



U.S. Small Business Administration

Investment Division

Small Business Investment Company Program

Financial Performance Report

For Cohorts 1994-2004

Through September 30, 2004

General Disclaimer

This report on the Small Business Investment Company (“SBIC”) program contains financial metrics and cashflows produced by the SBA. All data has been derived from databases maintained by the SBA’s Investment Division. SBIC financial cashflows were prepared from the program office data for presentation purposes and may differ from the figures presented in SBA’s audited financial statements. Neither the report nor the financials contained herein have been audited.

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1. Executive Summary

The purpose of the Small Business Investment Company (SBIC) program is to stimulate and supplement the flow of private equity capital and long term loans to small business concerns. SBICs are licensed with the expectation either that they will receive financial assistance in the form of SBA-guaranteed debentures or participating securities (“SBA-guaranteed leverage”), or they will operate without such financial assistance.

Debentures have a term of ten years, with semi-annual interest payments and a lump sum payment of principal at maturity. Participating securities are similar to debentures; however, SBA advances interest (known as “prioritized payments”) to the participating security pool investors and is reimbursed only when an SBIC has earnings. A unique feature of the participating securities is that SBA shares in the profits of the SBIC.

This report examines the financial performance of the SBIC program for cohort¹ years 1994-2004 for both the SBIC Debenture and Participating Securities Programs. It should be understood that the information provided in this document is based on actual cashflows and the reported current net asset values in the SBICs. For the purpose of developing subsidy² re-estimates for the Participating Securities and Debenture programs, SBA uses the actual cashflows, as presented in this report, as well as projections of future cashflows (such as future advancements of prioritized payments) not considered here. Subsidy re-estimates follow credit reform practices as outlined in OMB Circular No. A-11 Part 5-Federal Credit, Sections 185.5-185.7. Subsidy re-estimates are developed independent from the analyses shown in this report.

As of September 30, 2004, total lifetime subsidy re-estimates for cohorts 1992 through 2003 for the Debentures Program were negative \$77 million, indicating that actual program costs to date and current future estimates of program costs for those years are slightly lower than originally anticipated. Total lifetime subsidy re-estimates for the Participating Securities Program (cohorts 1994-2004) including interest were positive \$2.7 billion (of which \$0.5 billion is due to a one-time accounting adjustment), indicating that actual program costs to date and current future estimated program costs are higher than originally anticipated. These sums represent unanticipated losses to SBA, and in turn the taxpayers. In addition, total administrative costs for both programs over this period were approximately \$85.3 million, which were partially offset by examination and licensing fees of \$23.1 million received by SBA from the SBICs and SBIC applicants.

The following are highlights from this report, along with references to related sections within the report:

- **Financial Exposure ([Exhibit 5.1](#)):**

As of September 30, 2004, SBA’s total financial exposure in the SBIC program for cohorts 1994 through 2004 (as measured by undisbursed leverage commitments, outstanding SBA-guaranteed leverage, outstanding repurchased leverage, and unreimbursed advanced prioritized payments not associated with repurchased leverage) was \$11.25 billion for the participating securities (PS) program and \$2.84 billion for debentures.

¹ A cohort year means the fiscal year in which SBA issues a leverage commitment to an SBIC. Disbursements of the committed funds may take place up to 4 years after the commitment year. Typically SBICs have leverage from two or more cohort years. For federal budgeting purposes, performance must be examined by cohort year.

² The subsidy cost is the estimated present value of the cash flows from the Government (excluding administrative expenses) less the estimated present value of the cash flows to the Government resulting from a direct loan or loan guarantee, discounted to the time when the loan is disbursed. For further information refer to OMB Circular No. A-11 Part 5-Federal Credit, Sections 185.

▪ **Leverage Performance** ([Exhibit 5.4](#)):

- **Debentures:** For cohorts 1994-2004, through September 30, 2004, the SBA repurchased (i.e., transferred to the Office of Liquidation based on a condition of capital impairment or other regulatory event of default by the issuing SBIC) \$180 million of debenture leverage, representing 7% of all debenture leverage disbursed for these cohorts.
- **Participating Securities:** From the start of the program (FY1994) through September 30, 2004, SBA repurchased \$1.1 billion of PS leverage, representing 18% of all PS leverage issued.

▪ **Participating Securities SBIC Fund Statistics** ([Section 6](#))

The chart below presents approximated SBIC Participating Securities fund statistics on a pooled¹ basis by vintage year. (All metrics are approximations based on assumptions described in Appendix A.) “Vintage year” (VY) indicates the first year of operations in a fund. The venture industry typically analyzes private equity fund performance by vintage year to help take into account external conditions which impact performance as well as age of the fund. For example, the venture industry as a whole took a severe performance hit in VYs 1999 and 2000 due to the downturn of the market in 2000. Funds younger than 5 years are typically considered too young to evaluate performance.²

These statistics provide the reader with an understanding of the returns to private investors and SBA on a VY basis in the Participating Securities Program. Unleveraged fund performance returns are also calculated to provide an indication of the SBICs’ underlying performance in order to benchmark fund performance against the industry, measure the value of SBA leverage to private investors, and examine potential problems in the participating securities’ terms. (Notes: Unleveraged metrics treat SBA leverage on the same terms as capital raised from private investors.)

Exhibit 1.1: Participating Securities SBIC Pooled Fund Statistics by Vintage Year

Pooled IRR (Includes Residual Value^a), Distribution to Paid-In Capital (DPI), and Total Value to Paid-In Capital (TVPI) Through September 30, 2004

	Total Paid In ^b (in Millions of \$)	Percent of Total Paid In	Private ^c			SBA Lev & PP ^d			Unleveraged ^e		
			IRR	DPI	TVPI	IRR	DPI	TVPI	IRR	DPI	TVPI
VY 1994	\$ 913.7	9%	32.3%	3.08	3.46	-1.3%	0.78	0.96	19.7%	1.74	2.02
VY 1995	\$ 751.1	7%	49.6%	3.29	4.06	0.9%	0.78	1.03	25.9%	1.72	2.16
VY 1996	\$ 314.8	3%	-11.8%	0.26	0.61	-16.5%	0.19	0.57	-9.3%	0.25	0.69
VY 1997	\$ 592.7	6%	27.3%	1.33	1.76	-6.7%	0.47	0.83	10.5%	0.86	1.29
VY 1998	\$ 1,328.7	13%	20.9%	0.99	1.33	-14.7%	0.29	0.70	0.8%	0.57	1.01
VY 1999	\$ 1,709.2	17%	-14.5%	0.05	0.64	-15.7%	0.09	0.69	-10.7%	0.09	0.74
VY 2000	\$ 2,339.6	23%	-19.8%	0.04	0.64	-25.9%	0.07	0.66	-19.1%	0.06	0.70
VY 2001	\$ 1,051.7	10%	NM ^f	0.07	NM	NM	0.09	NM	NM	0.08	NM
VY 2002	\$ 686.9	7%	NM	0.01	NM	NM	0.06	NM	NM	0.04	NM
VY 2003	\$ 268.4	3%	NM	0.01	NM	NM	0.09	NM	NM	0.05	NM
VY 2004	\$ 210.2	2%	NM	-	NM	NM	0.15	NM	NM	0.01	NM
VY Composites											
VYs 1994 - 1998 ^g	\$ 3,901.1	38%	33.3%	1.89	2.33	-6.4%	0.53	0.84	15.2%	1.08	1.48
VYs 1994 - 2000 ^h	\$ 7,949.9	78%	20.4%	0.91	1.44	-12.3%	0.32	0.76	4.4%	0.57	1.09
VYs 1994 - 2004 ⁱ	\$10,167.1	100%	17.7%	0.69	1.29	-13.0%	0.28	0.78	2.5%	0.46	1.04

Notes on following page.

¹ “Pooled” indicates that cashflows from all funds are pooled into a single set of cashflows to evaluate performance.

² See “J-curve” in Appendix B – Glossary of Terms for further information.

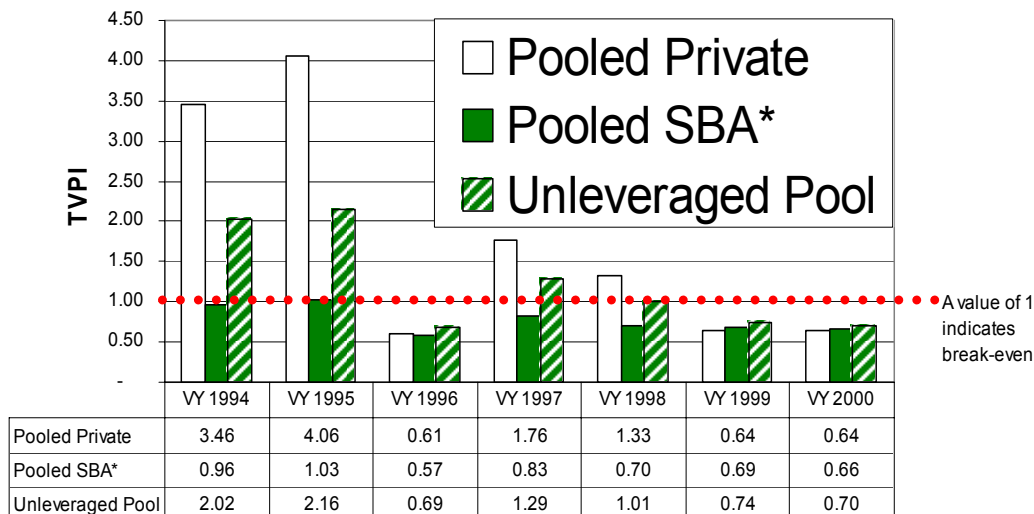
(Continued) Exhibit 1.1 Notes:

- a. **Residual Value:** The last financial statement received from each SBIC was used to calculate "residual value". In most cases the September 30, 2004 Form 468 Financial Statement was used. Residual values are calculated on an individual SBIC basis and then pooled.
- b. **Total Paid-in Capital:** Total Paid-in Capital includes private Paid-in Capital and SBA leverage. Advanced prioritized payments are not included.
- c. **Private:** Approximated performance to the private investors assumes a 20% Carried Interest is paid after return of capital.
- d. **SBA Lev & PP:** These calculations consider SBA's leverage and advanced prioritized payments as the Paid-In Capital. A DPI of 1 would indicate that SBA received distributions and fees equivalent to all capital guaranteed and advanced (i.e., leverage plus advanced prioritized payments). A TVPI of 1 indicates that distributions plus residual values currently reflect an anticipated break-even (excluding interest).
- e. **Unleveraged:** SBA leverage and Private Capital are considered Paid-in Capital and treated on the same terms with a 20% Carried Interest after repayment of capital. Since the SBICs do not receive advanced prioritized payments, these are not considered in these cashflows. This reflects the underlying performance of the funds for benchmarking purposes. It does not reflect how SBA's investment would have done if SBA were treated as one of the private investors, as the SBA has advanced prioritized payments.
- f. **NM: Not Meaningful.** Funds younger than 5 years are typically considered too young to evaluate performance, due to what is known as a "J-curve". (See Appendix B for further information on the "J-curve".)
- g. **VYs 1994-1998:** This composite of VYs encompasses the period (since inception of the PS program) during which the venture industry as a whole generated positive returns. Beginning with VY1999, the venture industry has not generated positive returns to date, because of the impact of the 2000 stock market downturn and the immaturity of more recent funds. As shown, the private investors are estimated to have received 1.9 times their Paid-in Capital, while the SBA has received about half. The TVPI of .84 indicates that the SBA is estimated to lose about 16% of the capital it has guaranteed or advanced (i.e., leverage plus prioritized payments), excluding interest.
- h. **VYs 1994-2000:** This composite of VYs include all funds that have been operating for five years or longer.
- i. **VYs 1994-2004:** This composite of VYs include all funds that took down PS leverage or commitments. (Funds that were licensed in FY 2004 that had not yet submitted Annual Form 468s are excluded from this analysis.)

The chart below shows the pooled TVPI by VY for VYs 1994-2000 graphically.

Exhibit 1.2: Pooled Total Value to Paid-In Capital by Vintage Year

As of September 30, 2004

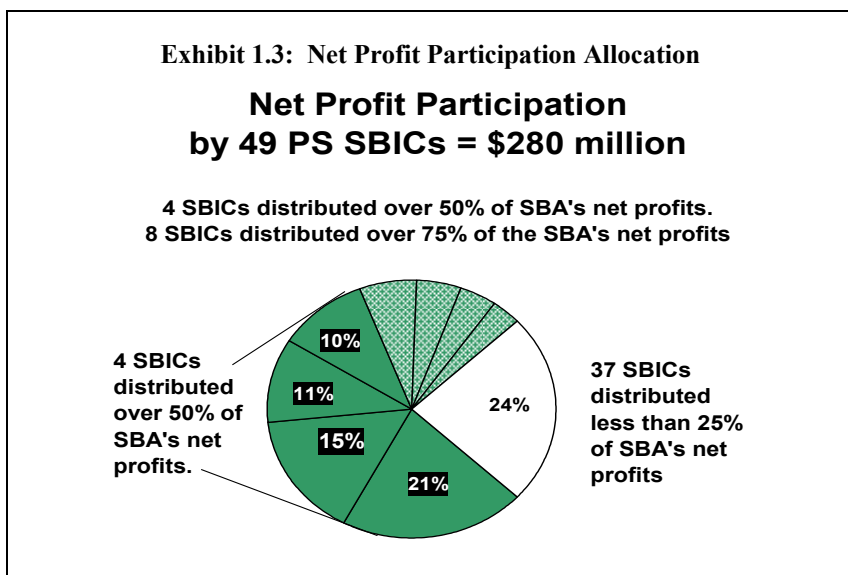


*Considers all SBA Leverage disbursed plus prioritized payments advanced by SBA as Paid-in Capital.

A few key points can be drawn from the table on the previous pages:

- **Cumulative Total Value to Paid-In Capital:** The SBA’s estimated total value to capital (either guaranteed or advanced) was 0.78 as of September 30, 2004, indicating that for every dollar that the SBA either guaranteed or advanced to date, the SBA’s estimated total value as of September 30, 2004 (either in cash already distributed or in residual value held by the SBICs), was 78 cents on the dollar. The SBA estimates that the private limited partners’ (as a pool) total value to paid-in capital was approximately 1.3, indicating a positive return for the private investors.
- **Cumulative Distributions to Paid-In Capital ([Exhibits 6.5, 6.8](#)):**
 - o **All VYs:** SBA’s ratio of cumulative distributions to capital (either guaranteed or advanced) was 0.28, indicating that for every dollar guaranteed or advanced by the SBA, approximately 28 cents on the dollar has been repaid either through distributions or “leverage fees”.¹ The SBA estimates that the distributions to private investor capital as a pool was approximately 0.69, indicating that for every dollar of private capital paid into the fund, the private investors as a pool received 69 cents on the dollar.
 - o **VYs 1994-1998:** Just as 1999 and 2000 represent the downward portion of the cycle in venture capital, VYs 1994-1998 represent a high point of the cycle and produced some of the best performing vintage years in venture history. (As such, they should not be used in isolation for purposes of forecasting.) Even during these “excellent” years, SBA received total distributions (including leverage fees) equivalent to approximately half of the capital it either guaranteed or advanced (leverage plus advanced prioritized payments). The respective private investors as a pool received 1.9 times their Paid-in Capital. Of the SBIC funds that made distributions to the private investors greater than or equal to their Paid-in Capital, over 75% have not fully repaid their SBA leverage.

Because allocation of profits strongly favor the private investor and profits are repaid before leverage, in several instances the private investors received distributions more than or equal to their paid-in capital and the SBA continued to have outstanding leverage. Part of the reason for the disparity between the private investors and SBA performance is the high concentration of profits in a few SBICs as shown in the chart below, indicating the high variance between SBIC funds.



The chart to the left shows that 4 SBICs distributed over 50% of SBA’s \$280 million in net profits (profits minus losses from in-kind distributions), while over 75% of SBA’s net profits came from 8 SBICs.

It should be noted that VYs 1994-1998 distributed \$278 million of the \$280 million in net profits (total profits minus losses from sale of stock distributions). This is due to the industry-wide problems in VYs 1999 and 2000 and the J-curve for post VY 2000 funds.

¹ “Leverage fees” are defined as fees paid by the SBICs to SBA at leverage commitment, leverage disbursement, and as part of annual fees. Annual fees are based on the subsidy rate, determined at time of commitment, and paid out of profit distributions only.

The distribution in overall performance, as measured by TVPI, also provides an indication of the variance between the SBIC funds. The table to the right shows the distribution of individual SBIC TVPI metrics for VYs 1994-1998. As shown, while there were some very successful SBIC funds, most are not successful from an SBA perspective and may not pay back either their leverage or their prioritized payments.

Exhibit 1.4: Distribution of TVPI Metrics for VYs 1994-1998

TVPI Range	SBA	Unleveraged
TVPI \geq 3	0	6
1.5 \leq TVPI < 3	3	13
1 \leq TVPI < 1.5	15	18
TVPI < 1	56	37
<i>Total Number of SBICs</i>	74	74

Summary

The Debenture Program is performing within original program estimates. The Participating Securities Program has suffered in performance due to 1) the calendar year 2000 downturn in the stock market and venture industry; 2) the terms of the instrument; and 3) more successful performance is concentrated in a smaller percentage of SBIC funds.

2. Introduction

On June 15, 2003, the SBA issued a Fiscal Year 2002 Special Report on the State of the SBIC Program (<http://www.sba.gov/INV/specialreport.html>), which examined the SBIC program's role in the private equity industry and provided cash analyses of both the SBIC Debentures and Participating Securities Programs through FY 2002. The Investment Division also publishes comprehensive statistical reports each year (www.sba.gov/INV/stat/index.html), which review SBIC financings and their impact on the economy.

This report updates the cash analyses from the June 2003 report through FY 2004 and examines the financial performance of the SBIC program for cohort¹ years 1994-2004, including statistics, capital impairment trends, and cashflow analyses for both the SBIC Debenture and Participating Securities Programs.

In addition, SBIC Participating Securities fund statistics are calculated and presented on a pooled² basis by vintage year. "Vintage year" (VY) indicates the first year of operations in a fund. The venture industry typically analyzes private equity fund performance by vintage year to help take into account external conditions which impact performance as well as age of the fund. For example, the venture industry as a whole took a severe performance hit in VYs 1999 and 2000 due to the downturn of the market in 2000. Also, funds younger than 5 years are typically considered too young to evaluate performance.³

These pooled statistics provide the reader with an understanding of the leveraged investment returns to private investors as well as the SBA's investment returns on a VY basis in the Participating Securities Program. Unleveraged fund performance returns are also calculated to provide an indication of the SBICs' underlying performance. (Note: Unleveraged metrics treat SBA leverage on the same terms as capital raised from private investors.) Appendix A describes general fund metric methodology and summarizes the assumptions used to calculate fund metrics. Appendix B provides a glossary of terms used throughout this report.

The information provided in this document is based on actual cashflows and reported current net asset values in the SBICs. For the purpose of developing subsidy⁴ re-estimates for the Participating Securities and Debenture programs, SBA uses the actual cashflows, as presented in this report, as well as projections of future cashflows (such as future advancements of prioritized payments) not considered here. Subsidy re-estimates follow credit reform practices as outlined in OMB Circular No. A-11 Part 5-Federal Credit, Sections 185.5-185.7. Subsidy re-estimates are developed independent from the analyses shown in this report.

As of September 30, 2004, total lifetime subsidy re-estimates for cohorts 1992 through 2004 for the Debentures Program were negative \$77 million, indicating that actual program costs to date and current estimates of future program costs for those years are slightly lower than originally anticipated. Total lifetime subsidy re-estimates for the Participating Securities Program (cohorts 1994-2004) were positive \$2.7 billion (of which \$0.5 billion is due to one-time accounting adjustments), indicating that actual program costs to date and current estimated future program costs for those years are higher than originally anticipated.

¹ A cohort year means the fiscal year in which SBA issues a leverage commitment to an SBIC. Disbursements of the committed funds may take place up to 4 years after the commitment year. Typically SBICs have leverage from two or more cohort years. For federal budgeting purposes, performance must be examined by cohort year.

² "Pooled" indicates that cashflows from all funds are pooled into a single set of cashflows to evaluate performance.

³ See "J-curve" in Appendix B – Glossary of Terms for further information.

⁴ The subsidy cost is the estimated present value of the cash flows from the Government (excluding administrative expenses) less the estimated present value of the cash flows to the Government resulting from a direct loan or loan guarantee, discounted to the time when the loan is disbursed. For further information refer to OMB Circular No. A-11 Part 5-Federal Credit, Sections 185.

3. Program Overview

The purpose of the Small Business Investment Company (SBIC) program is to stimulate and supplement the flow of private equity capital and long term loans to small business concerns. To participate in the SBIC program, a fund managed by a team of experienced private equity professionals must qualify for an SBIC license.

SBICs are licensed with the expectation either that they will receive financial assistance from SBA (“leverage”), in the form of SBA-guaranteed debentures or participating securities (“SBA-guaranteed leverage”), or that they will operate without such financial assistance. An SBIC’s business plan and investment strategy are the primary factors in determining the type of leverage used by an SBIC. Under certain circumstances, SBICs with Participating Securities leverage may issue debentures¹. Specialized SBICs (SSBICs) are SBICs that focus on investing in disadvantaged businesses.² Non-leveraged SBICs are not authorized to receive leverage—such firms typically obtain an SBIC license to provide their bank investors with a vehicle for Community Reinvestment Act (CRA) credit or for other business reasons.

After licensing, SBICs are monitored by the Investment Division’s Office of SBIC Operations. In cases of regulatory non-compliance, including capital impairment, the SBA has the right to transfer the SBIC to the Office of Liquidation and repurchase the SBA-guaranteed leverage issued by the SBIC (“repurchased leverage”). Alternatively, if the SBIC pays back its leverage and has no remaining obligations to the SBA it may choose to “surrender” its license, per 13 CFR 107.1900. For the purposes of this document, an SBIC is considered “active” if the SBIC has neither been transferred to the Office of Liquidation nor surrendered its license. An SBIC is considered “transferred” if it is currently under the management of the Office of Liquidation. The SBA’s total current portfolio consists of both “active” and “transferred” SBICs.

SBA Financial Assistance (“Leverage”) Description

How does SBA leverage work? An SBIC in good standing, with a demonstrated need for funds, may request leverage up to 300% of its private capital. The maximum amount of leverage varies according to the fund’s private capital and the type of leverage issued, but is generally limited to 2 times Private Regulatory Capital.³ To obtain leverage, SBICs issue debentures or participating securities, which are guaranteed by the SBA. Separate pools of either SBA-guaranteed debentures or participating securities are formed and sold to investors through securities offerings.

Under current procedures, debentures have a term of ten years, with semi-annual interest payments and a lump sum payment of principal at maturity. The ten-year debenture allows prepayment with penalty during the first five years and prepayment without penalty thereafter. The interest rate on the debenture is determined by market conditions at the time of the pooling.

Participating securities are similar to debentures, however, SBA advances interest (known as “prioritized payments”) to the participating security pool investors and is reimbursed only when an SBIC has earnings. A unique feature of the participating securities is that SBA shares in the profits of the SBIC. The table on the next page summarizes key differences between debentures and participating securities.

¹ Licensing of new Participating Security SBICs was discontinued as of October 1, 2004.

² Licensing of new SSBICs was discontinued as of October 1, 1996 as result of statutory changes.

³ See Appendix B for definition.

Exhibit 3.1: Comparison of SBIC Leverage Securities		
Feature	Debentures ^a	Participating Securities ^b
Amount of Leverage ^c	Up to 300% of Leverageable Capital	Up to 200% of Leverageable Capital
Term of Leverage	10 years	10 years
Interest Payments	Paid by the SBIC on semi-annual basis.	SBA advances interest payments to PS pool investors on a quarterly basis. SBA is repaid these interest payments, known as “prioritized payments,” only out of “profits” of the fund.
Repayment of Principal ^d	Allows prepayment with penalty during the first five years and prepayment without penalty thereafter. Due at 10 year maturity.	Paid out of distributions, per the distribution formula which pays prioritized payments first, profit second, and then redemption of principal. Regardless, due at 10 year maturity.
Profit Share	None	Based on profit formula described in 13 CFR Sec. 107.1530, but typically less than 10%
Commitment and Drawdown Fees	1% commitment + 2% drawdown fee	1% commitment + 2% drawdown fee
Annual Fee	Annual Fee based on subsidy rate, determined at time of commitment and due on a semi-annual basis.	Annual Fee based on subsidy rate, determined at time of commitment, paid out of <i>profit</i> distributions only

Notes

a. In addition to regular debentures, low/moderate income (LMI) debentures are also available to eligible SBICs. LMI debentures are generally similar to regular SBIC debentures, with several exceptions.

- Proceeds of LMI debentures must be invested in small businesses that are located in qualified LMI zones and employ residents of qualified LMI zones
- LMI debentures are available in both 5 and 10 year maturities
- Interest and annual charges on LMI debentures may be deferred for the first five years of debenture life
- LMI debentures are not pooled—rather, they are funded through an arrangement with a lender, currently the Federal Home Loan Bank of Chicago, throughout their entire term.

b. SBIC participating securities funds distribute capital based on fairly complex rules; however in simplest terms, such SBICs are required to make distributions in the following order:

- Prioritized payments if profitable based on retained earnings
- Optional “tax” distribution—SBA receives a share based on its profit participation rate
- Distribution of remaining profits:
 - If the SBA has *over* 50% of the capital in a fund, SBA and private investors split distribution 50-50. SBA applies its share first to profit participation and then as redemption of leverage
 - If the SBA has *less* than 50% of the capital in a fund, SBA gets profit participation only and private investors get the remainder
- After all profit has been distributed, the SBIC has the option of distributing any remaining liquidity to SBA and the private investors as a pro rata return of capital.

c. The maximum amount of leverage varies according to the SBIC’s private capital, as described in 13 CFR Sections 107.1150-1170.

d. The SBA has the right to repurchase/force redemptions of leverage for regulatory non-compliance which includes instances when an SBIC has a condition of capital impairment as defined in 13 CFR 107.1830-1850.

4. Financial Performance Highlights

- **SBA Leverage (Section 5)**

- **Financial Exposure (Exhibit 5.1):** As of September 30, 2004, SBA's total financial exposure in the SBIC program for cohorts 1994 through 2004 (as measured by undisbursed leverage commitments, outstanding SBA-guaranteed leverage, outstanding repurchased leverage, and unreimbursed advanced prioritized payments not associated with repurchased leverage) was \$11.25 billion for the participating securities (PS) program and \$2.84 billion for debenture.
- **Leverage Performance (Exhibit 5.4):**
 - **Debentures:** For cohorts 1994-2004, through September 30, 2004, the SBA repurchased (transferred to the Office of Liquidation) \$180 million of debenture leverage, representing 7% of all debenture leverage disbursed for these cohorts.
 - **Participating Securities:** From the start of the program (FY1994) through September 30, 2004, SBA repurchased (transferred to the Office of Liquidation) \$1.1 billion of PS leverage, representing 18% of all PS leverage issued.

- **Participating Securities SBIC Fund Statistics (Section 6)**

- **Cumulative Total Value to Paid-In Capital:** The SBA's estimated total value¹ to capital (either guaranteed or advanced) was 0.78 as of September 30, 2004, indicating that for every dollar that the SBA either guaranteed or advanced to date, the SBA's estimated total value as of September 30, 2004 (either in cash already distributed or in residual value held by the SBICs), was 78 cents on the dollar. The SBA estimates that the private limited partners' (as a pool²) total value to Paid-in Capital was approximately 1.3, indicating a positive return for the private investors.³
- **Cumulative Distributions to Paid-In Capital (Exhibits 6.5, 6.8):**
 - **All VYs:** SBA's ratio of cumulative distributions to capital (either guaranteed or advanced) was 0.28, indicating that for every dollar guaranteed or advanced by the SBA, approximately 28 cents on the dollar has been repaid either through distributions or leverage fees. The SBA estimates that the distributions to private investor capital as a pool was approximately 0.69, indicating that for every dollar of private capital paid into the fund, the private investors as a pool received 69 cents on the dollar.
 - **VYs 1994-1998:** Just as 1999 and 2000 represent the downward portion of the cycle in venture capital, VYs 1994-1998 represent a high point of the cycle and produced some of the best performing vintage years in venture history. (As such, they should not be used in isolation for purposes of forecasting.) Even during these "excellent" years, SBA received total distributions (including leverage fees) equivalent to approximately half of the capital it either guaranteed or advanced (leverage plus advanced prioritized payments). The respective private investors as a pool received 1.9 times their Paid-in Capital. Of the SBIC funds that made distributions to the private investors greater than or equal to their Paid-in Capital, over 75% have not fully repaid their SBA leverage.

¹ Total Value is measured by total distributions plus the remaining "residual value" of the net assets held by the fund. If the Total Value to Paid-in Capital (TVPI) equals 1, this would indicate a break-even scenario. See Appendix A for a further description and assumptions on the Total Value to Paid-in Capital Metric.

² Pooled statistics aggregate the cashflows from all SBIC participating securities funds, treating them as if they were a single portfolio.

³ Private and unleveraged statistics estimate a 20% Carried Interest after repayment of capital.

▪ **SBIC Capital Impairment¹ Statistics (Section 7)**

○ **Participating Securities (Exhibits 7.1 and 7.2):**

- **Transferred:** The cumulative percentage of PS SBICs (based on number of funds) licensed prior to calendar year 2001 that were transferred to the Office of Liquidation due primarily to capital impairment problems increased from 16% in September 2003 to 29% in September 30, 2004.
- **Active with Capital Impairment Over 60 Percent:** The cumulative percentage of PS SBICs (based on number of funds) licensed prior to calendar year 2001 that were active and had capital impairment percentages over 60% decreased from 33.3% at the end of FY 2003 to 25.5% at the end of FY 2004. This reduction was primarily due to SBA continuing to transfer active funds to the Office of Liquidation as regulations permit.
- **Transferred or Active with Capital Impairment Over 60 Percent:** These two points indicate that by September 30, 2004, 54.6% of PS SBICs (29.1% transferred + 25.5% over 60 percent capital impairment) licensed prior to calendar year 2001 were either transferred to the Office of Liquidation or had capital impairment percentages over 60%. This is a 5% increase from September 2003's ending year figure (49.6%).

- **Debenture (Exhibit 7.3):** Approximately 27.7% of debenture SBICs licensed prior to calendar year 2001 that were active as of December 2000 and had issued leverage in the last fifteen years were either transferred to the Office of Liquidation or have capital impairment percentages over 50 percent. This percentage has not changed from September 2003.

▪ **SBIC Cashflow Performance (Section 8)**

- **Debentures (Exhibit 8.1):** As of September 30, 2004, the debenture program's cash balance² (for cohorts 1994-2004) was \$66.3 million, a decrease of \$2.8 million in FY 2004 from the previous year.
- **Participating Securities (Exhibit 8.2):** The PS program cash balance was negative \$1.1 billion, a decrease of \$624 million in FY 2004, primarily due to repurchased leverage from transfers of highly capitally impaired funds.
- Given repurchase estimates and anticipated advanced prioritized payments (in the participating securities program only), both cash balances are expected to decline.

¹ "Capital impairment" is a measure that indicates the SBIC's financial condition and is calculated as defined in 13 CFR 107.1830-1850. A capital impairment number is calculated and reported each quarter by the Investment Division for each SBIC. These calculations do not include Class 2 appreciation (as defined in 13 CFR 107.1850), which can improve the statistic. If an SBIC's capital impairment percentage goes over its maximum, the SBA has the right to repurchase the SBIC's leverage and transfer the fund to the Office of Liquidation. The maximum permitted capital impairment varies based on the leverage ratio, stage and types of investment, and time since first leverage draw, however, for most PS funds older than five years, the maximum permitted is 60. The average maximum permitted capital impairment for debenture funds with leverage outstanding is 50.

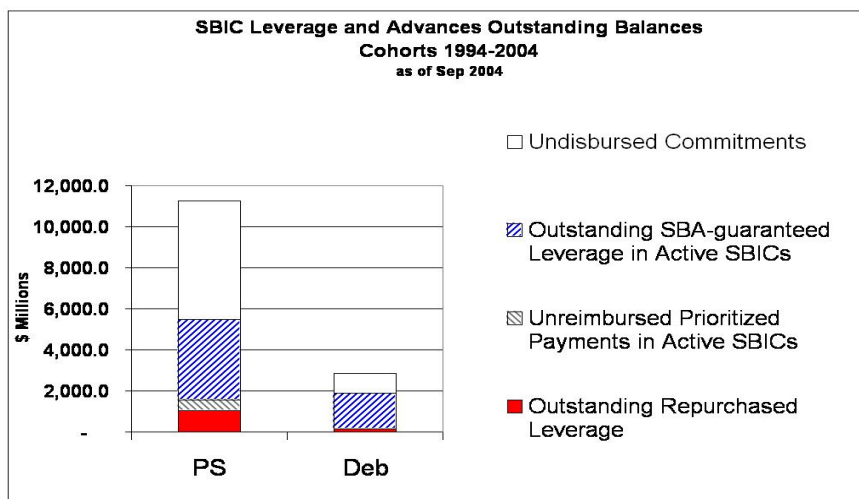
² The "cash balance" is the cumulative sum of net cashflows for each program through September 30, 2004. See Section 7 for further information on these cashflows. It should be noted that a negative "cash balance" represents neither the realized nor the estimated losses for either program.

5. SBA Leverage Statistics

Financial Exposure

The figure below measures SBA's financial exposure as the sum of outstanding undisbursed leverage commitments, outstanding SBA-guaranteed leverage in active SBICs, unreimbursed prioritized payments associated with outstanding SBA-guaranteed participating securities leverage in active SBICs, and outstanding repurchased leverage as of September 30, 2004. (Although SBICs transferred to the Office of Liquidation have unreimbursed prioritized payments associated with the repurchased leverage, it is unlikely that they will be recovered, since they are only repaid out of "profits". Most of these prioritized payments were written off by the Office of Liquidation by the end of FY 2004, indicating that the SBA does not expect recovery.)

Exhibit 5.1: SBIC Program Financial Exposure As of September 30, 2004



(\$ Millions)	PS	Deb
Undisbursed Commitments	5,752.6	933.2
Outstanding SBA-guaranteed Leverage in Active SBICs	3,930.0	1,759.3
Unreimbursed Prioritized Payments in Active SBICs	533.6	-
Outstanding Repurchased Leverage	1,031.5	146.0
	<u>11,247.7</u>	<u>2,838.5</u>
Unreimbursed Prioritized Payments Associated with Repurchased Leverage	268.4	
- Prioritized Payments Written Off in Liquidation	(257.9)	
Outstanding Prioritized Payments Associated with Repurchased Leverage	10.5	

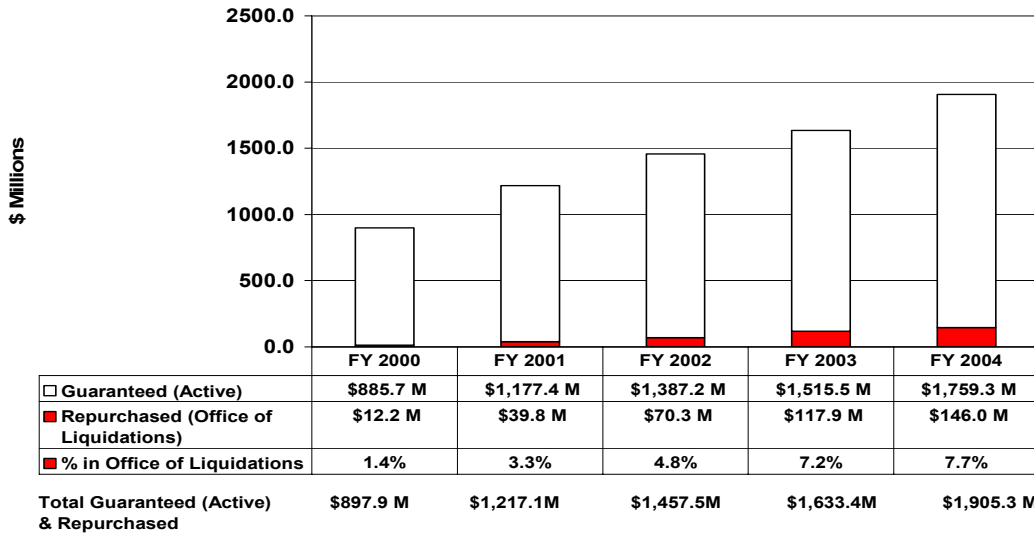
As shown, the PS undisbursed commitments alone are greater than all the debenture commitments and leverage for cohorts 1994-2004.

The exhibits on the next page show the growth of SBA's outstanding guaranteed and repurchased leverage for each of the programs since FY 2000. This provides indicators to how fast the program has grown in the past five years, the health of SBA's portfolio, and the oversight required to manage the program¹.

¹ A higher percentage of leverage repurchased tends to indicate a poorer performing portfolio, along with a need for greater SBA oversight.

Exhibit 5.2: Debenture Financial Exposure by Fiscal Year

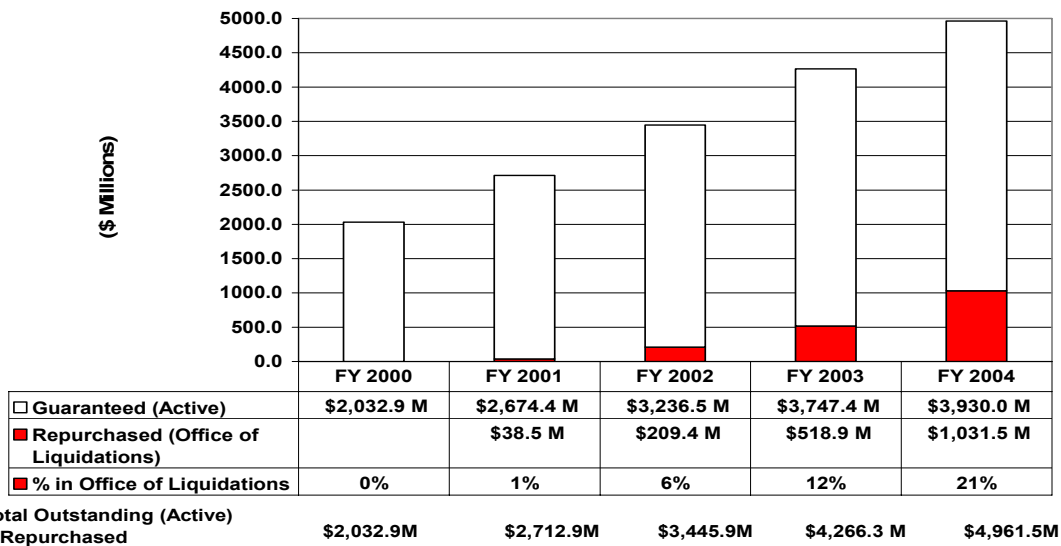
Outstanding SBA-Guaranteed and Repurchased Debenture Leverage Cohorts 1994-2004 Only (\$Millions)



- The total outstanding debenture leverage for cohorts 1994-2004 more than doubled since FY 2000. Of the \$1.9 billion in outstanding SBA guaranteed and repurchased leverage, only \$146 million is managed by the Office of Liquidation, representing 7.7% of the overall portfolio.

Exhibit 5.3: Participating Securities Financial Exposure (Leverage Only) by Fiscal Year

Outstanding SBA-Guaranteed and Repurchased PS Leverage (\$Millions)

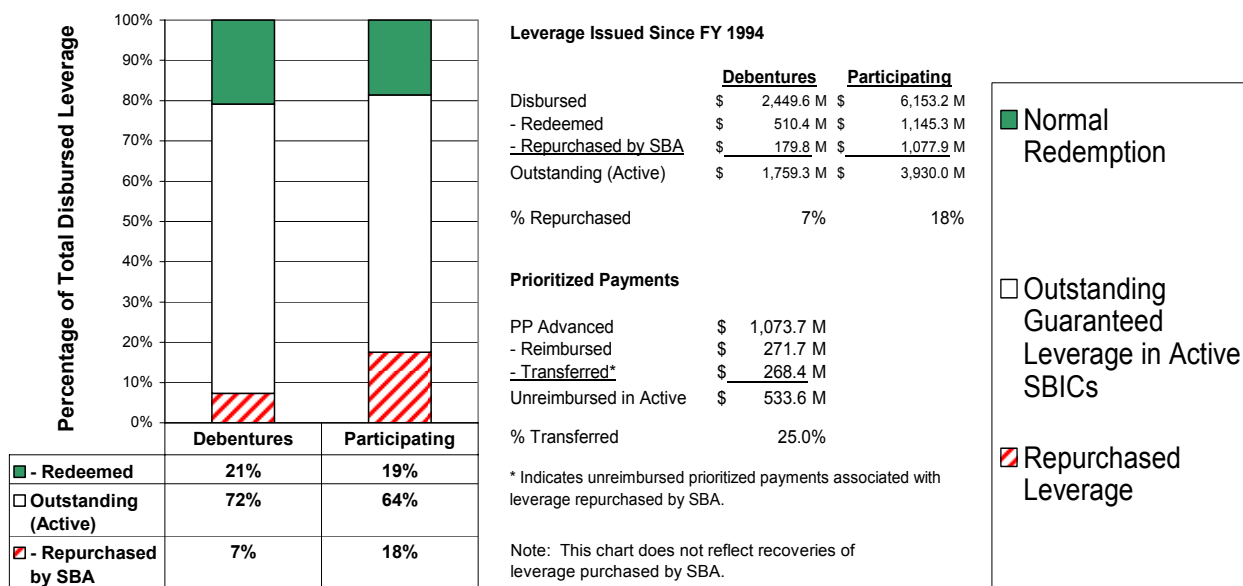


- The total outstanding PS leverage (both guaranteed and repurchased) at the end of FY 2004 was nearly two and a half times greater than at the end of FY 2000. Of the outstanding PS leverage, over \$1 billion is overseen by the Office of Liquidation, representing 21% of the overall PS portfolio. These numbers remain within the estimates identified at the end of FY 2003.

Leverage Performance

The previous analysis considered SBA’s current and historical financial exposure by looking at the outstanding balances. This only gives us a partial indication of the performance of the program. To evaluate leverage performance, redemptions need to be considered in addition to repurchases. To compare the debenture and PS program performances, the exhibit below looks at redemptions and repurchases as a percentage of total disbursements.

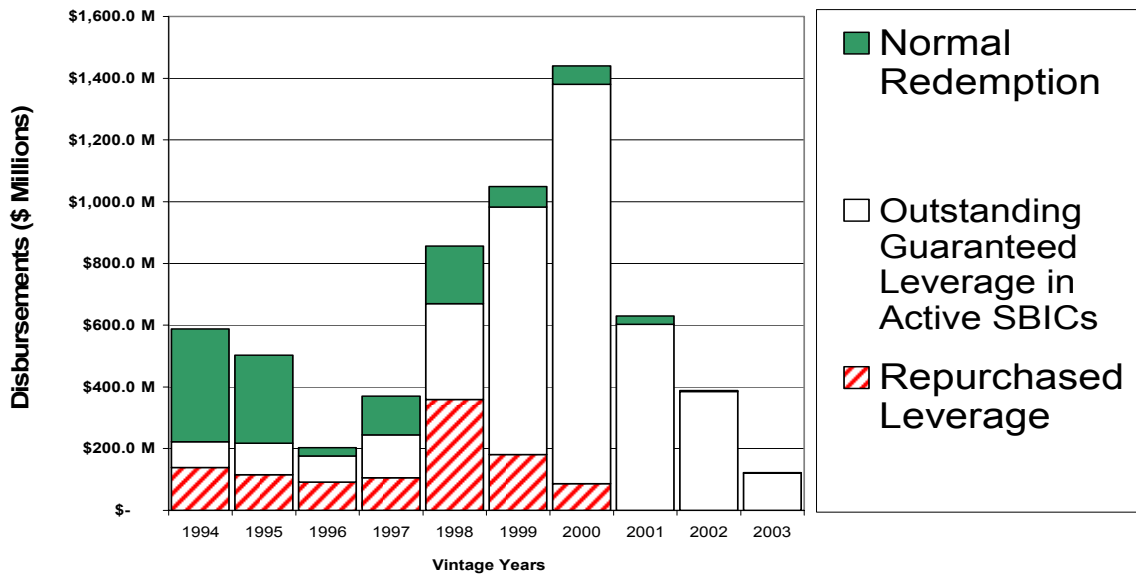
**Exhibit 5.4: Comparison of Disbursed Leverage Performance Issued Since FY 1994
 Cohorts 1994-2004**



- As shown, the debenture program (cohorts 1994-2004) redeemed 21% of all disbursements and the PS program redeemed a slightly lower percentage, 19% of all PS disbursements.
- Only 7% of debentures have been repurchased, while 18% have been repurchased in the PS program.
- In addition, the PS program advances prioritized payments (PP). Of those advanced, 25% have been reimbursed by the SBICs and 25% are associated with SBICs transferred to the Office of Liquidations. Almost all prioritized payments associated with repurchased leverage were written off by the end of FY 2004. However, these write-offs were offset by \$279 million in net profit participation (profit participation minus losses from in-kind distributions).

This analysis does not take into account SBIC age. Because most funds are not transferred prior to their fifth or sixth year, the ultimate transfer rate may differ. The chart on the next page breaks down the PS leverage performance into vintage years.

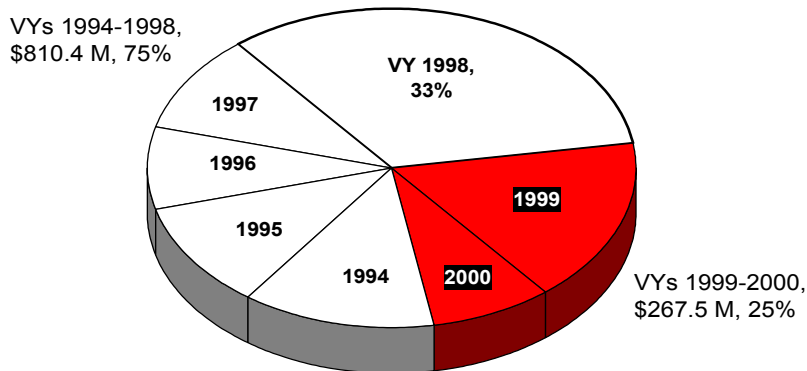
Exhibit 5.5: Participating Securities Disbursements by Vintage Year



As shown, through September 30, 2004, only VY 1994-2000 funds have been transferred to the Office of Liquidation.

As discussed in Section 1, most venture funds in vintage years 1999-2000 have not done well to date due to the sharp decline in equity values associated with the collapse of the “tech bubble” in 2000 and the overall downturn in the stock market. Likewise, this downturn was a one reason for many of the defaults in SBA’s portfolio. However, as shown in the chart below, through September 30, 2004 VYs 1999 and 2000 account for 25% of all leverage (by dollars) defaulted through FY 2004.

Exhibit 5.6: Repurchased Participating Securities Leverage by Vintage Year



VY 1998 accounts for 33% of the repurchased PS leverage.

It is expected that because of the heavy weighting (on a capital basis) in VYs 1999 and 2000, that the full impact of the VY 1999 and 2000 funds will be realized in future defaults. This expected impact has been taken into account in the FY 2004 end of year re-estimate for the program.

6. Participating Securities SBIC Fund Statistics

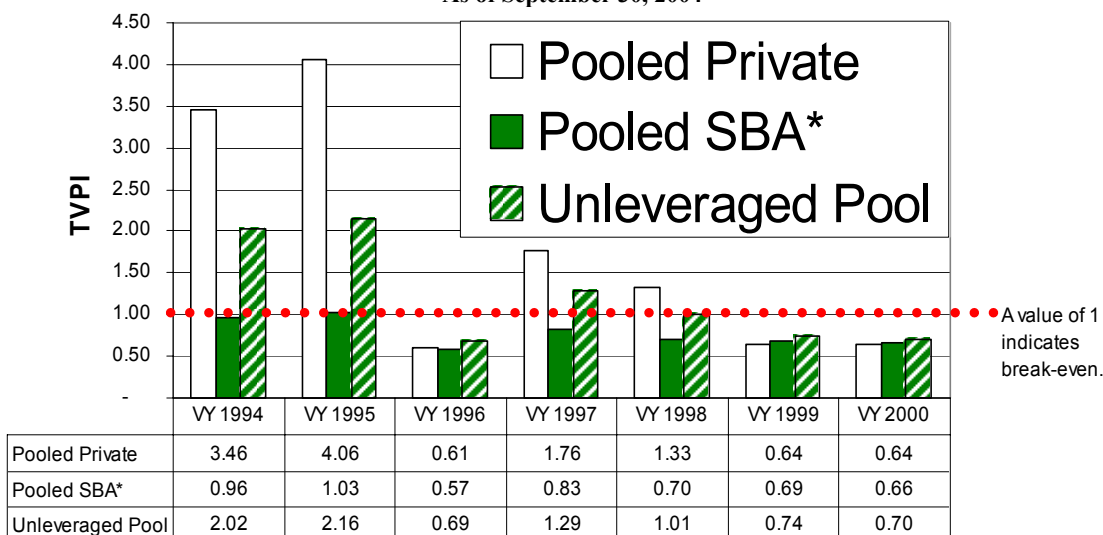
Due to the participating securities' terms, the leverage statistics do not necessarily reflect either how the PS SBICs performed or whether the SBA received total distributions sufficient to redeem the leverage. In a few cases, SBICs have paid leverage fees and made total distributions to SBA that equal or exceed disbursed leverage plus advanced prioritized payments (PP), but the SBIC still has an outstanding leverage balance. This is because the distribution formula allocates distributions to prioritized payments and profit *before* the leverage. In addition, the allocation of profits heavily favors the private investor.

Therefore, to evaluate SBIC investment performance, it is necessary to look at the returns to private investors, the returns to the SBA, and how the fund performed on an "unleveraged" basis. The "unleveraged" return information treats SBA leverage the same as the capital contributed to an SBIC by its private investors, sharing all distributions and fees on a *pro rata* basis and paying a 20% Carried Interest on profits.¹

Venture capital funds typically go through what is known as a "J-curve" in which returns tend to be negative for a few years at the beginning of a fund's investment cycle before eventually rising through investment gains both realized and unrealized. The following exhibits 5.1 through 5.3 provide pooled fund metrics² for VYs 1994 through 2000. Funds with VYs 2001 and later are considered to be too early to evaluate, based on the "J-curve".

Exhibit 6.1: Pooled Total Value to Paid-In Capital by Vintage Year

As of September 30, 2004



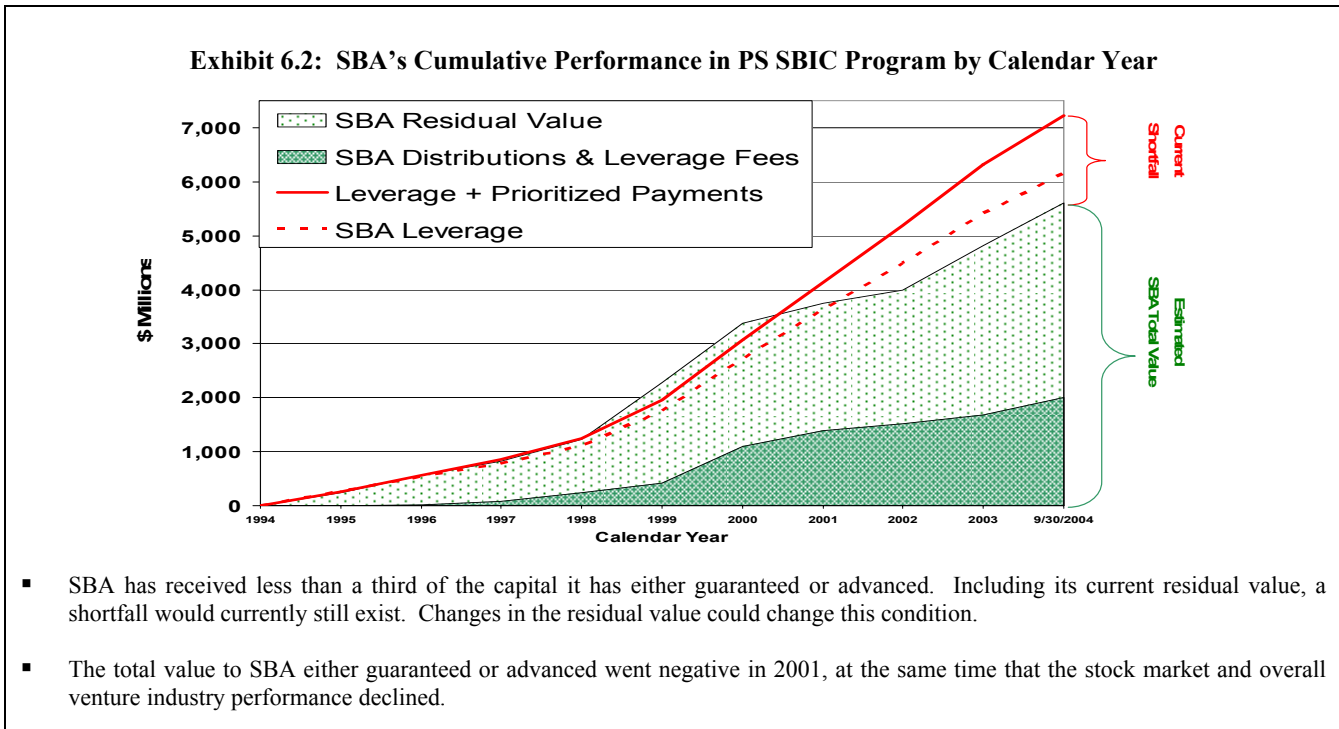
* Considers all SBA Leverage disbursed plus prioritized payments by SBA as Paid-in Capital.

- The only year in which the SBA appears to break even is vintage year 1995, where the pooled private total value to Paid-in Capital (TVPI) is over 4 and the unleveraged TVPI is over 2.

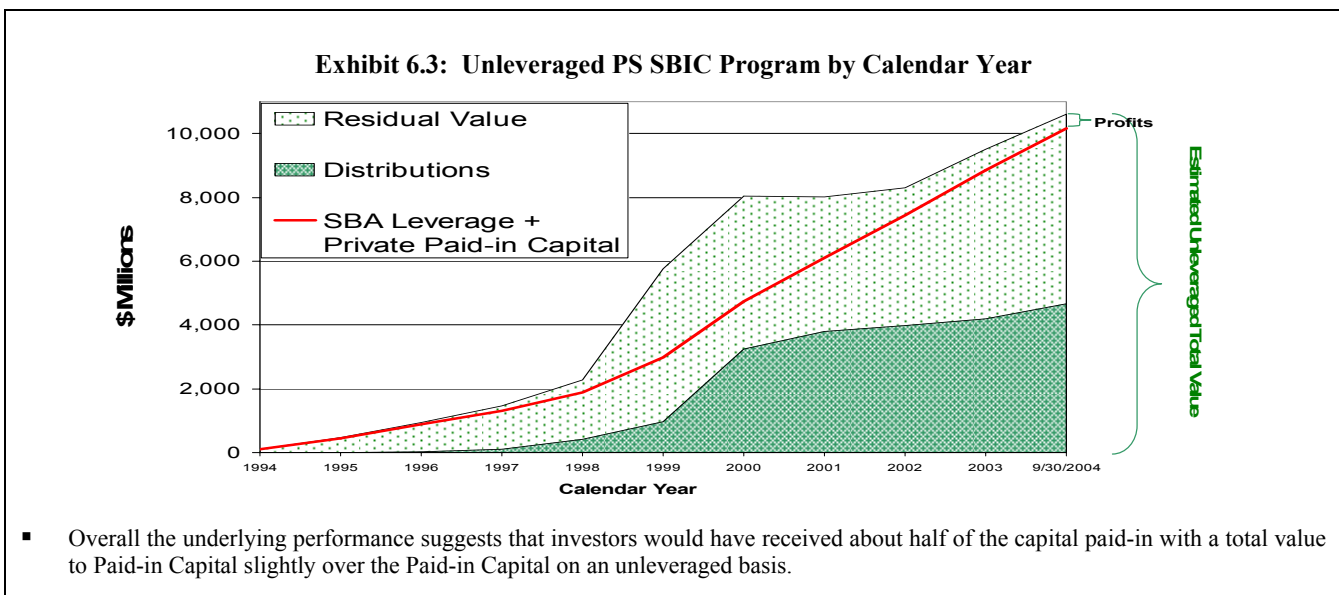
¹ See Appendix B for definition.

² Pooled fund metrics consider cashflows and residual values for all PS SBICs, aggregated as a single fund to compute internal rate of return and realization ratios.

The chart below provides a visual depiction of SBA's estimated shortfall as of September 30, 2004 in terms of leverage disbursed plus prioritized payments advanced versus distribution and residual value.



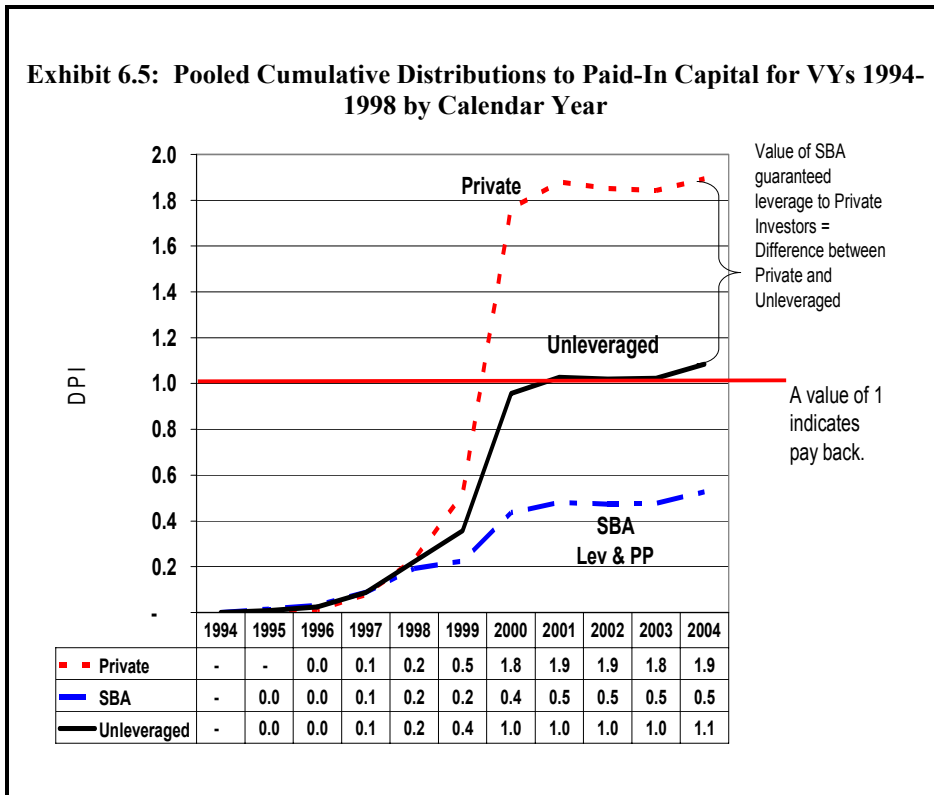
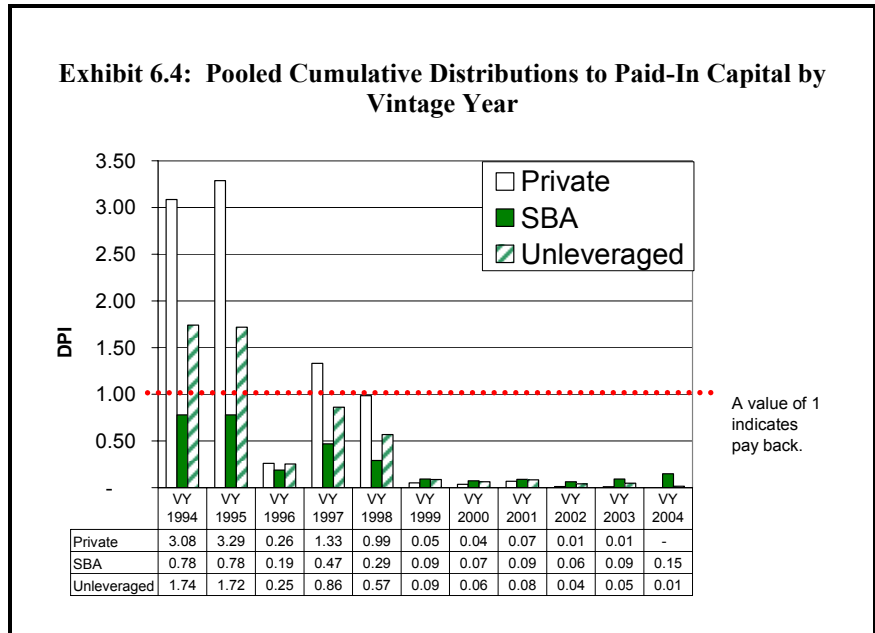
The above chart indicates how SBA performed, which does not necessarily reflect how the SBICs performed. The following chart shows the underlying performance of the SBICs, by considering the funds on an unleveraged basis.¹



¹ This shows the unleveraged performance of the PS SBIC programs cumulative to date, treating both SBA leverage and private Paid-in Capital on the same terms. Estimated distributions and residual values subtract a 20% Carried Interest on each fund after return of capital. Advanced prioritized payments are not considered.

The chart to the right shows the ratio of cumulative Distributions to Paid-in Capital (DPI) relative to private investors, SBA, and on an unleveraged basis. In general, the private investor performance has far exceeded the SBA's.

Also shown on this chart is the lack of activity by VYs 1999-2004 in terms of distributions, similar to the rest of the venture industry.



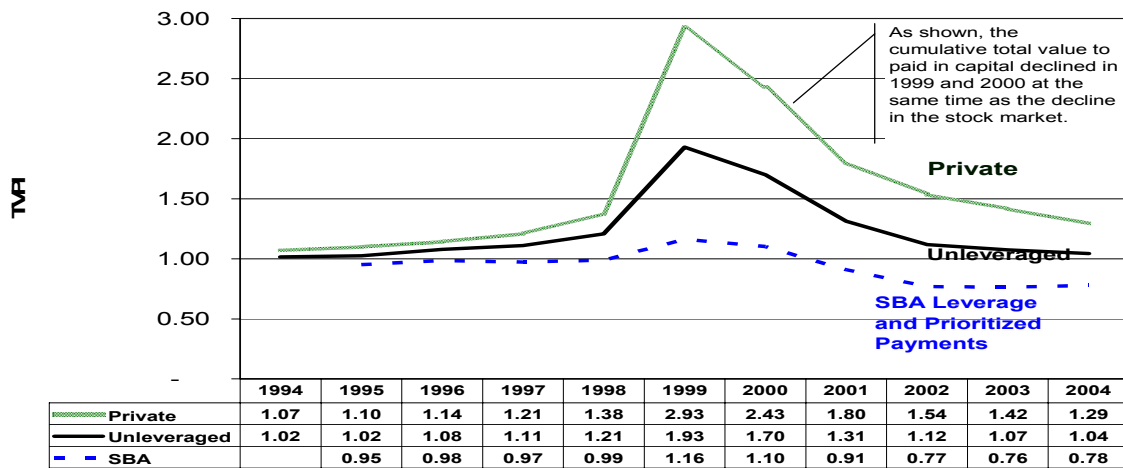
The chart to the left indicates the cumulative DPI by calendar year for those vintage years that have had significant distributions from activity (VYs 1994-1998) on a pooled basis for the private investors, the SBA (considering leverage and prioritized payments as SBA's Paid-in Capital), and on an unleveraged basis.

As shown, the private investors have consistently received greater returns than the SBA.

The chart also shows that distributions by the VY 1994-1998 funds have been essentially flat since 2000, although there was a slight up-tick in 2004.

While Distributions to Paid-in Capital indicates what has been received to date, Total Value to Paid-in Capital (TVPI) adds the residual value of the fund, indicating what investors would receive if the fund were liquidated today at its current net asset value. The chart below shows this metric for the private investor, the SBA, and on an unleveraged basis.

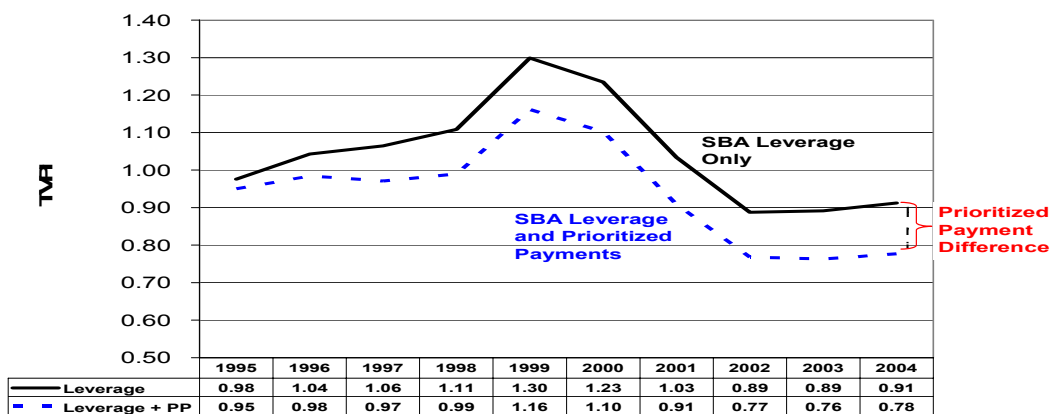
Exhibit 6.6: Pooled Total Value to Paid-in Capital by Calendar Year Cumulative for All Vintage Years



- As shown, based on the unleveraged multiple, SBIC performance has essentially remained flat since the end of calendar year 2003. While the above unleveraged metrics show a break-even scenario, the total value to paid-in capital metric neither considers the time value of money nor the cost of capital. The unleveraged IRR shown in Exhibit 6.8 shows the current unleveraged IRR to be 2.5%. Both cumulative TVPI and IRR measures change as distributions are made and net asset values in SBIC portfolios increase or decline.

By looking at just the SBA leverage, one can see the impact of the prioritized payments (shown below).

Exhibit 6.7: Pooled SBA Total Value to Capital With and Without Advanced Prioritized Payments by Calendar Year Cumulative for All Vintage Years



- The solid line shows the TVPI including only SBA leverage as paid-in capital. The dashed line shows the TVPI including both SBA leverage and advanced prioritized payments as paid-in capital. As shown, in 2004 SBA's overall TVPI grew for both SBA metrics. However, if the total value grows at a slower rate than SBA's continuing prioritized payments advances, the gap between the two curves shown above will grow.

The below chart shows all pooled statistics.

Exhibit 6.8: Participating Securities SBIC Pooled Fund Statistics by Vintage Year

Pooled IRR (Includes Residual Value ^a), Distributions to Paid In Capital (DPI), and Total Value to Paid In Capital (TVPI)
Through Sep 2004

Individual Vintage Years

	Total Paid In ^b (in Millions of \$)	Percent of Total Paid In	Private ^c			SBA Lev & PP ^d			Unleveraged ^e		
			IRR	DPI	TVPI	IRR	DPI	TVPI	IRR	DPI	TVPI
VY 1994	\$ 913.7	9%	32.3%	3.08	3.46	-1.3%	0.78	0.96	19.7%	1.74	2.02
VY 1995	\$ 751.1	7%	49.6%	3.29	4.06	0.9%	0.78	1.03	25.9%	1.72	2.16
VY 1996	\$ 314.8	3%	-11.8%	0.26	0.61	-16.5%	0.19	0.57	-9.3%	0.25	0.69
VY 1997	\$ 592.7	6%	27.3%	1.33	1.76	-6.7%	0.47	0.83	10.5%	0.86	1.29
VY 1998	\$ 1,328.7	13%	20.9%	0.99	1.33	-14.7%	0.29	0.70	0.8%	0.57	1.01
VY 1999	\$ 1,709.2	17%	-14.5%	0.05	0.64	-15.7%	0.09	0.69	-10.7%	0.09	0.74
VY 2000	\$ 2,339.6	23%	-19.8%	0.04	0.64	-25.9%	0.07	0.66	-19.1%	0.06	0.70
VY 2001	\$ 1,051.7	10%	NM ^f	0.07	NM	NM	0.09	NM	NM	0.08	NM
VY 2002	\$ 686.9	7%	NM	0.01	NM	NM	0.06	NM	NM	0.04	NM
VY 2003	\$ 268.4	3%	NM	0.01	NM	NM	0.09	NM	NM	0.05	NM
VY 2004	\$ 210.2	2%	NM	-	NM	NM	0.15	NM	NM	0.01	NM
VYs 1994 - 2004	\$10,167.1	100%	17.7%	0.69	1.29	-13.0%	0.28	0.78	2.5%	0.46	1.04

Through Cumulative Pooled Metrics for Composite Years

	Total Paid In ^b (in Millions of \$)	Percent of Total Paid In	Private			SBA Leverage & Prioritized Payments ^d			Unleveraged ^e		
			IRR	DPI	TVPI	IRR	DPI	TVPI	IRR	DPI	TVPI
VYs 1994 - 1995	\$ 1,664.8	16%	37.9%	3.17	3.71	-0.3%	0.78	0.99	21.9%	1.73	2.08
VYs 1994 - 1996	\$ 1,979.7	19%	35.2%	2.69	3.20	-2.4%	0.69	0.93	19.2%	1.50	1.86
VYs 1994 - 1997	\$ 2,572.4	25%	34.4%	2.36	2.85	-3.2%	0.64	0.91	18.1%	1.35	1.73
VYs 1994 - 1998	\$ 3,901.1	38%	33.3%	1.89	2.33	-6.4%	0.53	0.84	15.2%	1.08	1.48
VYs 1994 - 1999	\$ 5,610.4	55%	27.1%	1.30	1.79	-8.8%	0.41	0.80	9.8%	0.78	1.26
VYs 1994 - 2000	\$ 7,949.9	78%	20.4%	0.91	1.44	-12.3%	0.32	0.76	4.4%	0.57	1.09
VYs 1994 - 2001	\$ 9,001.6	89%	19.0%	0.81	1.38	-12.4%	0.29	0.77	3.6%	0.51	1.07
VYs 1994 - 2002	\$ 9,688.5	95%	18.4%	0.75	1.34	-12.8%	0.28	0.78	3.0%	0.48	1.06
VYs 1994 - 2003	\$ 9,956.9	98%	18.1%	0.72	1.32	-12.9%	0.28	0.78	2.7%	0.47	1.05
VYs 1994 - 2004	\$10,167.1	100%	17.7%	0.69	1.29	-13.0%	0.28	0.78	2.5%	0.46	1.04

Notes:

- Residual Value:** The last financial statement received from each SBIC was used to calculate "residual value". In most cases the September 30, 2004 Form 468 Financial Statement was used. Residual values are calculated on an individual SBIC basis and then pooled.
- Total Paid-in Capital:** Total Paid-in Capital includes private Paid-in Capital and SBA leverage. Advanced prioritized payments are not included.
- Private:** Approximated performance to the private investors assumes a 20% Carried Interest is paid after return of capital.
- SBA Lev & PP:** These calculations consider SBA's leverage and advanced prioritized payments as the Paid-In capital. A DPI of 1 would indicate that SBA received distributions and fees equivalent to all capital guaranteed and advanced (i.e., leverage plus advanced prioritized payments). A TVPI of 1 indicates that distributions plus residual values currently reflect an anticipated break-even (excluding interest).
- Unleveraged:** SBA leverage and Private Capital are considered Paid-in Capital and treated on the same terms with a 20% Carried Interest after repayment of capital. Since the SBICs do not receive advanced prioritized payments, these are not considered in these cashflows. This reflects the underlying performance of the funds for benchmarking purposes. It does not reflect how SBA's investment would have done if SBA were treated as one of the private investors, as the SBA has advanced prioritized payments.
- NM: Not Meaningful.** Funds younger than 5 years are typically considered too young to evaluate performance, due to what is known as a "J-curve". (See Appendix B for further information on the "J-curve".)

7. SBIC Capital Impairment Statistics

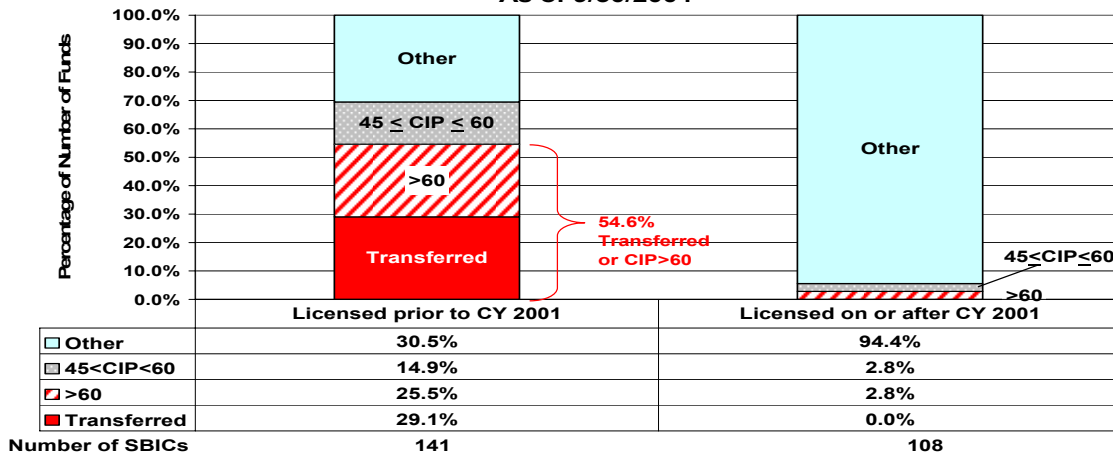
While the preceding sections of this report use typical venture industry metrics to measure the performance of funds, this section presents SBIC performance based on “capital impairment”, a regulatory measure that the SBA uses to assess a fund’s financial ability to repay its leverage. This measure is described in 13 CFR 107.1830 through 107.1850. In general, capital impairment measures the extent to which both the investment and operating losses of a fund have eroded the private capital commitments. For example, a capital impairment of 100% would indicate that operational and investment losses have completely eroded the total private capital commitments. If a fund exceeds its maximum allowable capital impairment percentage, the SBA has the right to transfer the SBIC to the Office of Liquidation. Capital impairment maximums vary based on the SBIC’s ratio of leverage to private capital, the time since the first disbursement of funding, and the percentage of equity capital investments in the SBIC’s portfolio. On average, PS funds older than 5 years have a maximum allowable capital impairment of 60 percent, while debenture funds have a maximum of 50 percent.

Note: The charts below may overstate capital impairment to some extent because these calculations do not consider “Class 2 appreciation,” a category of unrealized gain on investments that can reduce an SBIC’s capital impairment percentage (as defined in 13 CFR 107.1850).

Participating Security Funds

- Because capital impairment develops over time as a fund incurs losses, younger funds should be analyzed separately from older funds.
- The chart below shows a breakdown on the 9/30/2004¹ capital impairment percentages (CIPs) for participating securities, separating older funds (1994-2000) from younger funds (2001 and later). As shown, no participating securities fund licensed since 2001 has yet been transferred to the Office of Liquidation.

**Exhibit 7.1: PS Funds Capital Impairment Percentages Separating Older Funds from Younger Funds
 As of 9/30/2004**

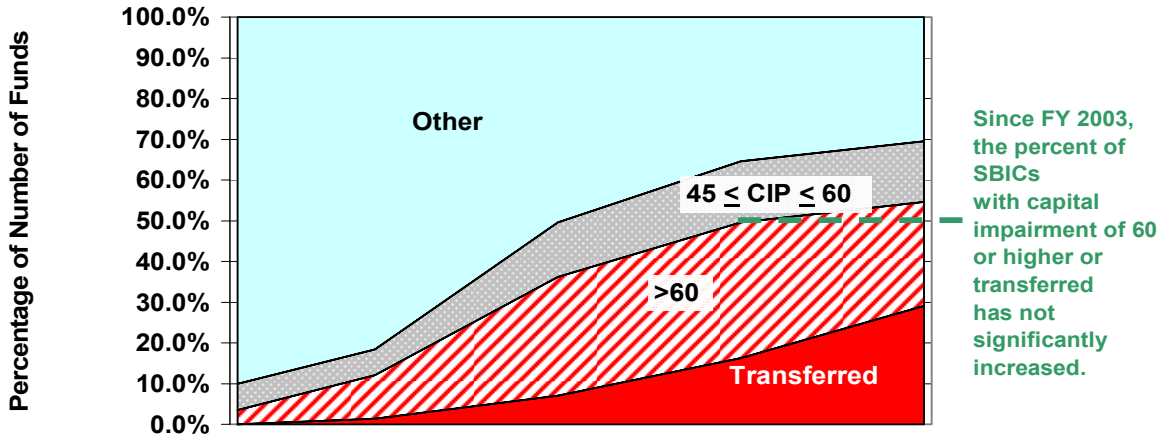


- 54.6% of PS funds licensed prior to calendar year 2001 had a CIP greater than 60% or were transferred to the Office of Liquidation.
- Less than 4% of PS funds licensed since calendar year 2001 have capital impairment percentages greater than 60%.

¹ If a fund did not submit a 9/30/2004 468 report, then the most recently calculated capital impairment was used.

The chart below shows the cumulative percentage of funds (by number) licensed prior to CY 2001 in each range of capital impairment (or transferred) over time in order to identify trends.

Exhibit 7.2: Cumulative Percentage of PS Funds (by Number) Licensed Prior to CY 2001 by Capital Impairment Range or Transferred (Last 5 Years)
 Number of Funds = 141



	12/30/2000	9/30/2001	9/30/2002	9/30/2003	9/30/2004
Other	90.1%	81.6%	50.4%	35.5%	30.5%
45 ≤ CIP ≤ 60	6.4%	6.4%	13.5%	14.9%	14.9%
CIP > 60	3.5%	10.6%	29.1%	33.3%	25.5%
Transferred	0.0%	1.4%	7.1%	16.3%	29.1%

Transferred or CIP>60 **3.5%** **12.1%** **36.2%** **49.6%** **54.6%**

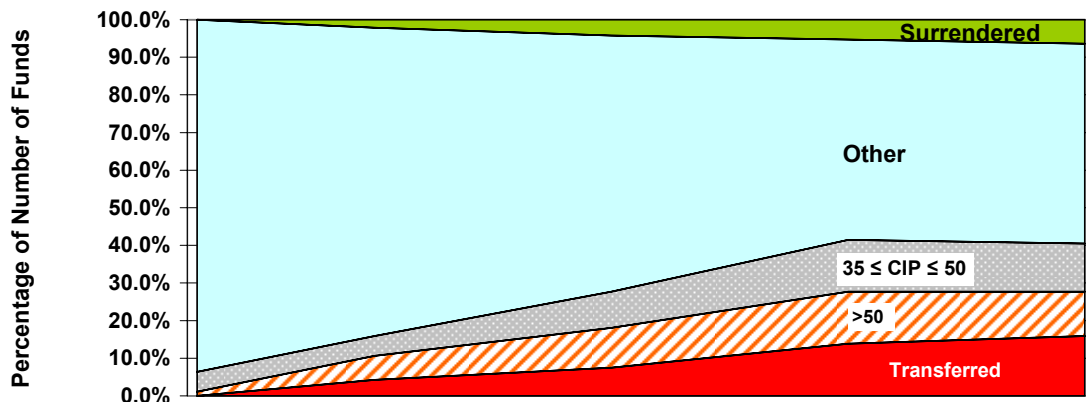
- The percentage of PS funds licensed prior to calendar year 2001 that have been transferred to the Office of Liquidations almost doubled in FY 2004 from FY 2003.
- However, the overall percentage of these funds that have either been transferred or are above 60% capital impairment increased only by 5%, the lowest growth rate for this measurement in the past five years.
- Thus, while the portfolio has not significantly declined in the past FY, the SBA continued to transfer financially troubled SBICs, as their maximum allowable CIP declined.

Debenture Funds

Because debenture funds are by nature less volatile and provide less return than participating securities funds, their maximum permissible level of capital impairment is generally lower. The below chart shows the percentage of funds licensed prior to calendar year 2001 (limited to those that were active as of December 2000 and had taken down leverage in the past 15 years) in each capital impairment range. (No debenture fund licensed on or after 2001 had a capital impairment percentage above 35% as of September 30, 2004.)

Exhibit 7.3: Cumulative Percentage of Debenture Funds (by Number) Licensed Prior to CY 2001 by Capital Impairment Range or Transferred by Quarter (Number of Funds = 94)

Debenture funds in chart below must have taken down leverage since 1989 and were active on December 2000.



	12/31/00	09/30/01	09/30/02	09/30/03	09/30/04
■ Surrendered	0.0%	2.1%	4.3%	5.3%	6.4%
□ <35	93.6%	81.9%	68.1%	53.2%	53.2%
▒ 35 ≤ CIP ≤ 50	5.3%	5.3%	9.6%	13.8%	12.8%
▨ CIP>50	1.1%	6.4%	10.6%	13.8%	11.7%
■ Transferred	0.0%	4.3%	7.4%	13.8%	16.0%

Transferred or >50 **1.1%** **10.6%** **18.1%** **27.7%** **27.7%**

*Note: "Surrendered" indicates an SBIC that has paid back all SBA-guaranteed leverage and has "surrendered" its SBIC license.

- The percentage of debenture funds transferred only went up by 2.2% in FY 2004 from FY 2003.
- The overall percentage that has been transferred or is above 50% capital impairment did not effectively change in FY 2004 from FY 2003.

8. Program Cashflow Performance

The tables below show the cashflow performance for both the debenture program and participating securities program for cohorts 1994-2004. These cashflows form the basis of the SBA's re-estimate process. In addition to the FY 1994-2004 totals, the last three years of data are provided to show trends.

The cash flow statements below do not reflect all of the information that is taken into account in the subsidy re-estimate process. Neither the debenture nor the participating securities statement includes interest on account balances, as is required under credit reform procedures. Also, the participating securities cash balance shows only the original appropriations, and does not include the additional appropriations received as a result of subsidy re-estimates. As noted in Section 1, total lifetime subsidy re-estimates for the Participating Securities Program were positive \$2.7 billion (of which \$0.5 billion is due to one-time accounting adjustments), indicating that current estimated program costs for those years are higher than originally anticipated. Through September 30, 2004, an additional \$2.7 billion was deposited into the Participating Securities Program account to cover the estimated performance losses and reconcile the one-time accounting adjustment.

Debentures

Exhibit 8.1: Debenture Cohorts 1994 through 2004 Cashflows through September 30, 2004

Debenture Cohorts 1994 through 2004 (in millions of dollars)	FYs 1994 - 2004 Total	FY 2004	FY 2003	FY 2002
Cash Inflows				
Appropriations*	79.5	-	-	-
Fees	137.3	29.1	23.2	21.6
Recoveries**	34.5	25.6	5.8	2.9
Cash Outflows				
Defaults	185.0	57.6	53.4	34.1
Net Cashflow	66.3	(2.8)	(24.4)	(9.6)
Beginning Cash	-	69.1	93.5	103.1
Ending Cash	66.3	66.3	69.1	93.5

End of Year Balances

Active Portfolio Outstanding Leverage	1,759.3	1,515.5	1,387.2
Liquidations Outstanding	150.5	118.6	71.0
Unfunded Commitments	933.2	862.2	765.2

* Appropriations: From FY 1994-1999, the Debentures program received appropriations. Starting in FY 2000, no further appropriations were received as part of program authorizations. Any appropriations associated with re-estimates are not included in the above numbers.

** Recoveries in FY 2004 were estimated based on the Office of Liquidations Cash Collection Report.

In FY 2004, Debenture SBICs with \$57.6 million in outstanding leverage were purchased by the SBA. The debentures currently maintain a positive cash balance of \$66.3 million. Although the Debenture program currently maintains positive cash balance, it is anticipated that the cash balance may fall below zero within the next year, based on current default estimates. However, because recovery rates on debenture funds have been historically high (over 70% recoveries on defaulted debentures), the net results are expected to maintain a zero subsidy rate with annual charges on par with historical annual charges.

Participating Securities

Exhibit 8.2: Participating Securities Cashflows through September 30, 2004

(In millions of \$)	FY 1994 - FY 2004 Totals	FY 2004	FY 2003	FY 2002
Cash Inflows				
- Appropriations ¹	\$ 149.4	\$ -	\$ -	\$ -
- Upfront Fees	\$ 237.0	\$ 59.6	\$ 29.3	\$ 30.0
- Prioritized Reimbursements, Annual Charges, Adjustments	\$ 298.8	\$ 33.1	\$ 14.4	\$ 18.6
Net Profit Participation ²	\$ 279.1	\$ 10.6	\$ 0.8	\$ 2.0
Recoveries in Office of Liquidation	\$ 48.4	\$ 41.2	\$ 7.1	\$ 0.1
Cash Outflows				
Prioritized Payments Advanced by SBA	\$ 1,073.7	\$ 214.5	\$ 210.3	\$ 190.4
Repurchases	\$ 1,077.9	\$ 553.8	\$ 314.6	\$ 171.0
Net loans in Office of Liquidation ³	\$ 2.0		\$ 2.0	
Net Cash	\$ (1,140.9)	\$ (623.8)	\$ (475.3)	\$ (310.7)
Beginning Cash	\$ -	\$ (517.1)	\$ (41.8)	\$ 268.9
Ending Cash	\$ (1,140.9)	\$ (1,140.9)	\$ (517.1)	\$ (41.8)
Other				
Committed/Approved ⁴	\$ 12,372.8	\$ 3,986.5	\$ 1,170.0	\$ 1,300.1
Disbursements	\$ 6,153.2	\$ 990.8	\$ 891.6	\$ 852.2
Commitments Cancelled ⁵	\$ 467.0	\$ 288.6	\$ 136.3	\$ 41.1
Normal Redemptions	\$ 1,145.3	\$ 262.9	\$ 66.1	\$ 110.6
Prioritized Payments Associated w/Repurchased Leverage in FY ⁶	\$ 268.4	152.1	61.6	44.3
Balances				
EOY Undisbursed Commitments	\$ 5,752.6	\$ 5,752.6	\$ 3,045.5	\$ 2,903.4
EOY Outstanding Leverage In Active	\$ 3,930.0	\$ 3,930.0	\$ 3,747.4	\$ 3,236.5
EOY Outstanding Repurchased Leverage ⁷	\$ 1,031.5	\$ 1,031.5	\$ 518.9	\$ 209.4
Unreimbursed Prioritized Payments Balance in Active ⁸	\$ 533.6	\$ 533.6	\$ 499.2	\$ 363.1

*** Notes:**

- 1. Appropriations:** From FY 1994-2001, the participating securities program received appropriations. Starting in FY 2002, no further appropriations were received as part of program authorizations. Additional appropriations associated with subsidiary re-estimates are not included in the above numbers.
- 2. Net Profit Participation:** Calculated as gross profit participation received by SBA plus gains from sale of in-kind (stock) distributions minus losses from sale of in-kind distributions.
- 3. Committed/Approved:** Indicates total commitments issued. Please note that in FY 2004 \$4 billion was conditionally committed to SBICs in participating securities. However, a few SBICs did not pay the accompanying commitment fee. Since they did not satisfy this condition, the amount Committed/Approved for FY 2004 does not include those amounts.
- 4. Net Loans in Office of Liquidation:** On a case by case basis, the Office of Liquidation will issue loans to a fund that has been transferred to its office. This is only performed when it is in the best financial interest of the SBA in order to maximize overall recoveries.
- 5. Commitments Cancelled:** Indicates commitments that were cancelled for various reasons, including: 1) the end of the disbursement timeframe occurred (4 years after the commitment year); 2) the SBIC was issued new commitments that required the cancellation of existing commitments to stay within the regulatory requirements; and 3) the SBIC was transferred to the Office of Liquidation and its undisbursed commitments were cancelled.
- 6. Prioritized Payments Associated w/Repurchased Leverage:** Indicates unreimbursed advanced prioritized payment balance associated with repurchased leverage in each FY. The Office of Liquidation estimates that almost none of the prioritized payments associated with leverage repurchased by SBA will be recovered, because the SBIC's obligation with regards to prioritized payments is based on profits. Typically funds transferred to the Office of Liquidations are not profitable.
- 7. EOY Outstanding Repurchased Leverage:** Calculated as total repurchased PS leverage plus net loans (see Note 4) minus associated recoveries received in the Office of Liquidation.
- 8. Unreimbursed Prioritized Payments Balance in Active:** Calculated as total prioritized payments advanced by the SBA minus reimbursements by SBICs minus prioritized payments associated with leverage repurchased by SBA.

Appendix A – Fund Metric Assumptions

Basic Venture Fund Metrics

The venture industry performs various statistical analyses to evaluate fund performance, including: internal rate of return (IRR); cumulative distributions to paid-in capital (DPI); residual value to paid-in capital (RVPI); and total value to paid-in capital (TVPI). These statistics are calculated both on a “vintage year” basis (i.e., grouping funds by the first year of fund operations) and cumulative basis (all data since the start of the data set).

It is important to understand that the venture industry is cyclical in relation to the market and therefore, some years will be worse than others. The vintage year methodology helps account for both the age of the fund and the market conditions during the fund’s operation by benchmarking funds by their first year of fund operations. Thomson Venture Economics, one of the leading experts in developing venture capital benchmarks, publishes both an annual investments benchmark report, and a database known as VentureExpert. The SBA currently uses VentureExpert as a resource in benchmarking the performance of its funds.

Each of the metrics is calculated on a pooled basis (treating all cashflows as if it came from a single fund) by vintage year. The basic performance measurements are derived from Thomson Venture Economics methodology, as described below.

Internal Rate of Return (IRR)

Thomson Venture Economics’ 2002 Investment Benchmarks Report: Venture Capital¹ defines IRR as “the discount rate that equates the net present value (NPV) of an investment’s cash inflows with its cash outflows.” Appendix A in the referenced report describes that in calculating the IRR, Venture Economics’ analysts “treat capital calls as negative cash flows, distributions of cash and stock as positive cash flows, and the residual value of the fund as a terminal positive value at the end of the investment horizon” being measured. All cashflows are net of expenses, fees, and carried interest. (Note: The SBA fund metrics are estimates, based on general assumptions described at the end of this appendix, under the section “Assumptions”.) The IRR is then calculated using those cashflows.

The IRR calculation is shown below:

$$0 = \sum_{i=0}^N CF_i (1 + IRR)^{-\left(\frac{n_i}{c}\right)}$$

Where

CF = Net cash flow = Distributions – Takedowns for all periods, except the last period in which Net cash flow = Net Asset Value + Distributions – Takedowns

i = Cash flow sequence

c = Compounding period per year

n = Number of periods between the current cash flow and the first cash flow.

While the industry performs these calculations on a monthly basis (compounding period = 12), because this level of detail is not always received by the SBA for all SBICs, SBIC data is on an annual basis.

¹ Thomson Venture Economics, 2002 Investment Benchmarks Report: Venture Capital, Newark, NJ 2002

Most spreadsheet programs, such as Excel and Lotus, will calculate the IRR using a spreadsheet function with net cashflows as the input, as shown in the example below:

(In Millions of \$)	Annual Cashflows									
	1	2	3	4	5	6	7	8	9	10
- Paid In Capital (Treated as Negative Cashflows)	-2	-2	-2	-2	-2					
+ Distributions in Cash	0	0	1	2	3	2	1	0		
+ Terminal Residual Value								7		
Net Cashflows	-2	-2	-1	0	1	2	1	7		

IRR 16%

One of the problems with the IRR metric is that it relies heavily on the residual value, which is an estimate that will fluctuate based on the fund's valuations. As shown above the IRR is 16%. However, this return is dependent upon the terminal residual value rather than on actual realized returns. Without the terminal residual value, the paid-in capital would not yet have been returned. The cumulative Distributions to Paid-In Capital (DPI) metrics address this problem.

Cumulative Distributions to Paid-In Capital (DPI)

Simply put, DPI indicates the ratio of cumulative distributions received to capital paid into the fund. All cashflows are considered on a positive basis. Cumulative paid-in capital and distributions (net of carried interest and fees) are computed annually and the ratio is determined by dividing cumulative distributions by cumulative paid-in capital, as shown in the example below.

(In Millions of \$)	Annual Cashflows									
	1	2	3	4	5	6	7	8	9	10
- Paid In Capital (Treated as Negative Cashflows)	-2	-2	-2	-2	-2					
+ Distributions in Cash	0	0	1	2	3	2	1	0		
+ Terminal Residual Value								7		
Net Cashflows	-2	-2	-1	0	1	2	1	7		

IRR 16%

Cumulative Paid In Capital	2	4	6	8	10	10	10	10		
Cumulative Distributions	0	0	1	3	6	8	9	9		
Cumulative Distributions to Paid in Capital	0	0	0.17	0.38	0.6	0.8	0.9	0.9		

As shown, while the fund has a 16% IRR in the eighth year, the fund has distributed only 0.9 of its paid-in capital. Of course, the fund has residual value left and may very well return much more than the paid-in capital. The total value of a fund is its distributions and its residual value. This is why residual value to paid-in capital (RVPI) is computed.

Residual Value to Paid-In Capital

RVPI indicates the ratio of the residual value in a fund to cumulative paid-in capital. Both numbers are positive. Residual value should be the net asset value minus any expenses and carried interests. Using our example, in the eighth year, the RVPI would be 0.7 (computed as residual value/cumulative paid-in capital, where residual value = 7 and cumulative paid-in capital = 10).

Total Value to Paid-In Capital

By adding the DPI and RVPI together, the Total Value to Paid-In Capital (TVPI) may be computed, indicating the overall value of the fund in respect to its paid-in capital. In our example, the TVPI is 1.6, indicating that current expectations indicate that the fund will return all the capital plus another 60%. When looking at this number, it is important to understand how much is in the residual value, as that would indicate a level of risk in unrealized returns.

Assumptions

Below is a summary of assumptions used in developing fund metrics, including internal rate of return (IRR), distributions to paid-in capital (DPI), residual value to paid-in capital (RVPI), and total value to paid-in capital (TVPI).

- Data from the Investment Division's Data Management tables were used to develop the metrics in this report.
- All IRRs are performed on an annual basis only, as there is insufficient information on the private paid-in capital to perform calculations on either a quarterly or monthly basis.
- SBA Leverage and Prioritized Payment Metrics use the following inputs to derive fund metrics:
 - Negative Cashflows:
 - SBA Participating Security Leverage Issuances
 - SBA Advanced Prioritized Payments
 - Positive Cashflows:
 - All SBA Leverage Fees (i.e., Commitment, Disbursement, and Annual Fees)
 - All SBA Distributions
 - Residual Value – Uses data from the last 468 received, based on the net asset value and the status of each fund, as noted below:
 - **Transferred:** If a fund has been transferred to liquidation, the residual value is the estimated recovery value, as identified by the Office of Liquidation at the end of FY 2004.
 - **Restricted:** A fund in “restricted operations” indicates a capitally impaired SBIC that has not been transferred to the Office of Liquidation but, has been placed by the Director of Operations into a special “restricted” status to provide the opportunity for the SBIC to cure itself of its capital impairment. In restricted operations, the SBA receives all distributions to the extent of its leverage. Therefore, for all funds in this “restricted” status, the SBA takes all residual value to the extent of its leverage.
 - **Active:** The residual value for active funds is determined using simplified distribution rules as identified in Exhibit 3.1 of this document.
- Private metrics use the following inputs to derive fund metrics:
 - Negative Cashflows: In general, private Paid-in Capital is estimated by adding the private capital identified on the balance sheet plus any regulatory capital distributions. Each annual

468 balance sheet and annual regulatory distributions is examined to determine timing by year.

- Positive Cashflows: Private distributions are estimated by taking the distributions allocated to the private investors and general partners from tables maintained by the Investment Division and subtracting 20% Carried Interest after distributions equivalent to private commitments are returned. (*Note: Actual allocation of private distributions will vary from fund to fund, depending on the limited partnership agreement.)
- Residual Value – Takes the net asset value from the last 468 received, subtracts the portion that goes to the SBA, and then subtracts what (if anything) would go to the GP, based on a 20% Carried Interest after return of private commitments. If a fund has been transferred to liquidation, uses liquidation value (typically 0).
- Unleveraged metrics examine fund performance treating SBA leverage on the same terms as private capital, with pro rata returns and 20% Carried Interest to the GP after repayment of capital. This helps the SBA measure the underlying performance of the funds.

Appendix B – Glossary of Terms

Term	Definition for Purposes of This Report
Carry / Carried Interest	Share of a venture/SBIC fund's profit that goes to the general partners/managers of the fund, providing an incentive for the managers.
Commitments / Committed Capital	Capital committed by investors to a venture/SBIC fund indicating the maximum amount the fund may draw down from the investor.
Debentures	Debt obligations issued by SBICs pursuant to section 303(a) of the Small Business Investment Act of 1958 and held or guaranteed by SBA.
Debt Security	A financing agreement/security that includes both equity and debt features (e.g., loan with warrants or convertible debt)
Disbursement	Leverage actually disbursed by the SBA to the SBIC.
Distribution	Any transfer of cash or permitted non-cash assets to SBA, its agent, or to partners in a partnership SBIC, or to shareholders in a corporate SBIC. Capitalization of Retained Earnings Available for Distribution constitutes a Distribution to the SBIC's non-SBA partners or shareholders.
Equity Security	Stock of any class in a corporation, stock options, warrants, limited partnership interests in a limited partnership, membership interests in a limited liability company, or joint venture interests.
J-Curve	Refers to venture capital's typical investment cycle in which returns tend to be negative for a few years at the beginning of a fund's investment cycle before eventually rising through investment gains both realized and unrealized.
Leverage	Financial assistance provided to a SBIC by SBA, either through the purchase or guaranty of an SBIC's Debentures or Participating Securities.
Limited Partnership	A partnership consisting of one or more general partners and one or more limited partners. Limited partners normally provide the financing of the partnership with little responsibility in terms of management or personal liability. General partners are responsible for managing the entity. Approximately two-thirds of SBICs are organized as limited partnerships.
Loan	A transaction evidenced by a debt instrument with no provision for the SBIC to acquire Equity Securities.
Paid-in Capital	The amount of capital that private investors have actually paid into the fund.
Participating Securities	Preferred stock, preferred limited partnership interests, or similar instruments issued by SBICs, including debentures having interest payable only to the extent of earnings, all of which are subject to the terms set forth in 13 CFR Sections 107.1500 through 107.1590 and section 303(g) of the Small Business Investment Act of 1958 as amended. To date, all Participating Securities have been preferred limited partnership interests.
Portfolio Company/Concern	Company to which a venture/SBIC fund has provided financial assistance.
Prioritized Payments	A cumulative preferred return on Participating Securities, which is contingent upon the profitability of the SBIC and which is passed through to

Term	Definition for Purposes of This Report
	the certificate holders. The SBA advances prioritized payments to certificate holders and is repaid if SBICs are profitable.
Private Capital	The capital contributed to a licensee by its private investors, plus unfunded binding commitments by institutional investors as defined in 13 CFR Section 107.50 to contribute capital to a licensee.
Profit Participation	Amount payable to SBA in consideration for SBA's guarantee of the SBICs' Participating Securities.
Regulatory Capital	The Paid-in Capital plus the unfunded Commitments of institutional investors, as defined in 13 CFR Section 107.50.
SBA Form 468	Reports submitted by the SBICs, containing financial and supplementary information on the SBIC. Forms are required to be submitted annually, but may be requested by the SBA more frequently.
Surrender	Action by SBIC licensee to return its license to the SBA. An SBIC may not surrender its license without SBA's prior written approval.
Valuation	The value of a company/business. In private equity, valuations are normally determined based on financings by a sophisticated investor with no prior relationships with the company. All SBICs are required to have valuation guidelines and to reassess Portfolio Company/Concern valuations at least annually.
Vintage Year	Usually indicates the year the first investment or capital call was made for the fund.