Income (loss) 	Revenues minus Expenses
Balance Sheet	
<ul style="list-style-type: none"> Assets 	Cash Reserve Balance SBIC Investments <ul style="list-style-type: none"> Active SBICs: <ul style="list-style-type: none"> Outstanding leverage Advanced prioritized payments Loss Allocations in Active Portfolio SBICs in Liquidations/Restructurings: <ul style="list-style-type: none"> Gross amount transferred (leverage and advanced prioritized payments) plus additions post transfer (such as judgments) Recoveries Actual losses and projected losses from SBIC portfolio in Liquidations/Restructurings
<ul style="list-style-type: none"> Liabilities & Capital 	<ul style="list-style-type: none"> Prioritized Payments Payable Total Funding, including interim and guaranteed pooled securities (Note: This equals the amount of outstanding leverage in assets. As outstanding leverage is increased, because securities are pooled to the public, no cash outflow occurs, except from associated advanced prioritized payments. However, these securities represent a liability to the program, as the SBA is the guarantor.) Cumulative SBIC Program Net Gains (Losses)

4.1 Consolidated SBIC Program Financials.

Since no financial statements have heretofore been developed and maintained for the SBIC program, a business starting point is required. Based on the beginning of the participating securities program, FY 1994 was chosen as the starting point, looking at only the debenture and participating security programs.

With the exception of appropriations and losses, all data was taken from the program records maintained by the Funding Administration Branch for the debenture and participating security programs for cohort years (FY of approvals) 1994 through 2002. These worksheets are developed by the Funding Administration Branch under the Office of Chief Administrative Officer. Appropriation data was provided by the Office of Chief Administrative Officer. Loss data was derived from the Subsidy Loss reports developed by Data Management under that same office. It should be noted that the SBIC financials disregard any leverage from previous cohort years and redeemable securities.

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Like a company with different product lines, the SBIC program has two different types of securities: debentures and participating securities. As shown in the diagram above, both have different repayment terms and associated risks. Therefore, it is appropriate to separate out each “product” in order to analyze how each area is performing. Financial statements are provided below for each program, along with the “consolidated” SBIC program.

Profit and Loss Statement²⁷

P&L for Cohort Years 1994 Through 2002 (in Millions of \$)	FY 1994 Through 2002 Activity			Notes
	Consolidated	Debenture	Participating Securities	
REVENUE				
Appropriations	228.9	79.5	149.4	a
Commitment, Disbursement, and Annual Charge	247.5	84.9	162.6	b
SBIC Adjustment Payments	5.8	-	5.8	c
Profit Participation				
Profit Participation Payments Made To SBA	280.7	-	280.7	d
Gain (Loss) on In-kind Securities	(13.0)	-	(13.0)	e
Net Profit Participation	<u>267.7</u>	<u>-</u>	<u>267.7</u>	
TOTAL REVENUE	\$ 749.9	\$ 164.4	\$ 585.5	
EXPENSE				
Actual Losses in Liquidations	<u>(1.1)</u>	<u>(1.1)</u>	<u>-</u>	f
Revenues minus Actual Losses	748.8	163.3	585.5	
Total Projected Losses on Assets	<u>(384.6)</u>	<u>(88.2)</u>	<u>(296.4)</u>	g
Consolidated Net Gain (Loss)	\$ <u>364.2</u>	\$ <u>75.2</u>	\$ <u>289.1</u>	

P&L Notes

- a Appropriations are government subsidies used to offset losses in the program. Appropriations went to zero in FY 2000 for the debentures program and FY 2002 for the participating securities program. Information was provided by Data Management.
- b Commitment, Disbursement, and Annual Charges are paid by the SBICs for the use of the capital.
- c Adjustment Payments are paid per Part 107, Section 1520. The Investment Division assumes that adjustment payments are earned when received.
- d Profit Participation payments are paid per Part 107, Section 1530. The Investment Division assumes that Profit Participation is earned when received by the Investment Division.
- e Represents gains or losses from sales of in-kind securities received by the SBA.
- f Losses represent actual write-offs/charge-offs on assets in liquidations.
- g This represents the projected losses or loss allowance for all assets within the program both in the restructurings/liquidations portfolio and the active portfolio, as projected in the “Annual Summary of SBICs and Ultimate Loss Rate Projections Report.” This number is estimated using historical information, as described in more detail in Section 4.2. However, as the Participating Securities Program has a ten year maturity, there is little historical data and the number above may be understated.

²⁷ These SBIC financial statements were prepared from the program office data for commercial presentation purposes and may differ from the figures presented in SBA’s audited financial statements.

Balance Sheet²⁸

Balance Sheet for Cohort Years 1994 through 2002
 (in Millions of \$)

ASSETS

	End Of FY 2002			Notes
	Consolidated	Debenture	Participating Securities	
Cash Reserve with zero beginning balance in 1994	54.3	93.9	(39.6)	a
SBIC Investments				
Active SBICs				
Outstanding Leverage	4,634.7	1,387.2	3,247.5	b
Unreimbursed Prioritized Payments	396.7	0.0	396.7	c
Cum Loss Allocations in Active Portfolio on Leverage/P	(238.3)	(65.9)	(172.4)	d
Net Active SBIC	4,793.2	1,321.3	3,471.8	
SBICs in Liquidation				
Leverage				
Gross Transferred Leverage	280.9	73.4	207.5	
Cum Recoveries	(3.1)	(2.9)	(0.3)	
<u>Cum. Actual Losses</u>	<u>(1.1)</u>	<u>(1.1)</u>	<u>-</u>	
Liquidation Portfolio Outstanding Leverage	276.7	69.4	207.2	e
<u>Loss Allocation Total</u>	<u>(102.1)</u>	<u>(22.3)</u>	<u>(79.8)</u>	f
Cum Total (Actual & Projected) Losses	(103.2)	(23.4)	(79.8)	
Net Liquidation SBIC Leverage	174.6	47.2	127.4	
Prioritized Payments				
Gross Unreimbursed Prioritized Payments Transferred	54.6		54.6	
Cum Recoveries	-		-	
<u>Cum. Actual Losses</u>	<u>-</u>		<u>-</u>	
Liquidation Outstanding Prioritized Payments	54.6		54.6	g
<u>Cum Projected PP Losses</u>	<u>(44.3)</u>		<u>(44.3)</u>	h
Net Liquidation Prioritized Payments	10.4		10.4	
Net SBICs in Liquidation	185.0	47.2	137.8	
TOTAL SBIC Investments	4,978.2	1,368.5	3,609.7	
TOTAL ASSETS	\$ 5,032.5	\$ 1,462.4	\$ 3,570.1	
LIABILITIES AND CAPITAL				
Prioritized Payments Payable	33.5		33.5	i
Total Funding & Capital	4,634.7	1,387.2	3,247.5	j
Retained Earnings for Period	364.2	75.2	289.1	k
TOTAL LIABILITIES AND CAPITAL	\$ 5,032.5	\$ 1,462.4	\$ 3,570.1	

Balance Sheet Notes

- a Started with a \$0 beginning balance and added in cashflows for the year from cashflow statement to derive ending balance.
- b Outstanding investments to active participating security and debenture SBICs that are overseen by the Office of SBIC Operations. Investments in this area are fully funded by SBA-Guaranteed Securities and Interim Funding.
- c This number reflects the amount of contingent unreimbursed prioritized payments that would be owed by the SBICs

²⁸ These SBIC financial statements were prepared from the program office data for commercial presentation purposes and may differ from the figures presented in SBA's audited financial statements.

Balance Sheet Notes

if they were profitable at FY 2002 end.

- d This figure represents the loss allocations in the active portfolio, as calculated by the SBIC program loss measure, as published in the “Annual Summary of SBICs and Ultimate Loss Rate Projections Report”. These figures differ from the cohort-based methodology required for budgeting under the Federal Credit Reform Act.

The calculation is based on an estimated Default Rate multiplied by an Estimated Loss Rate multiplied by the sum of the outstanding leverage and prioritized payments in the portfolio.

The estimated Default Rate is the total gross transferred leverage and advanced prioritized payments transferred into liquidation since 1966 divided by the total historical leverage plus advanced prioritized payment disbursements.

The Estimated Loss Rate is calculated by dividing the Allowances for Losses in Liquidation by the SBA Leverage When Transferred into Liquidation plus Advances Transferred to Liquidation. The Estimated Loss Rate applies only to those cases open in Liquidation.

Original SBIC and SSBIC calculations of both the default rate and the estimated loss rate are derived and applied separately.

As liquidations contains assets from preferred securities and debenture securities transferred to liquidations in years previous to FY 1994, a percentage of projected losses was derived based on the percentage of outstanding leverage attributable to FYs 1994 through 2002.

- e Represents outstanding leverage of SBICs that have for regulatory or financial reasons been transferred to the Office of Liquidations. This number is gross transferred leverage minus collections minus losses plus any additions since post transfer such as judgments or loans. When transferred, outstanding leverage is purchased from pools by the SBA, causing a cash outflow.
- f Represents projected losses in Liquidation Portfolio.

The Office of Liquidations performs an estimate of all projected net recoveries for all outstanding leverage that has been transferred to its office at the end of each FY. The assets of an SBIC from which SBA will seek to recover the leverage may include outstanding equities, debt securities, notes, or tangible property as well as any investment instrument an SBIC might have utilized in providing financing. At that time, using a detailed bottoms-up approach, on an asset by asset basis, the office reviews the recoverable value of the asset based on valuations, estimates, and appraisals as well as payment history, security, and other pertinent and available information dependent upon the type of holding, the priority of the investment, and the overall market conditions. The Office reassesses this estimate each year.

As liquidations contain assets from preferred securities and debenture securities transferred to liquidations in years previous to FY 1994, a percentage of projected losses was derived based on the percentage of outstanding leverage in liquidations attributable to FYs 1994 through 2002.

- g The number shown here is the total of outstanding prioritized payments transferred minus any recoveries or actual losses. Because Prioritized Payments are a contingent liability payable only from profits of the SBIC, they present a greater risk than outstanding leverage. Therefore, they are separated on the balance sheet from outstanding leverage to indicate this higher risk.

Balance Sheet Notes

While recoveries are ascertained from the Funding Administration Branch worksheets, actual losses for debentures are derived based on the percentage of recoveries attributable to cohort FYs 1994 through 2002 (i.e., it is assumed that recovery percentages of cohort years to overall recovery equals the actual loss percentage of cohort years to overall actual losses for that FY.)

- h Represents projected losses of prioritized payments. (See note f above to see how this is estimated.)
As shown, about 80% of prioritized payments transferred to liquidations are estimated as being a loss because of their contingent nature. These figures differ from the cohort-based methodology required for budgeting under the Federal Credit Reform Act.
- i This indicates the amount of Prioritized Payments, payable by the SBA as guarantor on behalf of the Active Participating Securities that do not have profits with which to make the payments.
- j Funding in terms of Interim Funding and Guaranteed Pools for Participating Securities and Debentures. Not included are commitments that have not yet been drawn down of \$3,668.1 million. They are not included in the balance sheet because they are contingent upon both a draw-down request and SBA approval.
- k This number is derived based on an initial zero cash balance for 1994 plus retained net income (losses) for each year.

4.2 Financial Discussion

Profit and Loss (P&L) Statement

While the SBIC program is not designed to make a profit, it is SBA's intention to ensure that the program – over time – does not lose money either, given appropriations and subsidies. The Profit & Loss Statement, including both actual and projected losses, should help indicate whether the program will break even with its current portfolio of investments.

As shown by the P&L Statement, between FY 1994 and 2002, the Debenture Program incurred a net gain of \$75.2 million and the Participating Securities Program incurred a net gain of \$289.1 million, resulting in a total \$364.2 million net gain. However, as the Participating Securities program has not yet completed a full business cycle, with ten year terms for guaranteed securities, projected losses must be looked at with some reservation. (Appendix B provides a full description of how projected losses are derived per the "Annual Summary of SBICs and Ultimate Loss Rate Projections," produced by Data Management.) We anticipate that as a fund of venture capital funds, the SBIC program's results will continue to reflect that of the rest of venture capital and the market.

Balance Sheet

While the Participating Securities Program appears to outperform the Debentures Program based on the P&L, the Balance Sheet demonstrates that, based on cash, the Debenture Program performs better. As shown, assuming a cash \$0 beginning balance for each program, at the end of FY 2002, the debenture program carried a \$93.9 million cash reserve, while the participating securities program carried a negative \$39.6 million cash balance, for a combined program cash balance total of \$54.3 million. Reasons for this difference include:

- Participating Security transfers into Liquidations of \$207.5 million of leverage (although \$.3 million was recovered) and \$54.6 million in prioritized payments through FYs 2000 and 2002. Transfers into Liquidations cause an immediate cash outflow for the program.
- Prioritized payments are advanced to trust certificate holders by the SBA, creating a receivable. As with any receivable, as it goes up, cash balance goes down. By the end of FY 2002, prioritized payments owed by the SBICs in the active portfolio totaled \$396.7 million. While the offsetting \$33.5 million in prioritized payments payable under liabilities somewhat offsets this figure, it still leaves over \$363.2 million as a cash out, not counting the additional \$54.6 million in Liquidations. Exhibit 24 on the next page shows the net prioritized payments in the active portfolio accumulating over time. As shown, additional prioritized payments resulted in cash out of \$129.2 million in the active portfolio in FY 2002.

Cash Drivers – Program Inflows and Outflows

The primary sources of outflows for the Debenture and Participating Securities Program are Advanced Prioritized Payments made on behalf of the SBICs and Transfers to Liquidations.²⁹ The primary cash inflows are Revenues, Recoveries in Liquidations, and Appropriations. (Prior to FY 2002, the SBIC program received appropriations to cover expected program costs.) For the program to operate in a cost neutral manner, fees and other inflows must be enough to cover losses sustained by the program over time. Timing is a relevant factor for measuring results. Generally, fees tend to come early in the loan guarantee cycle, while transfers to liquidations (also known as "defaults") will vary, depending on market conditions, as will recoveries. As discussed in Section 2.2, when the market is high, SBIC

²⁹ Neither actual nor projected losses impact the cash reserve as projected losses are accounted for in the balance sheet (offsetting P&L losses) and actual losses occur in liquidations where cash associated with the asset was already paid out.

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venture funds (as with the average venture fund) tend to perform well. When the market is down, it takes longer to realize returns. Therefore, to assess the financial performance of the SBIC program, SBA must estimate the percentage of outstanding guarantees that are likely to default as well as estimate the likely recoveries on any SBICs moved into liquidation status.³⁰

Cash drivers are identified below by year from FY 1994 through 2002, in order to begin evaluating trends.

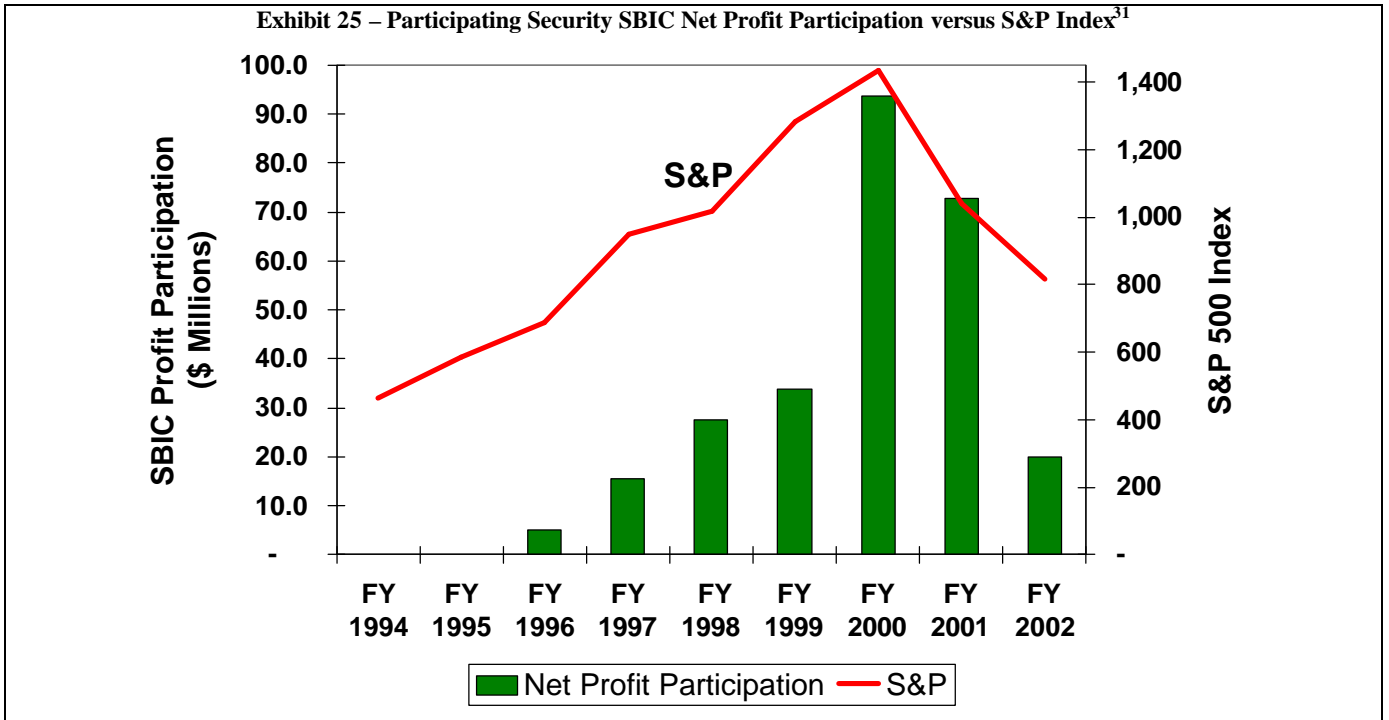
Exhibit 24 – SBIC Cash Drivers (\$Millions)											
CASH DRIVERS (In \$Millions)	FY 1994	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	Totals	Notes
<u>Cash Inflows</u>											
Other Revenues	1.3	5.1	11.2	24.5	50.9	65.9	149.0	139.2	73.8	521.1	
Appropriations	33.7	42.0	40.5	21.7	20.2	20.3	24.3	26.2	-	228.9	
Recoveries	-	-	-	-	-	-	0.2	-	2.9	3.1	
<u>Cash Outflows</u>											
Net Transfers to Liquidations	-	-	-	-	-	(0.8)	(11.6)	(76.5)	(246.7)	(335.5)	a
Net Prioritized Payments	-	(3.2)	(15.8)	(26.4)	(31.0)	(40.3)	(29.6)	(87.7)	(129.2)	(363.2)	b
Cashflow	35.0	43.9	35.9	19.8	40.1	45.1	132.4	1.3	(299.3)	54.3	
Cash Beginning	-	35.0	78.9	114.8	134.6	174.7	219.8	352.2	353.5		
Cash Ending	35.0	78.9	114.8	134.6	174.7	219.8	352.2	353.5	54.3		
<p>Notes: a) Net transfers to liquidations includes transfers to liquidations, any post transfer additions, such as judgements, minus any transfers back to operations & redeemable securities transferred. (Includes both leverage and prioritized payments.)</p> <p>b) Net prioritized payments are all prioritized payments that are owed by the SBICs that have actually been paid out by the SBIC program not transferred to liquidations.</p>											

As shown, since FY 2000 (the height of the venture capital market), revenues went down considerably and recoveries were negligible, while transfers to Liquidations and Prioritized Payments went up. Because of these conditions, cash decreased by 85% in FY 2002. Cash went from a balance of \$353.5 million in FY 2000 to a balance of \$54.3 million in FY 2002.

Given the decline in the stock market since FY 2000 and the resulting impacts to the venture industry, this is to be expected. Across the years the program returned \$521.1 million in revenues to the U.S. Treasury. However, as discussed in Section 2.2, when the stock market is down, the venture capital market suffers. As shown in Exhibit 25, when the market was high, SBICs returned profit participation, which has decreased since FY 2000. We anticipate that SBICs will continue to perform similarly to the rest of the venture capital industry.

Since the program is designed to break even over time, the SBA continues to assess and analyze the structure of the program in terms of fees and profit participation to keep the program at zero appropriation. Given the vicissitudes of the market, the fees and profit participation need to be high enough to cover cash outflows during the lows in the economic cycle. In addition, the SBA has developed and is currently testing a risk assessment model designed to provide increased communications and scrutiny commensurate with the assessed risk.

³⁰ For budgeting and accounting purposes, the SBIC program is included under the Federal Credit Reform Act (FCRA). The FCRA requires Federal credit agencies to estimate the net present value of the cost of loans and loan guarantees on a cohort basis and receive any required appropriations prior to entering into loan or loan guarantee commitments. To the extent that the original cost estimates underestimate the actual cost, permanent indefinite budget authority is available to cover the cost. To the extent that the original cost estimate overestimated the actual cost, the excess reserve amount is returned to Treasury and is not available to the program for any purpose without additional appropriations action



³¹ S&P Data derived from Commodity Systems Incorporated via Yahoo.com, using September historical prices (symbol SPB) through December 31, 2002.