Inspection
of
SBIC Best Practices

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TO: Erskine B. Bowles
Administrator

THROUGH: James F. Hoobler
Inspector General;

FROM: Tim Cross
Assistant Inspector General
for Inspection and Evaluation

SUBJECT: SBIC Best Practices Inspection

I am pleased to submit our inspection report on Small Business Investment Company (SBIC) Best Practices.

The inspection team received excellent cooperation from Investment Division staff and from senior officers of the SBICs it reviewed and their portfolio firms. Bob Stillman and his staff provided us with helpful feedback on the report in draft, and their formal comments on the final report are attached in full as an appendix.

We believe the inspection findings provide an accurate compilation of the characteristics that mark financially successful SBICs. We hope that this will prove useful to the Investment Division in licensing future SBICs, as well as to a broader audience seeking information about the program or about "best practice" analyses.

If you have any questions or comments, we would be happy to discuss them with you at your convenience.

Attachment

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ABBREVIATIONS

CEO	chief executive officer
CFO	chief financial officer
CPA	certified public accountant
IPO	initial public offering
LBO	leveraged buy out
MBA	Master of Business Administration
OIG	Office of Inspector General
SBA	Small Business Administration
SBC	small business concern
SBIC	small business investment company
SSBIC	specialized small business investment company

EXECUTIVE SUMMARY

Purpose and Background

Over the last several years, concern has mounted over the large number of Small Business Investment Companies (SBICs) that have failed. As of May 31, 1994, 199 active SBICs were in liquidation with outstanding Agency-guaranteed debt of more than $531 million. While the Small Business Administration (SBA) has identified a number of program deficiencies and begun to address them through extensive changes in SBIC regulations, relatively little attention has been given to examining the effective operations of financially successful SBICs. This inspection seeks to identify the "best practices" of a cross-section of successful SBICs for potentially broader application within the program.

The Office of Inspector General (OIG) initiated this study to assist SBA management in identifying and encouraging good program operations. Specifically, our objectives were to identify management practices common to profitable SBICs that could be replicated in new or otherwise less successful SBICs and to describe the impact such SBICs have had on the financial well-being of their successful portfolio companies.

SBICs are private sector corporations and partnerships that are licensed by SBA to provide equity capital and long-term debt, guaranteed by SBA, to small business concerns (SBCs) in need of financing for development, growth, and modernization. Since 1972, the Agency has also licensed specialized SBICs (SSBICs) to provide such financing to SBCs owned by socially or economically disadvantaged persons.

To qualify for a license, an applicant must meet capitalization requirements ($2.5 million for SBICs and $1.5 million for SSBICs) and have an SBA-approved manager to oversee the SBIC's' operations and to serve its portfolio companies. For each dollar of private capital raised, the SBICs may receive between two and three dollars of long-term (up to 10 years) leverage in the form of SBA-guaranteed debentures.

To identify SBIC best practices, we conducted case studies of nine financially successful SBICs which varied according to size of assets, investment orientation, concentration of industries in which they invest, and whether or not they were bank-affiliated. We conducted in-depth interviews with the presidents and key officers of the SBICs and reviewed the SBICs' financial records, business plans, and other pertinent information. We attempted to corroborate our observations by comparing the characteristics of the financially successful SBICs with those of failed SBICs. Finally, to estimate the profitable SBICs' impact on the financial condition of their portfolio companies, we surveyed key officers of 17 SBCs. These

'Unless otherwise indicated, SBICs include regular SBICs and SSBICs.

companies, selected from the portfolios of all nine SBICs, were among those identified by the SBIC presidents as their most financially successful investments.

We recognize that conclusions based on case studies of seven regular SBICs and two SSBICs are not representative of the universe of 280 active SBICs. We believe, however, that our comprehensive review of a cross-section of successful SBICs may offer useful insights into practices that correlate with SBIC profitability.

Principal Findings

Not surprisingly, we confirmed that well -qualified, capable management, and adequate capitalization are essential minimum requirements for an SBIC's financial success. More specifically, we found seven “best practices" that were common to the nine profitable SBICs we studied. Based on recently published studies, the opinions of knowledgeable Agency officials, and our file review of two SBICs in liquidation, these same practices are often absent from failed SBICs.

1. **Financially successful SBICs are headed by managers and officers who are well-qualified in terms of their work experience and academic backgrounds.** The top managers have many years of experience in venture capital or related fields, including investment banking and corporate finance, and, along with most other senior officers, have advanced degrees in relevant fields. Three out of four officers in the nine SBICs we visited had graduate degrees, over 80 percent of which were Masters degrees in Business Administration (~I13As). The bulk of the MBAs were obtained from the nation's 25 top graduate schools of business. Finally, senior managers in the SBCs we surveyed solidly praised the SBIC managers for their integrity, professionalism, and intuitive business sense.

2. **Profitable SBICs offer compensation packages and intangible benefits sufficient to attract and retain high-quality personnel.** Most *of* the presidents of the financially successful SBICs are compensated at levels equivalent to or higher than compensation received by their counterparts in private venture capital firms. Compensation includes salaries plus bonuses, often based on a percentage of the SBIC's annual pre -Tax income (usually 20 percent). The two SBICs we examined in which the presidents received compensation that was lower than the industry average had not yet implemented their planned bonus systems.

3. **Financially successful SBICs are adequately capitalized and follow good cash management principles.** The amount of private capital held by the SBICs we studied ranged from $1 million to $120 million. To ensure that they had adequate cash on

2Based on the U.S. News & World Report annual survey of graduate schools of business, March 21, 1994.

hand to meet current obligations, for example, the less-capitalized SBICs made smaller investments to spread risk more effectively and invested only in those SBCs that could be liquid within a two -to four year time frame.

4. **Profitable SBIC investment strategies generally minimize risk.** These strategies most often include investing in (1) industries in which the presidents and officers have personal experience and expertise, (2) later-stage companies with proven track records, (3) SBCs with an established market niche, and (4) SBCs whose management's have a record of competence and integrity. Overall, their investment strategies tended to be conservative, with emphasis on keeping risk low.

5. **Financially successful SBICs use a systematic approach to identify, evaluate, and structure deals.** All the SBICs have extensive, reliable networks of contacts to identify investment opportunities. Before making an investment decision, deal officers carefully assess the prospective SBC's management team and conduct a thorough due diligence review to determine the company's financial health and prospects for growth. When structuring a deal, the SBICs try to match the type of financial instrument -equity, debt, or some combination -with the needs of the SBC while ensuring an acceptable return for themselves.

6. **Profitable SBICs closely monitor the financial health of their portfolio companies to protect their interests.** Presidents and officers of the equity-oriented SBICs usually attend meetings of the SBCs' boards of directors and frequently occupy seats on the boards. They also regularly review the companies' financial and operational records. Debt -oriented SBICs monitor their SBCs primarily by establishing good cash collection procedures and rigorously following up on late payments.

7. **Successful SBICs add "value" to their portfolio companies, in conjunction with financing, thereby increasing the companies' net worth.** The SBICs actively assist their companies in recruiting key personnel, developing long -range strategy, analyzing prospective mergers and acquisitions, and obtaining additional sources of capital from banks and other investors. The presidents and key officers of the profitable portfolio companies in our survey stressed the important role such assistance had in their companies' financial success.

Impact of SBICs on Portfolio Companies' Financial Wellbeing

The nine SBICs had provided a total of $37.1 million in financing to the 17 SBCs surveyed, representing ova 21 percent of the SBCs' total financing. Overall, as of May 1994, the number of employees at the SBCs had doubled and the amount of their revenues had almost tripled since receiving the SBICs' initial financings. It must be noted, however, that these gains occurred in SBCs identified as among the most successful recipients of SBIC financing, and that, in most cases, the gains cannot be directly attributed to SBIC support because the SBCs also received other sources of financing. In four cases in which the SBIC was the only source of financing, however, the $6.6 million in SBIC investments fostered the creation of 268 jobs.

New SBA regulations issued in April 1994 require SBICs to assess and report annually the economic impact of each financing, including such indicators as the number of full -time equivalent jobs created or retained and the revenue and taxes generated by the companies. Depending on the quality of the data, e.g., the credibility of the job -creation figures submitted, we believe these reports will be useful for measuring the SBIC program's effectiveness. To minimize the burden on SBICs and to assure comparability through standardization, we suggest that SBA develop specific guidance for SBCs on the type of information to be provided. In addition, the Agency should require SBICs to report the total amount of financing each portfolio company received from other sources to enable SBA to estimate more accurately the extent of the SBICs' impact on the economy.

Investment Division Comments

The Investment Division commented that this report accurately summarizes the characteristics which it should seek to find in new license applicants and tries to encourage among its current licensees. In response to our observation that successful SBICs appear to favor investments in established, later -stage companies, the Division pointed out that to promote the public policy of developing new businesses, it sometimes encourages early -stage investment strategies. To offset the risk involved in such strategies, the Division stated that it carefully licenses managers with experience and talent in this type of investment. The Division reviewed a draft of this report and we have incorporated their comments into the final version. The full text of their comments can be found in Appendix B.

Background

To stimulate the small business segment of the economy, the Small Business Investment Act of 1958 (the Act) authorized the Small Business Administration (SBA) to license private sector corporations and partnerships, known as Small Business Investment Companies (SBICs), to provide equity capital and long -term loan funds to small business concerns (SBCs) in need of financing for their growth, expansion, and modernization. The Act was amended in 1972 to establish the specialized SBIC (SSBIC) program, which targets SBCs owned by socially or economically disadvantaged persons. SBICs' obtain their resources primarily from two sources--privately invested capital and long -term debentures guaranteed by SBA. As of September 30, 1993, there were l77 SBICs with about $2 billion in private capital and $548 million in SBA leverage, and 103 SSBICs with about $191 million in private capital and
$311 million in SBA leverage.

SBICs may finance SBCs through equity (stock), debt (loans), or a combination of both. Equity -oriented SBICs are those for which more than 70 percent of the total dollar amount *of* their investments in small businesses is in the form of equity financing. Conversely, debt-oriented SBICs have more than 70 percent of their dollar investments in the form of debt. All other SBICs are considered balanced. As of September 30, 1993, 65 SBICs were equity-oriented, 101 were debt -oriented, and 111 were balanced, according to a responsible SBA official.

To qualify for a license under the SBIC program, a corporation or limited partnership must meet minimum capitalization requirements ($2.5 million for SBICs and $1.5 million for SSBICs) and have an SBA approved manager to oversee the SBIC's operations and serve its portfolio companies. For each dollar of private capital maintained, the SBICs may receive up to $2 to $3 of long-term (up to 10 years) leverage in the form of SBA -guaranteed debentures. The debentures provide for semiannual interest payments and a lump-sum principal payment at maturity. In addition, an SSBIC qualifies for leverage equal to 100 percent of its private capital through the sale of 4 percent, cumulative, preferred stock to SBA.

In recent years, the Congress and SBA have become concerned over the increasing number of SBICs entering liquidation. According to the U.S. General Accounting Office, for the five-year period ending in September 1991, SBA incurred losses of over $90 million from the liquidation of 126 SBICs. This was more than 3 -1/2 times the amount lost during the previous 28 years. Most SBICs entered liquidation due to excessive losses, defaults on payments to SBA, or bankruptcy. [2] As of May 31, 1994, 199 active SBICs were in liquidation with outstanding SBA guaranteed debt of over $531 million.

[1]Unless otherwise noted, “SBIC” represents both regular SBICs and SSBICs.

2<u>Small Business: Financial Health of Small Business Investment Companies</u> (GAOIRCED-93-51, May 5, 1993, p. 1).

In April 1994, SBA issued new regulations for the SBIC program that affected the eligibility and operations of the SBICs and the financial assistance provided by SBA. A key change to the regulations was the establishment of a new form of SBA leverage known as a participating security,3 available to regular SBICs that make equity investments. Under the previous regulations, leverage for regular SBICs consisted solely of debentures requiring semiannual interest payments. Regular SBICs that primarily made equity investments, however, were often unable to meet their payments on debentures due to insufficient returns from SBCs with low cash flow. With the participating securities, the SBICs are required to make payments to holders of the securities only after sufficient profits have been earned.

Other changes to the SBIC program regulations in 1994 include (1) a requirement that each SBIC's management have the necessary "knowledge, experience and capability" to make the type of investments contemplated under the program and stipulated in the SBIC's business plan, (2) an increase in the maximum amount of SBA leverage available to each SBIC from $35 million to $90 million, and (3) a requirement that the SBICs report on the economic impact of each SBIC financing, specifying jobs created or retained, expanded revenues and taxes generated by the SBC, and other economic benefits. [4]

The SBIC program is administered by SBA's Investment Division. Within the Division, the Office of Operations oversees and regulates all SBICs in good standing. At the end of each fiscal year, the Office requires each SBIC to submit a report (SBA Form 468) that includes independently audited financial statements. Operations staff review the reports to determine the financial health of the SBICs.

In addition, the Division's Office of Liquidation oversees the liquidation and sale of assets of SBICs that have violated program regulations or entered bankruptcy. The Office of Examination inspects the books and records of active SBICs to ensure compliance with program regulations. Finally, a newly founded Licensing Unit is responsible for performing in-depth analyses of applicants' business plans, management qualifications, performance projections, and other criteria to ensure that new SBICs meet eligibility requirements and standards for quality.

[3]Participating securities are equity -type securities with the characteristics of preferred stock or a preferred limited partnership interest. Payment on these securities is required only to the extent of earnings.

[4]Federal Register, Vol. 59, No. 68, Part II, pp.l6897 -16956, April 8, 1994.

Objectives, Scope, and Methodology

We initiated this inspection in November 1993, in response to the Clinton Administration's emphasis on identifying and encouraging good program operations throughout Government. Specifically, the objectives of our inspection were (1) to identify management practices common to financially successful SBICs that could be replicated in new or otherwise less successful SBICs and (2) to determine the impact such SBICs have had on their portfolio companies in terms of growth.

To obtain information on the operations and management components of a successful venture capital firm, we met with outside venture capital experts, the presidents of the National Association of Small Business Investment Companies and the National Association of Investment Companies, and key SBA officials.

We also conducted case studies of nine financially successful SBICs, including two SSBICs, to identify traits common to profitable SBICs. The seven regular SBICs we examined included BT Capital Corp. (New York), Capital Southwest Venture Corp. (Dallas), CIP Capital, L.P. (Malvern, PA), Kansas Venture Capital, Inc. (Overland Park, KA), Norwest Growth Fund, Inc. (Minneapolis), TLC Funding Corp. (Tarrytown, NY), and Ventex Partners, Ltd. (Houston); the two SSBICs were Peterson Finance and Investment Company (Chicago) and TSG Ventures, Inc. (Stanford, CT). Appendix A to this report provides a profile of each SBIC and SSBIC.

To select the companies for our case studies, we asked Investment Division officials to identify regular SBICs and SSBICs that, based on their knowledge and experience, were operating at a profit. We then verified the selected companies' profitability based on their most recent annual financial statements filed with SBA. We considered their net income[5], return on invested capital[6], unrealized gains, liquidity, and retained earnings. We eliminated any companies in which SBA examiners or auditors had recently found regulatory violations. Finally, using Investment Division data on SBIC investment activities and financial condition, we selected what we consider a fair representation of SBICs in terms of size, investment orientation, bank affiliation, and concentration of industries in which they invest. To distinguish by size, we defined a large SBIC as having more than $10 million in capital resources and a small SBIC as having less than $5 million. We used the Investment Division's criteria to determine investment affiliation: an equity-oriented SBIC is defined as one that made 70 percent or more of its financings (in terms of dollars) through equity investments and a loan-oriented SBIC as one that made 70 percent or more of its financings in loans.

[5]Defined as net investment income plus realized gain on sale of securities.

[6]Defined as the ratio of net income to private capital plus retained earnings.

For selection purposes, we defined a bank -dominated SBIC as one in which a bank had at least a 50 percent interest and a nonbank SBIC as one with no bank ownership. We defined an industry-concentrated SBIC as one with at least 60 percent of its financings in any one particular major industry area (as defined by SIC codes) and a diversified SBIC as one with no more than 40 percent of its financings in any one major industry area Finally, we selected one Black-operated SSBIC and one Asian -operated SSBIC.

To conduct our case studies, we reviewed SBA files containing each SBIC's licensing application and pertinent information on its operations. These files included such documentation as officers' resumes, business plans, and annual financial statements. When necessary, we obtained clarification on information contained in the files from the SBA account executive responsible for the SBIC.

In addition, we conducted in -depth interviews with the presidents and other key officers of the SBICs, and, in some cases, members of their boards of directors. During these interviews, we obtained information on the background and characteristics of the SBIC officers, officers' compensation arrangements, fund -raising and investment strategies, deal structuring, monitoring of investments, the extent of technical assistance provided to portfolio companies, and exit strategies.

We also compared the SBIC presidents' compensation with that of their counterparts in private sector venture capital Firms, as reported by Hay Management Consultants in its 1992 annual Hay Venture Capital/LBO Industry Compensation Report (the most recent year available). We excluded from our analysis the compensation of the presidents of two SBICs that made only loans. In our opinion, these SBICs functioned more as lending companies than venture capital firms, and salary comparisons between the two groups would not be valid. For the seven presidents whose salaries we compared with the Hay Consultants' data, we used SBIC presidents' base salaries for the most recently available fiscal year combined with any bonuses received in 1993. We compared these compensation levels with the median Compensation levels (salary plus bonus) reported by the Hay Group. The median was based on self-reports of 59 presidents/chief executive officers (CEOs) who responded to the survey.

We recognize that because this study's conclusions are based on case studies of seven regular SBICs and two SSBICs, they cannot be projected to the universe of 280 SBICs. The nine SBICs are not intended to be a representative sample of all SBICs. We believe, however, that our comprehensive data gathering on a cross -section of SBICs make the common factors we identified among the nine financially successful SBICs useful for projecting whether individual SBICs will be profitable.

We attempted to further substantiate our observations by comparing the characteristics of the financially successful SBICs in our study with those of failed SBICs. To determine factors lending to the financial failure of SBICs, we reviewed recent reports on the subject and spoke with the former Director and the current Acting Director of the Liquidation Division, as well as with other knowledgeable officials in the Investment Division. We also reviewed the files of one SBIC and one SSBIC currently in liquidation and clarified information contained in the files with the responsible SBA officials and Agents in receivership. [7] Liquidation officials selected the files at our request to illustrate the characteristics of failed SBICs.

To determine the impact that the SBICs in our study have had on successful SBCs in their portfolios, we conducted telephone interviews with the presidents or other key officials of 17 SBCs that have received financing from the SBICs. We obtained information from at least one SBC for each of the nine SBICs in our study. The companies we contacted were among those identified by the SBICs as their most profitable, subsequent to receiving the SBIC's financing.

We conducted our work between December 1993 and June 1994 in accordance with the Quality Standards for Inspections issued in March 1993 by the President's Council on Integrity and Efficiency.

[7]Under a receivership, a Federal court appoints SBA as “receiver” to liquidate SBICs' assets. SBA, in turn contracts with agents for this purpose and oversees their work.

FINDINGS

Practices Common to Profitable SBICs

Practice 1. Financially successful SBICs are headed by managers who are well qualified in terms of their work experience and academic backgrounds.

Attributes:

· Presidents had many years of experience in venture capital or related fields.

· Presidents and officers had relevant academic training--frequently advanced degrees-- business related fields.

· Presidents exhibited integrity and strong business skills, in the opinions of portfolio company officials .

Overwhelmingly, the presidents and officers of the SBICs we visited were well-qualified for their positions, based both on their previous work experience and academic training. The heads of the portfolio companies with whom we spoke expressed great respect for their respective SBIC presidents' business acumen, integrity, and willingness to share their expertise with the SBCs.

Principals Had Many Years of Relevant Work Experience

At each of the seven SBICs we visited that made equity investments, the presidents had many years of previous venture capital, investment, investment banking, and/or corporate finance experience. At the two loan-oriented SBICs, the presidents appeared to be equally well-qualified: both were certified public accountants (CPAs) with several years of public accounting experience, and one also had several years experience in owning and operating a finance company. Most of the presidents had been in their current positions for at least 10 years. Furthermore, the majority of the professional staff at the equity -oriented SBICs had worked for two or more years in investment banking, corporate finance, or venture capital before joining the SBIC.

SBIC representatives, SBA program officials, and other outside experts agree that experience in venture capital and related areas, e.g., investment banking or corporate finance, is critical to successfully managing an SBIC. These backgrounds are valuable in raising private capital for the SBIC, identifying deal sources, and making wise investment decisions. A recent study on private venture capital reported a link between venture capital experience and a firm's ability to attract private capital. [8] By the same token, knowledgeable SBA officials consider experience in commercial lending, credit management, and collection vital for the successful management of a loan -oriented SBIC.

The president of one equity -oriented SBIC --who has held the positio n for 11 years--previously had nine years of investment banking and corporate finance experience, including negotiating mergers and acquisitions, before joining the SBIC as a vice -president in 1979. In addition, he had also owned and operated a small business for five years--an experience which he said is valuable in making decisions on whether or not to finance a prospective company.

The head of another equity -oriented SBIC had more than 25 years of investment banking, corporate finance, and venture capital experience when he assumed his position in 1984. He also sits on the boards of directors of several outside companies. Several SBIC officers at the equity -oriented SBICs we visited told us that they had made their employment decisions based, in part, on the quality and experience of the SBIC's management team and the mentoring that the new officers expected to receive from their managers.

The presidents of the two SBICs that make strictly loan financings were also well-qualified. One, for example, is an attorney and CPA who also owns and operates an equipment financing company. President since the SBIC was licensed in 1970, he also has about 40 years of experience as an attorney (specializing in commercial and tax law) and 30 years as a partner in a public accounting practice.

Officers Had Relevant Advanced Degrees

By and large, the presidents and other deal officers [9] have excellent academic qualifications. Of the 37 officers in the nine SBICs we studied, nearly three-quarters have one or more graduate degrees, 81 percent of which are MBAs. Other advanced degrees include JDs, MSs or PhDs in Engineering or Technology, and an MS in Economics. Seventy -seven percent of the MBA holders obtained their degrees from business schools that rank among the nation's top 25. [10] In addition, almost half of the 37 officers had received scholastic honors in their undergraduate or graduate programs (e.g., graduating magna cum laude), and 30 percent had obtained a CPA certificate. Jeffry Timmons, the co -author of Venture Capital at a Crossroads and a leading researcher on venture capitalism, stated that he has consistently

[8] W.Bygrave and J. Timmons, Venture Capital at the Crossroads (Boston: 1992), p.202.

[9] Deal officers are professional staff at equity -oriented SBICs who engage in identifying and evaluating investment opportunities and structuring the resulting deals.

[10] Based on the U.S. News & World Report annual survey of graduate schools of business, March 21, 1994.

observed that better -managed venture capital firms are characterized by managers who have excelled in their academic or professional pursuits, regardless of the field.

Members of Boards of Directors Were Also Highly Qualified

Three of the nine SBICs have active boards of directors, i.e., boards which meet regularly on a formal basis, have responsibility for approving all investing and/or lending decisions, and whose members assist - through their extensive professional and/or community networks--in identifying or evaluating deal opportunities. In all three SBICs, the board members have wide-ranging experience in venture capital or commercial lending and in many cases are leaders in their fields. For example, in one large bank-dominated SBIC which makes numerous investments in manufacturing, board members include former CEOs of major manufacturing corporations, and the past chairman and vice chairman of the parent bank.

Personal Characteristics of SBIC Managers and Officers

The presidents and other key officers of the SBICs' portfolio companies that we surveyed voiced strong praise for the SBIC managers in terms of their integrity, professionalism, helpfulness, and business sense. In many cases, the SBIC is one of a number of investors in a company and the amount of its investment is small compared to others the company received.

For example, a vice president of a medical equipment and supplies company stated that he considers the SBIC that invested $3 million in his company (out of a total of $27 million that the firm received in investments and bank loans) to be a "true friend" of the company. He noted that the SBIC's officers with whom he dealt provided expert advice and assistance whenever the company made a request. He considers the SBIC officers to be "true professionals who know what they are doing. n

The chief financial officer (CFO) of a telecommunications company praised the president of the SBIC from which it received two investments totaling $1.1 million for his "sincere" interest in wanting to help the company. The CFO said the SBIC president acts as a business advisor to the company by assisting with business strategy and generally giving his "wisdom" when the company makes business decisions.

Six companies specifically referred to the SBIC presidents' and officers' integrity and steadfast support, as demonstrated, for example, by their willingness to help the companies through business downturns rather than immediately taking ownership of the company to protect their interests, as other venture capitalists might. [11] The president of a diamond

[11] 13 CFR 107.801(c) permits a licensee to acquire temporary voting control over an SBC where reasonably necessary for the protection of its investment.

manufacturing company which had received $1.75 million from an SBIC said the officer with whom he dealt gave him "total confidence" that the SBIC wasn't going to "steal” his company. The president said that, as a consequence of a previous deal in which an investment firm took ownership of his former company during a downturn, he generally views investment bankers as “bank robbers without the masks." In contrast, he regards the SBIC as "tough but honest."

Similarly, the president of a sporting goods company that received a $6 million financing from an SBIC in our study stated he had heard “horror stories” about venture capital firms that sell their interest too soon or rush to take over a business. His experience with the SBIC dispelled this notion, however, when he found that the officer with whom he dealt was more interested in the growth of his company than a short-term profit.

During our extensive interviews with the presidents of the financially successful SBICs, we observed common personality characteristics. The presidents came across as self-confident and sincere, had exceptional interpersonal skills, and spoke enthusiastically and, we believe, candidly about all aspects of their work. Several referred specifically to the importance they place on integrity, not only in the managers of the companies in which they invest, but in their own staffs. In general, they appeared to value staff honesty and decency as much as staff competence. Consistent with the premium they place on integrity, the presidents also indicated a willingness to comply with SBA program regulations, despite personal reservations, in some cases, about the need for specific provisions. SBIC program management believes there is a correlation between performance and regulatory compliance, based on its observations that the more successful SBICs tend to have fewer violations of SBA regulations.

Practice 2. Profitable SBICs offer compensation packages and intangible benefits sufficient to attract and retain high-quality personnel.

Attributes:

- Most of the financially successful SBICs provide their presidents with compensation that is competitive with the private venture capital industry.
- Some SBICs offer stock options or bonuses based on their pretax income.
- SBICs with lower compensation offer other valued benefits, such as staff cohesiveness and empowerment.

Successful SBICs place a high priority on attracting and retaining quality staff, and most of those in our study offer their presidents compensation packages (base salary plus bonuses) that are competitive with others in the private sector. SBICs with compensation packages lower than those of the private sector usually offer other intangible benefits.

The Majority of Successful SBIC Presidents Receive Compensation That Is Competitive With the Private Sector

In 1993, four of the seven presidents of equity -oriented SBICs recei ved compensation that was higher than that of their peers at private venture capital firms.'2 Another SBIC president declined to disclose his compensation, but indicated that it was competitive with that of his counterparts in private firms. Each of these five presidents stated that their individual compensation packages are a key reason they have remained with the SBIC.

The presidents of two other equity -oriented SBICs received total compensation in 1993 that was less than 50 percent of the average for private sector presidents. Neither of the SBICs, however, had yet established planned bonus systems, and one of the two presidents, as well as his three officers, had earlier agreed to receive nominal salaries during the SBIC's first few years of operation. He indicated that he expects to realize significant bonuses when the SBIC, which has been licensed less than three years, begins to sell its investments.

Several other SBIC officers to whom we spoke cited competitive salaries, bonuses based on SBIC pretax income, and stock options as the primary compensation package features that

[12]One of the four SBIC presidents said he received high compensation in 1993 because of an unusually large bonus due to significant gains on selling profitable investments.

helped attract and retain them. High salaries may be a particularly important factor for officers with extensive backgrounds in related areas. Three officers who stressed salary levels are particularly well-qualified: two have investment banking backgrounds and the other has been an entrepreneurial consultant and a controller of a manufacturing business.

Currently, five of the seven SBICs offer or plan to offer bonuses to all deal officers based on a specified percentage (usually 20 percent) of the SBIC's pretax income. The president of one of these SBICs stated that, although most private venture capital firm officers do not receive bonuses on pretax income until the age of 40, two vice-presidents at his current SBIC, under the age of 40, share in the pretax income bonus. Another SBIC offers a stock option plan, in addition to bonuses, for selected senior officials, and a vice-president told us that the plan is a major reason he stays with that firm.

Profitable SBICs Offer Other Intangible Benefits to Attract and Retain Staff

While we did not have enough data on SBIC officers' compensation (other than that of the presidents) to make a valid comparison with compensation packages offered in the private sector, our discussions with the officers indicated that the SBICs are able to attract and retain quality staff using intangible benefits as well as salary. In particular, they indicated that the absence of a rigid bureaucracy allows deal officers to wield significant influence on investment decisions.

Several SBICs have small staffs, which appeal to many of the SBIC professionals with whom we spoke because they can work on all aspects of deal making, including finding and evaluating the deals. Further, the fact that deal officers must concur on an investment proposal before finalizing it or submitting it to the board of directors produces a sense of staff empowerment. Officials at several SBICs told us that they enjoy their work because they are free to discuss investment opportunities informally among themselves and have significant latitude in exercising their creative judgment in identifying and evaluating investments.

Several SBIC presidents stated that quality-of-life considerations, such as strong staff cohesiveness and limited travel, also assist in attracting and retaining quality staff. One SBIC president, for example, told us that staff compatibility is important to morale and that, when hiring, he considers how well new candidates would fit in with existing staff in terms of motivation, work habits, and personality. The president and officers of another SBIC attested to its collegial atmosphere; all the staff knew each other previously through former jobs or networking, and they work well together.

Practice 3. Financially successful SBICs are adequately capitalized and follow good cash management principles.

Attributes:

· SBICs with relatively low private capital adapt their investment strategies to the size and mix of investments appropriate for their available capital.

· SBICs take steps to ensure that they can make payments on SBA debentures and other liabilities.

All the SBICs we reviewed appear to have adequate capital for their operating needs, with private capital ranging from $1 million to $120 million. We believe that all SBICs in the study follow good cash management principles in maintaining a solid liquidity position. [13]

SBICs With Limited Private Capital Tailor Investment Strategies to the Amount of Funds Available

SBICs with relatively small private capital design their investment strategies according to the amount of capital available. For example, two of those in our study confine themselves to straight loan financings, which ensure sufficient cash inflows for paying off current liabilities. Each also uses a rigorous loan approval process to assure the creditworthiness of loan applicants. One primarily makes loans in industries in which the president--the SBIC's only deal officer--has experience and expertise. In another case, an equity -oriented SBIC only makes investments that can be converted to cash within a two-to-four year timeframe, thus assuring a sound liquidity position.

As an example of the way private capital availability affects investment size, one SBIC with private capital of just over $1 million makes investments ranging between $80,000 and $100,000. In contrast, an SBIC with $120 million in private capital makes some investments exceeding $14 million. By making a larger number of relatively small investments, SBICs with limited capital are able to spread overall risk, thus minimizing their chances of financial failure. [14]

[13] Liquidity position refers to a company's ability to generate cash from its assets to pay short-term liabilities. The higher the ratio of “liquid” assets to short -term liabilities, the better the company's liquidity position.

[14] SBA regulations stipulate that investments in any one portfolio concern cannot exceed 20 percent of the SBIC's private capital (30 percent for SSBICs).

Financially Successful SBICs Exercise Prudent Cash Management Principles

Regardless of the amount of private capital available, each of the profitable SBICs stresses sound cash management principles, especially in terms of matching cash flows of assets and liabilities so that the firm has a solid liquidity position. According to a 1991 study, [15] a major factor responsible for the financial failure of some SBICs is a mismatch between its sources and uses of funds. The mismatch occurs when an SBIC makes equity investments that have insufficient returns over the near term to cover its immediate liabilities, including semiannual interest payments on SBA debentures.

The SBICs in our study that have significant SBA leverage, relative to their private capital, fully recognize the need to have cash on hand to meet current obligations. For instance, one SBIC that has almost equal amounts of SBA leverage and private capital invests in SBCs in which its equity investments can be liquidated within two to four years. This ensures that the SBIC will have adequate cash to make payments on its SBA leverage and other liabilities.

In another case, a loan -oriented SBIC with a small proportion of private capital is able to meet its semiannual payments on an SBA debenture bearing a 12 percent interest rate by charging the maximum allowable interest rate on the loans it makes. [16] A third SBIC favors making financings in the form of notes convertible to common stock so that, at least initially, it can depend on an inflow of cash to meet SBA debenture payments and other current liabilities.

The SBICs' strong liquidity positions, measured by the ratio of current assets to current liabilities, are evidence *of* sound cash management principles. To test their positions, we measured each SBIC's current ratio (current assets to current liabilities) as of the most recent fiscal year-end. At that time, seven of the nine SBICs had a ratio over 10; as a general rule, a ratio of 2.0 or higher signifies a sound liquidity position in terms of debt -paying ability. [17] Although two of the profitable SBICs had ratios of less than 1.0, we believe that their liquidity positions were sound, given their available capital resources and other circumstances. The SBIC with a ratio of 0.14, which was partially due to $5 million in SBA debt maturing within the current year, had over $20 million in unrealized gains on its investments, part of which could be sold to meet current obligations. The SBIC with a current ratio of 0.96 had,

[15] E. Holloway and J. Werner, SBIC Program Review of Selected Issues for the Committee on Small Business. United States Senate (Washington: June 1991), p. 69.

[16] Previously, the maximum interest rate an SBIC could charge on loans was the higher of (1) 15 percent or (2) the current interest rate on SBA debentures plus 7 percent. New SBIC regulations, issued in April 1994, added a third option to the maximum allowable interest rate: the weighted average cost of qualifying borrowings (SBA debenture and other borrowings of the licensee) plus 7 percent.

[17] W. Pyle and K. Larson, Fundamental Accounting Principles (Homewood, IL: 10th Edition, 1984), *pp.* 695-696. The authors further state that the current ratio is only one factor that is used in analyzing a company's liquidity position.

as current debt, a $68 million note to a related party (a parent corporation), which can be more readily postponed than debt to a third party. This SBIC also had a $15.6 million unrealized gain on unsold investments.

Practice 4. Profitable SBIC investment strategies generally minimizerisk.

Attributes

- SBICs develop clear and well -defined investment strategies and adhere closely to them.
- Strategies include reducing risk by investing in:
- Industries in which the SBIC managers have expertise;
- Later-stage companies with proven track records;
- Companies which have an established market niche; and
- Firms whose management has a record of competence and integrity.

Successful SBICs have explicit investment strategies that generally serve to minimize risk. The SBICs in our study favor strategies that are inherently conservative, e.g., investing in companies in which they can expect to exit in a relatively short time (three to five years), and emphasize the importance of adhering to their investment strategies. We believe such strategies are key to the SBICs' financial success. As effective as they are, however, they appear to run counter to popular perceptions of venture capital as primary funding for relatively long-term, high-risk investments in "seed" companies, start-ups, and high technology businesses."

The SBICs' strategies typically include what one president called "sticking to your knitting: focusing investments in industries where officers have expertise and avoiding industries in which they have little or no experience. For example, as a group, the officers at one SBIC have backgrounds in physics, pharmacology, and corporate finance in the telecommunications industry. Accordingly, their strategy is to concentrate investments in the biotechnology, telecommunications, and financial services industries. Another SBIC's strategy is to invest primarily in retail firms, manufacturers, specialty chemical firms, and high-technology

[18] A seed company has only a concept, which has yet to be implemented, and usually searches for funding to develop a business plan, build 8 team, develop products, or conduct market research. A start-up company normally has completed product development and initial marketing; it may be in the process of organizing or may have been in business for a short time, but has not yet sold its product commercially.

industries, reflecting the SBIC officials' backgrounds in chemical engineering, mechanical engineering, aerospace engineering, and retailing. Because profitable SBICs generally avoid industries they do not thoroughly understand, most do not invest in high technology industries. One official told us, however, that his SBIC would consider co-investing in high technology if the other investor had the requisite industry knowledge.

SBICs Prefer Investing in Established, Later-Stage Companies

Most of the successful SBICs favor investing mainly in later-stage companies, which are established firms with proven track records, and specifically avoid start-up or seed companies due to the riskiness of these investments. One president stated that after investing in two start-up companies that subsequently failed, his SBIC no longer makes such investments.

Two SBICs prefer financing leveraged buy-outs (LBOS)[19] because of the potential for large financial gains. According to one president, LBO investments have a history of profitability, highly predictable cash flow, and managers with track records. Another SBIC president noted that LBO investments are "a less risky way to help businesses grow.

We recognize that such "safe" investment strategies may conflict with the program's public policy goal of investing in SBCs that could not otherwise get financing. The portfolios of some of the successful SBICs we reviewed, however, did include some high risk investments, e.g., start-ups and high tech companies. The Associate Administrator for Investment stated his belief that many SBICs have made money on risky investments. Such investment decisions are prudent, he said, as long as they are made by managers who understand the nature of the risk.

SBICs Favor Companies with a Market Niche and Proven Management

Successful SBICs generally seek to invest only in those businesses that have a market niche, i.e., a competitive advantage in a clearly defined segment of the market. S~3ICs also look for companies with management teams that have a reputation for competence and integrity -- factors that many consider the most crucial part of their investment strategies. The discussion under Practice S describes further how SBICs analyze SBC managerial capability and integrity when making investment decisions.

[19] In a leveraged buy out, a purchaser may use SBIC financing, possibly combined with other financing, to buy an existing business.

SBICs Use Other Conservative Investment Strategies

SBICs apply additional strategies to protect against losses, including using a rigorous investment approval process and making debt rather than the more risky equity financings. Three of the equity -oriented SBICs require that deal officers unanimously agree on an investment opportunity; one, in fact, conceded that it may miss some good opportunities because of this policy, but the policy keeps losses to a minimum.

Several equity -oriented SBICs prefer making financings with debt securities (debt convertible to stock) rather than equity securities (preferred stock or common stock) because debt securities offer a current return with periodic interest payments. In many cases, however, SBICs may be forced to issue equity securities because of competition from outside investors and an SBC's desire to keep its liabilities constant so that it can more easily obtain additional financing.

Many of the SBICs prefer restricting investments to SBCs that they believe can meet certain performance criteria. For example, several SBICs finance only businesses that can generate liquidity, i.e., firms that are relatively easy to sell to an outside party, within a specified timeframe, usually three to five years. Another SBIC frequently conditions its deals on the SBC making an initial public offering (IPO) of stock within a specified period of time. The SBIC provides added financial incentives for the companies to meet the IPO timeframes, such as returning some stock to the SBC without recompense. Other SBICs favor investments that will achieve a specified rate of return over a fixed period and focus their investment analysis on determining the likelihood of the SBC achieving the return rates.

SBICs Consistently Follow Their Investment Strategy

Profitable SBICs rarely deviate from their investment strategies unless changing market or economic conditions force them to do so. Several SBIC officials emphasize the importance *of this* disciplined approach *to* venture capital investing. One president, for example, stated that during the economic boom in the 1980s, venture capital firms tended to overpay on investments or make investments that did not fit their investment strategies "just to get into the game.” As a result, these firms would often give up potential profits on such investments. In contrast, according to this official, his SBIC exercises caution by always following its investment strategy and avoiding impulsive investments. Due to their more limited ability to absorb losses, the smaller SBICs were particularly emphatic about the danger of deviating from an investment strategy.

Larger SBICs, which generally have a wider array of industry expertise, may be better able to modify their investment strategies in response to changing economic or market trends. One SBIC views an investment strategy as being dynamic, and its officers hold periodic meetings to discuss possible changes. For example, he indicated that during an economic boom it may be better to invest in start -ups rather than later -stage concerns. Conversely,

during recessions, it may be more advisable to invest in later -stage companies. Many successful SBICs insist on retaining sufficient flexibility in their strategies to permit changes in industry focus or business stage warranted by shifts in the marketplace. For example, one SBIC has refrained from investing in health care industries due to uncertainty over the sweeping changes in health care that are under discussion in the Congress. As a general rule, however, the senior managers of profitable SBICs make a conscientious effort to adhere to their investment strategies.

Practice 5. Financially successful SBICs use a systematic approach to identify, evaluate, and structure deals.

Attributes:

- SBICs have extensive networks of industry contacts to identify investment opportunities.
- SBICs thoroughly assess each SBC's management team and conduct due diligence renews.
- SBICs structure deals to benefit the companies while ensuring adequate protection for the SBICs.

A successful SBIC tailors its investment process--identifying, evaluating, and structuring deals--to its particular investment strategies and goals.

SBICs Use Extensive Networks of Contacts to Identify Investment Opportunities

The goal of any venture capital firm is to identify new and young companies with high potential for growth. While only a few of the SBICs we visited concentrate on relatively high -risk firms, such as start -up or early -stage companies, all strive to identify companies with high growth potential. The primary sources for identifying and referring investment opportunities are the personal networks established by SBIC officials within various industries. These networks often evolve from previous work experience in the venture capital industry and personal affiliations with the business community. According to several SBIC officials, the better the reputation of the SBIC, the greater the network's effectiveness in referring quality investment opportunities.

The SBICs' networks generally consist of lawyers, accountants, investment bankers, brokers, other SBICs, venture capital firms, current and former portfolio companies, social and professional organizations, and co-investors. Attorneys and accountants are among the best sources for referring investment opportunities because, as the president of one SBIC stated, "as their clients' businesses grow, so do their own." Current and former portfolio companies are also excellent sources; in one case, two-thirds of the SBIC's investment portfolio is made up of companies referred by other portfolio firms. Many SBICs direct their marketing efforts towards their networks by sending out brochures and other materials to keep their names in front of those most likely to come into contact with quality investment opportunities. Most of the 17 SBCs we contacted stated that they learned of an SBIC either because someone in the company was familiar with it or because a third party, such as a financial advisor, accountant, or another venture capital firm, referred them to it.

A few SBICs also use the traditional cold call method to identify investment opportunities in their industries of interest. One SBIC indicated that its officers spend much of their time "knocking on as many doors as possible." An SBIC that concentrates in high-tech industries often finds good investment opportunities at colleges and universities involved in technological research. A loan-oriented SBIC has had success in identifying prospects by obtaining a list of trade show attendees in advance and contacting them to try to set up meetings during the show.

By all accounts, however, most investment opportunities are unsolicited deals that, as one officer put it, "come in over the transom." Because the vast majority of unsolicited deals fail initial screening for lack of key attributes of quality, e.g., growth potential, qualified management, and market niche, profitable SBICs end up screening numerous deal possibilities before finding one worthy of investment. The average number of investment opportunities received annually by the equity-oriented SBICs we reviewed ranges from 480 to 2400, but the number of new deals each executes ranges from 1 to 20 a year.

SBICs Carefully Analyze and Evaluate Each Prospective Deal Before Making an Investment

Successful SBICs use a systematic process for evaluating investment opportunities they have identified. A prospective deal is subjected to a detailed analysis focusing on the company's management, business plan, financial records, and other key attributes. The company's potential for growth is the primary consideration in equity financings, and its ability to repay is the foremost concern in debt financings. The president of one SBIC commented that the deal assessment process is "part art and part science;" assessing the ability and integrity of a company's managers is largely an art acquired through experience and intuition, while analyzing technical data, such as financial statement reviews and market analyses, requires the appropriate technical skills.

Management Analysis. All the SBIC officials we contacted agree that it is essential for an SBIC to gather enough information about the capability and integrity of the key officers of a business concern to achieve a high level of comfort with management before making a deal. The management assessment process normally begins after the preliminary market analysis and reference checks have been conducted. This is largely an intuitive process involving face-to-face meetings in formal and informal settings, with the goal of spending sufficient time with the principals to gain insight into their characters. To illustrate the importance of the caliber of managers, one SBIC vice-president indicated that he would rather have an "A-plus management team and a B-minus deal than a good deal and a poor manager. The primary management attributes that SBICs try to assess include:

- The capability to take the company to the next level;
- Compatibility with SBIC officials;
- Reputation in the industry;
- Integrity;
- Knowledge of the industry;
- Track record; and
- Grasp of what it takes to succeed.

Factors that might eliminate a prospective deal include:

· Lack of command of key issues;
· No clear vision on how the company will go forward;
· Generalized answers to specific questions posed by SBIC officials;
· Inadequate understanding of the market competition; and
· Unrealistic expectations.

Technical Evaluations. The due diligence review is the other major part of the deal analysis process. During this phase, the SBIC determines if a prospective SBC is financially sound and whether it has a viable product or service that translates into growth opportunities. The technical evaluation typically includes: (1) a review of the company's financial data, tax returns, revenue projections, and business plan to determine the financial health of the company, its strategy for growth, and how it will perform under various economic and business conditions; (2) reference checks with suppliers, customers, and industry contacts to assess, among other things, the integrity and reliability of the company's management; (3) credit cheeks to determine the SBC's payment history; (4) legal reviews to determine such matters as patent rights; (S) industry and market analyses to assess competition, trends, and position or niche; and (6) exit potential.

The SBICs normally perform technical reviews in -house except when special circumstances require outside expertise, such as matters involving legal elements and highly technical issues.

Deal Assessment Process Varies According to Size of SBIC and Level of Risk. The principal difference in the way the SBICs assess deals relates most often to the formality of the process, with the smaller SBICs (five or fewer officers) tending to be less structured in their approach than the larger firms. For example, at one small SBIC all three investment officers participate in the deal assessment process from the initial pre -screening to the closing of a deal. They all attend the face -to-face meetings, which are usually informal, and all three must agree before offering a deal. Because two of the officers comprise the SBIC's board of directors, there is no need to make formal presentations to the board. According to the president of the SBIC, this informal method of operation grants the officers the flexibility needed to react quickly to investment opportunities. In another SBIC consisting of three officers, the sponsoring officer has primary responsibility for performing the deal assessment, while the other two remain largely outside the process. According to the SBIC's president, this helps the two outside officers to keep perspective and remain impartial in judging prospects. Once the assessment is completed, a unanimous vote of the three officers is required before a deal is presented to the Board of Director's investment committee.

In larger SBICs, the deal assessment process tends to be more formal. For example, in the case of an SBIC that has over a dozen investment officers, if a particular investment opportunity is considered risky, i.e., outside the SBIC's investment strategy, the assessment process is very structured. The sponsoring officer prepares a memo early in the process outlining specific details of the prospective deal and circulates it to all the SBIC's partners. Each partner then has an opportunity to comment on the deal, including providing personal knowledge about the company's management team or discussing the marketability of its product or service. After the sponsoring officer completes the initial assessment process, the prospective company's management team provides a formal presentation to all the SBIC's partners. At this point, unanimous agreement is required or the deal is removed from consideration. After completion of the assessment process, the deal is presented to an investment committee of the board of directors for final approval.

If the investment opportunity is not considered risky, as defined by this SBIC's investment criteria, the process is somewhat less structured. A team of three deal officers is assembled, including the sponsoring officer who is responsible for performing the initial assessment and briefing the other two team members on the strengths and weaknesses of the prospective deal. A detailed analysis is performed after all three team members agree to pursue the deal. Once completed, a memorandum outlining the particulars of the deal is presented to the investment committee for approval.

There are many alternative approaches, of course, but among the profitable SBICs we examined, the larger the SBIC and the riskier the investment opportunity, the more structured and formal the deal assessment process is likely to be.

Deals are Structured to Meet the Goals of the Small Business and Protect the Interest of the SBICs

Once a deal is approved, the next step in the investment process is to structure it to satisfy the goals of both the SBIC and the SBC. Accordingly, the SBICs attempt to match the type of financial instruments--equity, debt, or combination--with the needs of the SBC while creating an acceptable return for the SBICs.

Deal Structuring in Equity-Oriented SBICs. Several factors affect the type of instruments used to finance a deal, including the amount of SBA leverage outstanding, the stage of the small business, and whether other investors are involved. Generally, SBICs with little or no SBA leverage and access to large amounts of capital tend to be more equity -oriented in their deal structuring, that is, they use preferred stock, common stock, and convertible debt. Occasionally, the SBICs use debt instruments for follow-on investments, but normally they include an equity component. Equity instruments have the advantage of allowing the invested companies to present to creditors a balance sheet with fewer liabilities. Convertible notes offer an SBIC a current return, but the experience of one SBIC suggests that careful consideration must be given to potential conflicts with the strategies of co investors. A debt oriented approach, for example, might not fit well with a co- investor strategy that emphasizes equity instruments. An investment may also be structured in stages; one SBIC, for example, sets a total investment target up front for each deal but only invests 30 to 50 percent of that amount in the initial financing, so that funds are available to participate in subsequent rounds of investments.

Successful SBICs often build performance incentives into their deals. For example, one SBIC adjusts the amount of its equity interest in a portfolio company based on the company's performance without increasing or decreasing the dollar amount invested in the company. If a company meets or exceeds certain financial or performance milestones, the SBIC reduces its equity share in the company by returning stock to the company. Conversely, if the company fails to meet these milestones, the SBIC might require the company to issue additional stock to the SBIC without compensation. Other SBICs attach warrants [20] and put options [21] to their deals to offset the risk that an SBC will not meet its projections. To provide additional motivation for SBC managers, some SBICs structure their deals t~ require the SBCs to establish a compensation package that provides its managers with ownership, such as stock options. A further incentive is to link the availability of follow -on investments with meeting specified performance goals.

Deal Structuring in Debt-Oriented SBICs. Deal structuring for the two debt-oriented SBICs is less complicated because it involves debt instruments only. I~e only significant variables for the debt instruments are their terms: the amount, length of payment period, interest rates, and payment schedule. For e~ample, loan terms may provide for "interest only" payments in the first year to alleviate some of the financial burden on the SBC. Alternatively, an SBIC may negotiate step transactions for loans that carry built-in performance incentives i.e., disbursing loan proceeds in increments after certain conditions are met, such as opening a new store. This benefits both parties because it reduces the amount of the SBIC's capital at risk and saves the borrower interest cost on loan amounts not disbursed.

[20]A warrant is a type of option to purchase additional securities from the issuer at a specified price within a specified time period.

[2l]A put option is a contract entitling the holder to sell (put) a specific number of shares of a security at a specified price within a specified period of time.

Practice 6. Profitable SBICs closely monitor the financial healthof their portfolio companies to protect their interests.

Attributes:

· SBICs monitor portfolio companies by:

· Occupying a position on the companies' board of directors or observing board meetings;

· Meeting with the companies' managers and conducting site visits;

· Reviewing the companies' financial and operational information; and

· Maintaining good cash collection procedures.

To track the progress and financial health of the invested companies, all the SBICs closely monitor their investments. The method varies depending on the type (debt or equity) and size of the investment, and it ranges from simply keeping a watch over loan payments to daily oversight of the SBC's operations.

Successful equity -oriented SBICs usually secure either a seat on the SBC's board of directors or observation rights for all board meetings. This is normally structured into the terms of the deal to ensure that the SBICs are kept apprised of and have input into major management decisions. Most of the SBICs also perform at least one of the following monitoring activities: (1) conduct site visits and meet regularly with the SBC's management team; (2) review monthly financial statements, annual business plans, and annual audits; and (3) perform quarterly valuations of the portfolio concerns. In addition, when a portfolio company experiences problems, the SBICs accelerate their monitoring efforts by (1) requiring weekly "flash reports" highlighting business activity, (2) holding weekly face -to-face meetings with the managers, and/or (3) encouraging more frequent meetings *of* the SBC's board of directors. In extreme cases, SBIC officials will require daily meetings with the company's management team for a short period; however, they try to avoid daily oversight due to the heavy staff commitment it requires.

For the debt -oriented SBICs, monitoring loans mostly consists of establishing good cash collection procedures and keeping a careful watch on delinquent payments. One of the SBICs we studied uses a rigorous system for collecting payment; it encodes blank checks with the account number of each of the portfolio companies. When payment is due, a check is automatically deposited into the SBIC's account. Thus, the SBIC quickly learns of a problem if the bank returns the check due to insufficient funds. The SBIC reports it has been so successful using this approach that 15 other lending companies have emulated it. One of the SBIC's borrowers commented that this process was more efficient than the traditional promissory note system because it eliminated the need for a middleman. Both of the successful debt-oriented SBICs follow standard lender procedures in cases of late payment, and, on occasion, they may restructure the terms of a delinquent loan by reducing the monthly payments and increasing the term of the loan.

Practice 7. Successful SBICs add "value" to their portfolio companies, in Conjunction with financing, thereby increasing the companies' net worth.

Attributes:

- SBICs assist their portfolio companies by:
- Recruiting key personnel;
- Contributing to strategic planning;
- Analyzing prospective mergers and acquisitions; and
- Helping SBCs obtain additional sources of funds.

In addition to providing financing, the majority of the successful SBICs provide assistance to their SBCs ranging from personnel recruitment to active participation in business planning and decision -making. These activities are especially important in the venture capital industry because they add value to portfolio companies by helping their net worth grow. As one veteran venture capitalist noted, "value -added often provides the margin of success over failure.” [22]

Among the successful SBICs, officers most frequently reported assisting SBCs by identifying and recruiting candidates for key positions and analyzing and developing forecasts for prospective mergers, acquisitions, and initial public offerings. [23] The SBICs also provide assistance in the following areas:

developing compensation and employee benefit packages; Identifying problems and formulating resolutions; Attracting other investors; Assisting SBCs in obtaining credit from vendors and banks; Long -range planning; and Enhancing financial systems.

As an example, the CFO of a telecommunications company indicated that the SBIC has added value by having its president act as chairman of the company's board of directors and assist

[22] Bygrave and Timmons, op. cit., p. 2a7.

[23] An initial public offering occurs when a company makes its stock available for sale in the publicly traded market for the first time.

in strategic planning. When the two -year-old company received the SBIC's first financing of $500,000 in 1991 (representing one -third of the company's total initial financing), the company was a defense business that was venturing into telecommunications. Between 1991 and 1993, according to the CFO, the company had turned itself around so successfully that it received an additional $125 million in financing from other sources for further expansion.

Several company representatives credited SBICs with helping them obtain additional financing, either by identifying other investors or lenders or by providing credibility to the company through its association with the SBIC. The vice -president of one company, for example, which had initially obtained $14 million in financing from numerous investors, including $100,000 from the SBIC [24], said that the SBIC's participation in the joint financing provided reassurance to other potential investors and influenced their decision to make the financing .

A medical equipment and supplies company reported that when an SBIC provided $3.2 million financing in 1986, it also identified and recruited a new manager for the company. The individual had previously performed well as a manager of another company that the SBIC had financed, and the firm's vice president credited him and others who he brought in to run the company with the company's success today.

As a final example, the president of a gasoline station that received a $25,000 loan from one of the two SSBICs in our study relies on the SBIC manager to explain business matters to him in the Korean Language. When the station had to close for remodeling for two and one-half months, the loan allowed the company to maintain a positive cash flow, continue to pay its bills, and return to normal operations.

[24] The SBIC subsequently made a follow -on investment of $83,000.

Portfolio Companies Credited SBIC Financing with Having Significant Impact on Their Financial Growth

The portfolio companies we surveyed, which were selected by the SBICs in our best practices review, reported that the SBICs significantly affected their companies' growth by providing critical financing and other added value. The nine SBICs provided a total of $37.1 million in financing to the 17 SBCs surveyed, representing just over 21 percent of the SBCs' total financing. Overall, as of May 1994, the number of employees at the SBCs had doubled and the amount of their revenues had almost tripled since receiving the SBICs' initial financings.
Six of the financings were early stage (including seed and start-up), two were mezzanine,[25] four were later stage, and five were LBO or acquisition. It should be noted, however, that, except in four cases where the SBIC provided the only source of financing to the SBC, there is no way to attribute these gains directly to the support provided by the SBICs. As shown in Table 1, in these four cases, the SBICs financed a total of $6.6 million, leading to the creation of 268 jobs. Two of the four SBCs were start-up companies.

Impact on Company Growth When the SBIC was the Lead or Sole Investor

Most of the SBCs received financing from multiple investors or lenders along with the SBIC financing, making it virtually impossible to identify the specific impact of the SBIC's investment on a company's growth. Only in the case of the four companies in which the SBICs provided sole financing could SBIC support be credited with the subsequent growth in employment or revenues.

SBICs also had an impact on companies' growth by providing financing that enabled the SBCs to obtain new private financing. For example, a manufacturer of plastic materials received a $650,000 financing from an SBIC in 1989, and a local bank conditioned its loan and line of credit of almost $2 million on the company's receipt of the SBIC's financing. Funding from the SBIC and the bank, together, enabled the company to expand its product line and markets so that today the company has 100 employees and $18 million in revenue, compared to 32 employees and S3 million in 1989. The SBC reported that although it had initially attempted to obtain financing from other sources, the SBIC was "the only one that believed in our business plan."

Similarly, a diamond manufacturing company which received an SBIC financing of $1.75 million in 1991 to purchase an existing diamond plant indicated that no bank had been willing to make it a loan. The SBIC's investment enabled the company to make the acquisition, add new services and products, and develop a world-wide market, according to

[25]Mezzanine financing is provided for major expansion of a company that is experiencing increased sales volume and is either breaking even or profitable. The financing is used for plant expansion, marketing, working capital, or development of an improved product.

Table 1: Changes in Employee Levels and Revenue At the 17 SBCs Surveyed, After Receiving SBIC Financing

	SBIC Portion of SBC's Total Financing (%)[a]	Amount of SBIC Financing (000s)	Number of Employees: Before Financing[b]	Number of Employees: Current[b]	Annual Revenue (000s): Before Financing[b]	Annual Revenue (000s): FY 1993[b]
1.	100.0	$425	0	40	$0	$5,000
2.	100.0	200	0	28	0	c
3.	100.0	25	7	7	2,200	2,700
4.	100.0	6,000	250	450	16,000	28,000
5.	85.4	1,750	7	52	900	5,200
6.	76.9	15,000	c	c	c	c
7.	41.1 [d]	767	420	380 [e]	21,000	47,000
8.	40.0	2,000	310	440 [f]	67,000	80,000
9	37.1	708	28	60	1,800	10,000
10.	24.0 [d]	1,200	0	130	0	74,000
11.	14.4	650	32	100	3,000	18,000
12.	11.8	3,200	85	230	17,500	50,000
13.	8.3	500	125	250	11,000	23,000
14.	5.6	2,100	4	180 [f]	750	7,000
15.	5.6	2,000	250	700	30,000	80,000 [g]
16.	5.3	410	25	40	0 [h]	0 [h]
17.	1.3	183	4	36	0	23,000 [i]
	21.1%	$37,118	1,547	3,123	$171,150	$452,900

Notes

a] The percentage was calculated as a ratio of the amount of the SBIC's financing to the amount of total financing received by the company. The amount of total financing was estimated by company officials.

b] As estimated by company officials.

c] Information not available.

d] This calculation excludes funds obtained through initial public offerings, which the SBC made subsequent to the SBIC's initial financing.

e] Reductions in employees can be primarily attributed to the sale of some subsidiaries and the application of technology resulting in a lower demand for labor.

f] Most of the growth in revenue and employees can be attributed to an acquisition.

g] About two-thirds of the growth in employees and revenue can be attributed to acquisitions and one-third to internal growth.

h] As of fiscal year 1993, the SBC had not yet brought its product to market.

i] The company anticipates FY 1994 revenue in the $40 – $46 million range.

the president. By 1993, he said, the company's revenue had increased from $1 million to $5.2 million, the number of employees had grown from 7 to 52, and its after-tax profit was 13 percent. While the president conceded that the company had been profitable before the SBIC's financing and would have continued growing without it, the SBIC's financing "accelerated its rate of growth."

New Regulations Require SBICs to Report Economic Impact of Each Financing

Only one of the nine SBICs we reviewed systematically reports the economic benefits of its financings. In its 1993 Annual Report, for example, the SBIC reported the number of jobs created and preserved; the capital expenditures made by its existing portfolio companies; the aggregate amount paid in Federal, State and local taxes; and the total size of the companies payroll. Federal regulations published on April 8, 1994, now require SBICs to assess and annually report to SBA the economic impact of each financing. [26] Such reports must estimate the full-time equivalent jobs created or retained, the impact of the financing on the business in terms of expanded revenue and taxes, and other "appropriate economic benefits," such as technology development, commercialization, or minority business development. The regulations require the reports to accompany each SBIC's annual financial statement (SBA Form 468).

Depending on the quality of the data, we believe these reports will be useful for measuring the SBIC program's effectiveness. To minimize the burden on SBICs and to assure comparability through standardized reporting, we suggest that the Agency develop specific guidance on the type and format of information to be provided. Further, the Agency should require SBICs to report the total amount of financing each portfolio company receives from other sources. Such information is necessary to gauge more accurately the extent of the SBICs' impact on the economy.

[26] Federal Register, Vol. 59, No. 68, 107.304(c), April 8, 1994.

SBICs Failed Primarily Because of a Combination of Unqualified Management and Low Private Capital

Our review confirmed that well -qualified, capable management is crucial to an SBIC's financial success. According to SBA officials and recent studies of the SBIC program, many SBICs have failed [27] primarily due to (1) deficiencies in SBIC managers' qualifications, practices, and integrity and (2) inadequate private capital to sustain the SBICs. Adverse economic conditions also appeared to contribute to some SBICs' failure. We reviewed the files of two SBICs that entered liquidation. The files indicated that management lacked sufficient lending and venture capital experience, which resulted in inappropriate investments
given the SBICs' levels of private capital available. In contrast, each of the successful SBICs we reviewed clearly appear to be run by well -qualified managers with good track records.

We recognize that our review of the operations of nine financially successful and two failed SBICs does not provide a representative profile of the universe of 280 active SBICs and 199 licensees in liquidation. We believe, however, that our discussions with SBA officials and other experts on why SBICs failed, combined with our detailed data -gathering on the SBICs that we reviewed, suggest that our results may be illustrative of important differences between successful and failed SBICs.

Managerial Shortcomings Led to SBICs' Failure

SBA officials and a recent Congressionally -sponsored study [28] on the SBIC program cited management deficiencies as a primary cause for SBICs' failure. Such deficiencies included the managers' (1) lack of relevant experience or education, (2) failure to assure a sound liquidity position of the SBIC, [29] (3) failure to properly match expected returns with investments' risk levels, and (4) lack of regulatory compliance and participation in acts of fraud. SBA officials attributed these problems, in part, to previously loose standards for licensing SBICs and, in response, have recently taken steps to strengthen licensing standards. New SBA guidelines effective May 23, 1994, provide that, among other things, prospective licensees have (1) a suitable management team relative to the types of investing being proposed; (2) private capital that is adequate to operate the SBIC (preferably in excess of the $2.5 million statutory minimum); (3) a comprehensive, practical business plan; and (4) a financial forecast that demonstrates understanding of the use of venture capital, credit, and cash flow management relating to the types of investments being proposed.

[27] As of May 31, 1994, 199 SBICs were in SBA's Office of Liquidation, having total SBA leverage outstanding of S531.6 million.

[28] Holloway and Werner, op. cit., p. 65.

[29] A sound liquidity position means that a company has the financial capability to pay off current liabilities and remain solvent.

Managers of Failed SBICs Lacked Relevant Experience. The SBA officials agreed that, in the past, SBIC managers often did not have sufficient experience or academic background to operate SBICs effectively. For example, if an SBIC engaged in equity financings, there was no requirement that the manager have venture capital experience. Similarly, if the SBIC engaged in making loans, there was no requirement that the manager have a background in credit management or loan collection. Furthermore, according to an SBA official, SBIC managers often did not limit their investments to those industry areas for which they had experience or expertise.

For example, the managers of the two SBICs in liquidation --an SBIC and an SSBIC that made primarily loans lacked relevant lending experience. The SSBIC manager's previous work experience consisted of owning and operating a travel agency and performing consulting services which primarily involved being a foreign language translator--experiences which were not relevant to lending or venture capital financing. As a result, the manager made loans to marginally profitable businesses which could not sustain periodic payments on the loans. The regular SBIC's manager also made highly risky investments, primarily in seasonal firms with one product. The firms were generally start -up companies, which further increased the investment risk. Both SBICs, according to the receivership agents, made loans that were inadequately collateralized and failed to use effective collection and monitoring efforts.

In contrast, the two profitable SBICs in our review that make loans (one regular SBIC and one SSBIC), have managers with relevant experience. Both are CPAs with many years of lending experience. Further, the regular SBIC focuses its investments in industry areas where the manager has experience and expertise (equipment financings for laundromats and restaurants). The specialized SBIC has a meticulous loan approval process where its board of directors acts as a loan committee. Several of the board members have extensive lending experience--one is president of a local bank and two others are the current and former chairman of the bank's Board of Directors.

A possible reason for the lack of qualified management may be the SBICs' failure to implement compensation plans based, in part, on the SBICs' profits. The Acting Director of the Office of Liquidation pointed out that the vast majority of failed SBICs did not have incentive -based compensation plans, such as bonuses based on SBIC profits. He believes that such compensation plans may lead to better management and reduce the chances of SBIC failure.

Failed SBICs Had Poor Cash Management. According to SBA officials, as well as several published studies [30] on the SBIC program, SBICs' inadequate cash management practices contributed to the failure of several licensees. For example, several studies have noted that

[30] Financing Entrepreneurial Business: An Agenda for Action, page v.; General Accounting Office, op. cit., p.6; Holloway and Werner, op. cit., p. 69.

SBICs which made equity investments in small businesses, while paying fixed semiannual interest payments on SBA debentures, were at greater risk of financial problems and, ultimately, of liquidation. Equity investments typically do not yield immediate and constant returns; as a result, SBICs often could not match the income received on their investments with the fixed semiannual interest payments to SBA.

Several financially successful SBICs in our study recognize the vulnerability of their limited private capital and make corresponding adjustments in their investment strategy. For example, one equity-oriented SBIC only finances those small businesses which will generate liquidity within a two-to -four year timeframe; such provisions enable the SBIC to have cash readily available to meet semiannual interest payments on SBA leverage and other current liabilities.

Failed SBICs Did Not Properly Match Risk With Rates of Return. In addition, SBA officials told us that failed licensees often did not set a high enough rate of return on their investments to justify their risk. The proceeds were often insufficient to enable the SBICs to pay their expenses, thus precipitating their collapse. In contrast, one financially successful, loan-oriented SBIC in our study charges the maximum interest rate allowable by SBA to help offset its payment on SBA debentures bearing a 12 percent interest rate.[31]

Many Failed SBICs Violated Regulations. In contrast to our observation that successful SBICs demonstrated regulatory compliance, most failed SBICs had a poor record of regulatory compliance, according to SBA officials. These regulatory violations may include fraudulent acts to benefit SBIC principals.

SBICs Failed Because They Were Not Adequately Capitalized

According to SBA officials and published studies[32] on the SBIC program, SBICs with low amounts of private capital have a greater likelihood of failing. A recent study also confirmed that larger SBICs, in terms of private capital, tended to be financially stronger than smaller SBICs.[33] Because venture capital investments carry relatively high risk, SBICs with larger amounts of private capital have a greater chance of overall success because they usually were able to spread their risks by making more investments.

[31]Previously, the maximum interest rate an SBIC could charge for loans was the higher of (1) 15 percent or (2) the current interest rate on SBA debentures plus 7 percent. New SBIC regulations, issued in April 1994, added a third option to the maximum allowable interest rate: the weighted average cost of qualifying borrowings (SBA debenture and other borrowings of the licensee) plus 7 percent.

[32]General Accounting Office, op. cit., p. 2; Werner and Holloway, op. cit., p. 68.

[33]General Accounting Office, op. cit., p. 2.

To compensate for low capitalization, according to a knowledgeable SBA official, SBICs should make more financings with loans that are credit-worthy, or spread risk among many relatively small investments. For example, two successful SBICs we reviewed, one regular SBIC and one specialized SBIC, have low private capital amounts but make financings almost exclusively through loans to generate immediate cash inflows. In addition, both SBICs perform detailed due diligence to ensure that the borrowers are credit -worthy, have rigorous loan approval processes, and conduct thorough monitoring of their loans.

Economic Downturns Have Contributed to SBICs' Failure

Published reports and SBA officials also point to the state of the economy as contributing to the SBICs' financial failure. A 1992 SBA Investment Advisory Council report stated that an economic downturn, combined with the SBICs' general inability to convert their equity investments into cash in the public securities market for several years, led to higher levels of SBIC failures.34 An SBA official pointed out that the recent collapse of the New England real estate market, combined with the high interest rate on the SBA debentures that the SBICs were paying off, contributed to the failure of some SBICs in that region.

[34] Investment Advisory Council, op. cit., page v.

APPENDIX A

PROFILES OF SUCCESSFUL SBICs REVIEWED

[FOIA NAME DELETION]

YEAR LICENSED:	1972
PRIVATE CAPITAL:	$120,008,034
SBA LEVERAGE:	$19,000,000
ASSET SIZE:	Large
OWNERSHIP:	Bank Dominated
INVESTMENTT ORIENTATION:	Balanced
INDUSTRY CONCENTRATION:	Diversified
MAJOR AREAS OF INVESTMENT:	Manufacturing
NUMBER OF CURRENT INVESTMENTS:	36

[FOIA NAME DELETION]

YEAR LICENSED:	1961
PRIVATE CAPITAL:	$14,229,271
SBA LEVERAGE:	S15,000,000
ASSET SIZE:	Large
OWNERSHIP:	Nonbank -Dominated
INVESTMENT ORIENTATION:	Balanced
INDUSTRY CONCENTRATION:	Concentrated
MAJOR AREAS OF INVEST:	Manuf;High Tech
NUMBER OF CURRENT INVESTMENTS:	23

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[FOIA NAME DELETION]

YEAR LICENSED:	1991
PRIVATE CAPITAL:	$5,658,278
SBA LEVERAGE:	$6,000,000
ASSET SIZE:	Large
OWNERSHIP:	Nonbank -Dominated
INVESTMENT ORIENTATION:	Equity
INDUSTRY CONCENTRATION:	Neither Diversified Nor Concentrated

MAJOR AREAS OF INVESTMENT:

Manufacturing; High Tech; Services;
Transportation, Communication, and Utilities

NUMBER OF CURRENT Investments: l5

[FOIA NAME DELETION]

YEAR LICENSED	1977
PRIVATE CAPITAL:	$11,582,791
SBA LEVERAGE:	$0
ASSET SIZE:	Large
OWNERSHIP:	Nonbank -Dominated
INVESTMENT ORIENTATION:	Loan
INDUSTRY CONCEN~RATION:	Concentrated

MAJOR AREAS OF INVESTMENT:
Manufacturing; High Tech

NUMBER OF CURRENT INVESTMENTS: 13

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I

[FOIA NAME DELETION]

YEAR LICENSED: 1960

PRIVATE CAPITAL: $28,982,360

SBA LE~AGE: $4,800,000

ASSET SIZE: Large

OWNERSHIP: Bank-Dominated

INVESTMENT ORIENTATION: Equity

INDUSTRY CONCENTRATION:
Concentrated

MAJOR AREAS OF INVESTMENT:
High Tech; Manufacturing;
Services

NIJMBER OF CURRENT INVESTMENTS: 49

[FOIA NAME DELETION]

YEAR LICENSED: 1984

PRIVATE C APITAL : $1,035,000

SBA LEVERAGE: $1,035,000

ASSET SIZE: Small

OWNERSHIP: Nonbank-Dominated
INVESTMENT ORIENTATION: Loan

INDUSTRY CONCENTRATION: Neither Diversified
Nor Concentrated

MAJOR AREAS OF INVESTMENT: Retail Trade; Manufacturing

NUMBER OF CURRENT INVESTMENTS: 26

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[FOIA NAME DELETION]

YEAR LICENSED:	1980
PRIVATE CAPITAL:	$1,500,000
SBA LEVERAGE:	$1,044,000
ASSET SIZE:	Small
OWNERSHIP:	Nonbank~ -Dominated
INVESTMENT ORIENTATION:	Loan
INDUSTRY CONCENTRATION:	Neither Diversified Nor Concentrated
MAJOR AREAS OF INVESTMENT:	Services; Retail Trade
NUMBER OF CURRENT INVESTMENTS:	57

[FOIA NAME DELETION]

YEAR LICENSED:	1971
PRIVATE CAPITAL:	$8,199,819
SBA LEVERAGE:	$10,295,000
ASSET SIZE:	Large
OWNERSHIP:	Nonbank -Dominated
INVESTMENT ORIENTATION :	Equity
INDUSTRY CONCENTRATION:	Diversified
MAJOR AREAS OF INVESTMENT:	Transportation, Communication, and Utilities; Services; Manufacturing
NUMBER OF CIJRRENT INVESTMENTS:	20

APPENDIX A

[FOIA NAME DELETION]

YEAR LICENSED:	1979
PRIVATE CAPITAL:	$19,901,804
SBA LEVERAGE:	$0
ASSET SIZE:	Large
OWNERSHIP:	Bank-Dominated
INVESTMENT ORIENTATION:	Equity
INDUSTRY CONCENTRATION:	Neither Diversified Nor Concentrated
MAJOR AREAS OF INVESTMENT:	Services; High Tech; Manufacturing
NUMBER OF CURRENT INVESTMLNTS:	14

APPENDIX B

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

To: Tim Cross, Assistant Inspector General
for Inspection and Evaluation

From: Robert D. Stillman, Associate Administrator for Investment

Subject: IG Inspection of SBIC Best Practices

Date: August 22, 1994

You and your team, led by Deborah Eisenberg, have done an excellent piece of work in examining the best practices of our most successful SBICs. Your well written report is a splendid summary of the characteristics which we should seek to find in new license applicants, and try to encourage among our current licensees.

It is particularly heartening to note the importance of management among the seven practices common to profitable SBICs. And most gratifying to find that the most successful managers have prepared themselves by education and experience, have provided a strong capital base, and conduct their business within the regulations of the program, while profiting from a compensation based on the success of the enterprise. This is truly a formula for success of all the parties involved.

We are pleased to find that the best practices you have identified are also reflected in the set of characteristics we describe in our attached "Guidelines for Applicants Applying for an SBIC License", which we send to prospective licensees. We will also apply your insights to other aspects of our management of the program.

As you observe, in promoting the public policy of developing new businesses, we at SBA sometimes encourage early stage investment strategies which appear to be risky. However, this is offset by carefully licensing managers with experience and talent in this type of investment, and by using the new participating security. This instrument allows us to provide leverage which is appropriately matched to long term equity investments.

Your report will be very useful in training our staff, and in demonstrating to our licensees that it is in their interest as well as the government's that they follow the seven principles you identify, in the management of their businesses. Thanks for your thoughtful review.

cc: Erskine B. Bowles
Cassandra M. Pulley
James S. Hoobler

APPENDIX C

CONTRIBUTORS TO THIS REPORT

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