



Small Business Investment Companies: An Investment Option for Banks

Abstract

This *Insights* report describes the Small Business Investment Company (SBIC), its role in capital markets, and how banks can use SBICs to expand their small-business finance activities. The report also outlines risks and regulatory considerations of SBIC investments and explains how these investments may receive consideration under the Community Reinvestment Act (CRA).

The information presented in this report was obtained from a variety of sources, including bankers, non-supervised financial intermediaries, SBIC general partners, trade groups, the Office of Investment at the Small Business Administration (SBA), and other parties involved with SBICs. Appendix E contains a resource directory of additional information on the SBIC program.

I. What Are Small Business Investment Companies?

SBICs are privately owned and managed investment funds licensed and regulated by the SBA. The SBIC license allows SBICs to employ private capital and funds borrowed at low cost using SBA-guaranteed securities, called debentures, to make investments in qualifying small businesses and smaller enterprises as defined by SBA regulations.¹ The SBIC program was created in 1958 to stimulate growth in America's small-business sector by supplementing the long-term debt and private equity capital available to small businesses. The American Recovery and Reinvestment Act of 2009 enhanced the program by increasing the maximum funding available to SBICs and, in turn, to small businesses.²

SBICs generally are formed as limited partnerships, with the fund managers acting as the general partner (GP). The limited partners (LP), who supply the majority of the private funding, are typically institutional investors, including banks, and high-net-worth individual investors. SBICs invest in small businesses that range in size from \$1 million to \$100 million in annual revenues but fulfill the regulatory small-business size requirements, including having less than \$18 million in net worth and posting net

¹ SBICs are required to dedicate 25 percent of their investment dollars to smaller enterprises. Definitions of a small business and a smaller enterprise can be found in 13 CFR 121.301(c) as well as parts 121.101, 121.103, and 107.710. See www.access.gpo.gov/nara/cfr/waisidx_09/13cfr107_09.html.

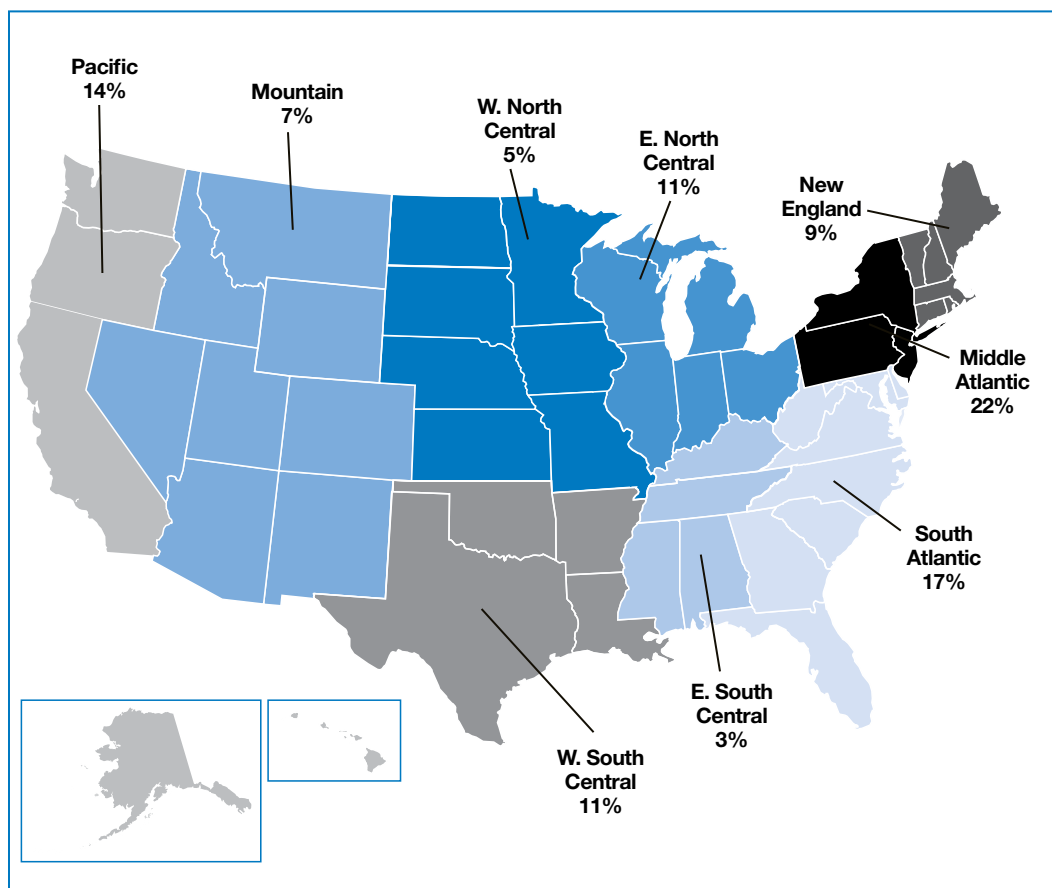
² For more information on the impact of the American Recovery and Reinvestment Act, see "Economic Development Programs: Providing Lending Opportunities for Banks" in the OCC's *Community Developments Investments* Spring 2010 newsletter, at www.occ.gov/static/community-affairs/community-developments-investments/spring10/cde10spring_index.htm.

revenue of less than \$6 million annually. On average, SBICs invest between \$1 million and \$10 million per investment, although some SBICs go outside this range.

As of July 31, 2012, there were 299 licensed SBICs using private capital and SBA-guaranteed securities of more than \$18 billion.³ In fiscal year (FY) 2011, the SBA issued \$1.82 billion in new SBIC commitments and SBICs invested \$2.83 billion in 1,339 small businesses that created an estimated 56,211 jobs.⁴

SBICs have invested in a variety of industries. From FY 2007 through FY 2011, nearly 20 percent of SBICs' investments were in the manufacturing sector. Next in volume were investments in consumer-related businesses, transportation, and business services. Additionally, the SBIC portfolio is geographically diverse with a greater volume of investments historically originating along the East and West Coasts.⁵ Figure 1 shows the distribution of debenture SBICs around the country.

Figure 1: SBIC Debenture Portfolio by SBIC Location, FY 2007–2011



Source: Office of Investment, SBA.

Note: Percentages do not total 100 due to rounding.

There are two types of SBICs: leveraged or debenture SBICs, which use SBA leverage in the form of SBA-backed borrowings, and unleveraged SBICs, which do not. Unleveraged

³ SBA, "SBIC Program Overview," www.sbia.org, via the Resources, SBIC Program, Statistics tabs (accessed August 1, 2012). For a complete list of active SBICs by state, see www.sba.gov/content/all-sbic-licensees-state.

⁴ SBA, "SBIC Program Overview," www.sba.gov/content/sbic-program-overview-2 (accessed May 4, 2012).

⁵ Ibid.

SBICs, including bank-owned SBICs, make up about 15 percent of active SBICs.⁶ Although there are advantages for a bank to be the sole investor in an SBIC (see section III), this report will focus on banks' investments in debenture SBICs as limited partners.

II. Why Are SBICs of Interest to Banks?

SBIC investments allow banks to earn competitive returns and receive CRA consideration while helping them attract, serve, and retain customers. Banks can collaborate with SBICs to provide long-term financing to small businesses that might not otherwise obtain the financing they need from traditional sources. In general, banks may be interested in investing in SBICs for the following reasons:

Investment performance. The primary factor that banks consider when investing in SBICs is whether they can earn a competitive return on invested capital. As with other investment choices, an SBIC has to make the case to potential investors of the soundness of its business model and the potential for producing competitive investment returns. Because debenture SBICs can supplement their own private capital with SBA leverage in amounts of up to three times their private capital, their financing is often provided at a significantly lower cost than might be the case with private equity capital.⁷ Section VI of this report provides information about the historic returns of debenture SBICs compared with similar investment funds.

CRA consideration. Bank equity investments in SBICs meet the definition of qualified investments under the CRA.⁸ Large banks and intermediate small banks receive CRA consideration under the "investment test" or "community development test," respectively,⁹ for investments in SBICs when they benefit the bank's assessment area or a broader statewide or regional area that includes the bank's assessment area(s).¹⁰

⁶ There were 44 bank-owned, unleveraged SBICs as of June 30, 2012. See SBA, "SBIC Program Overview," www.sbia.org, via the Resources, SBIC Program, Statistics tabs (accessed August 1, 2012).

⁷ Typically, SBA leverage is provided at twice the amount of private capital. It can go up to three times the amount of capital, however, if the SBIC fund meets certain requirements. These requirements can be found in 13 CFR 107.1150.

⁸ SBICs are one of the examples of qualified investments. See 75 Fed. Reg. 47 (March 11, 2010), p.11652, __.12(t)-4.

⁹ *Ibid.*, __.22(d)-1. A bank that has made an equity or equity-type investment in a third party, such as an SBIC, may elect to receive CRA consideration under the lending test for community development loans made by the third party. The bank's pro rata share of any lending activity considered under the lending test is based on its percentage of equity ownership in the SBIC. The bank, however, can request consideration under only one test for the full amount of either the investment or the loans, or partial consideration of different portions of the investment and loans. For an example, see OCC, *Community Developments*, "Expanding Your CRA Reach With CD Banks and CDFIs," Summer 2002, <http://www.occ.gov/static/community-affairs/Summer-08.pdf>. Current-period investments are considered for CRA at their original investment amount, even if that amount is greater than the current book value of the investment. Prior-period investments are considered at the book value of the investment at the end of the current CRA evaluation period.

¹⁰ *Ibid.*, __.12(h)-6 and 7. The institution's assessment areas need not receive an immediate or direct benefit from the SBIC's investments, provided that the purpose, mandate, or function of the SBIC includes serving geographies or individuals located within the institution's assessment area. If an institution has adequately addressed the community development needs of its assessment area(s), it can receive consideration for SBIC investments that benefit geographies or individuals located in a broader statewide or regional area that includes an institution's assessment area. Because portfolio companies in SBICs may be geographically dispersed, banks should consider the investment objectives identified in the fund's business plan to determine whether the investments will likely benefit the bank's assessment area or broader statewide or regional area that includes the bank's assessment area. A bank making an investment can rely on the SBIC fund manager's written documentation that the SBIC will use its best efforts to invest in businesses aligning with the bank's assessment areas. An SBIC fund manager can also explicitly earmark certain investments that fall within a particular geography of interest to a bank. However, investments can only be earmarked to one investor, to avoid double counting of that investment for CRA purposes.

To enhance a satisfactory rating, banks evaluated under the small-bank CRA test can request that examiners review their performance in making qualified investments, such as SBICs.¹¹

Small-business development opportunities. When investing in SBICs as limited partners, many banks build financial relationships with companies that compose the SBIC's investment portfolio. For example, banks may refer their small-business customers that do not meet their underwriting guidelines to the SBICs in which they have invested. By doing so, banks can maintain their commercial banking relationships with the small-business customers.

III. How Do SBICs Work?

Like other private investment firms, SBICs make investments with the goal of achieving favorable rates of return for their investors. The difference lies in the nature of the investments made and the role the government plays in providing leverage. As mentioned previously, licensed SBICs can be unleveraged (use only private capital), including bank-owned SBICs, or leveraged (supplement private capital with SBA-guaranteed debentures).¹² An SBIC that successfully invests its funds in portfolio companies can achieve enhanced rates of return through the use of SBA-guaranteed debentures.

SBIC Leverage and Cost of Capital

Applicants to the SBIC program raise capital for a specific investment fund, which then sets its own strategy by making investments in small businesses through debt, equity, or both.¹³ SBIC managers are required to raise a minimum of \$5 million of private capital to establish an SBIC.¹⁴ In practice, however, most SBICs raise significantly more, with average fund sizes ranging from \$25 million to \$30 million in private capital and typically comprising twice as much in SBA leverage.¹⁵

The primary difference between a leveraged SBIC and an unleveraged SBIC is the former's access to low-cost funding through the SBA's guarantees of debentures.¹⁶ Debentures are non-amortizing 10-year debt securities with interest payments made on a semiannual basis. The interest rate of the debenture is fixed within six months of issuance at a premium over the 10-year U.S. Treasury note. Debentures mature and are due to be paid in full by the end of the 10-year term. The SBIC debentures are pooled by the SBA twice a year (in March and September) and sold to the public in the form of debenture participation certificates. These certificates are fractional undivided interests in the pool

¹¹ Performance with respect to qualified investments may be used to help raise a small bank's CRA rating from Satisfactory to Outstanding. However, these activities may not be used to lower a rating, nor can they raise the lending test or overall CRA rating from Needs to Improve or Substantial Noncompliance to a Satisfactory level. For more information on how ratings are determined, see 12 CFR 25, appendix A.

¹² Before 2004, SBICs were able to obtain SBA leverage in one of two ways: preferred limited partnership interests called participating securities or interest-only loans called debentures. The SBA Participating Securities Program was terminated in 2004.

¹³ From FY 2007 through FY 2011, equity funds represented 45 percent of active funds, followed by debt-with-equity funds (43 percent) and debt-only funds (12 percent).

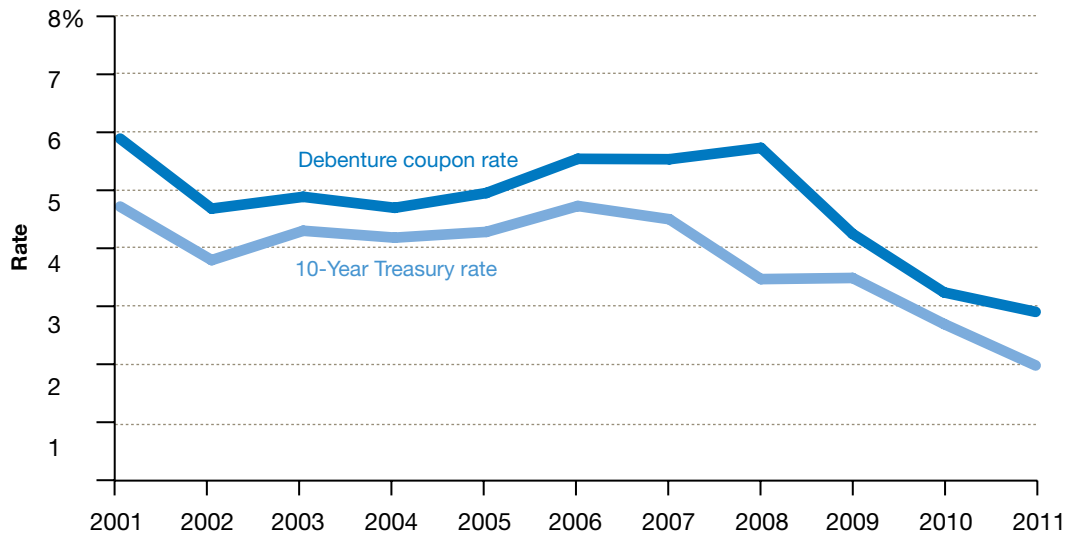
¹⁴ 13 CFR 107.210.

¹⁵ Office of Investment, SBA.

¹⁶ Once a debenture SBIC is licensed and operating, it makes investments using a combination of its private capital and SBA leverage. The SBA leverage is typically drawn in installments over a five-year period. For each installment, the SBIC issues a debenture.

of debentures and are backed by SBA guarantees.¹⁷ Figure 2 illustrates the debenture trust certificate coupon rate over the last 10 years compared with the yield on the 10-year Treasury note.

Figure 2: The Cost of SBA Leverage



Source: Office of Investment, SBA.

SBIC Licensing Process

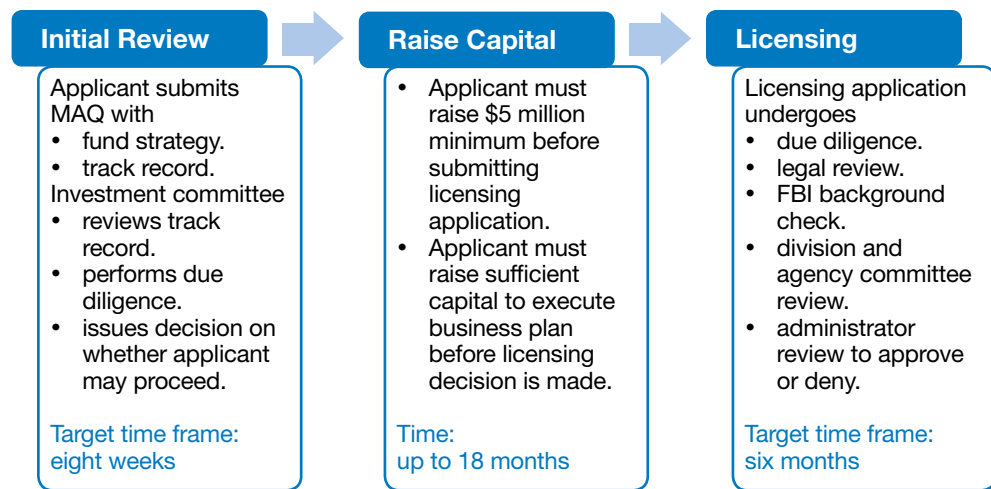
The process of obtaining an SBIC license from the SBA is rigorous. Applicants must (1) undergo an initial review, (2) raise capital, and (3) go through a final licensing review that includes due diligence, legal review, and background checks.¹⁸ As part of the initial review, and to determine whether the management team has the necessary qualifications to manage an SBIC, the SBA requires applicants to fill out an extensive management assessment questionnaire (MAQ) that contains key information about the proposed fund, its investing strategy, its operations, its decision-making, its oversight, and its legal provisions. About one in five applicants who begin the SBIC process, which can take 12 to 26 months, is awarded a license.¹⁹ The process is illustrated in figure 3.

¹⁷ The certificates typically are issued in multiples of \$5,000 with minimum original principal amounts of \$100,000. The denomination signifies a holder's pro rata share of the aggregate principal amount of the debentures on the pooling date.

¹⁸ Once the SBA has preliminarily approved the SBIC applicant, it provides a "green light" letter that authorizes the applicant to file a formal application for an SBIC license. The applicant must secure private capital commitments of at least \$5 million before its license is approved. See SBA, "SBIC Application Process," www.sba.gov/content/sbic-application-process (accessed May 4, 2012).

¹⁹ SBA, "Program Statistics & Administrative Performance," www.sba.gov/content/program-statistics-administrative-performance (accessed May 4, 2012).

Figure 3: SBIC Licensing Process



Source: Office of Investment, SBA.

SBIC Operations and Oversight

Once an SBIC is licensed, it must meet the SBA’s reporting requirements, which include quarterly and annual financial reports.²⁰ Funds receiving SBA leverage must have an annual independent audit by a certified public accountant. The SBA’s Office of Examinations regularly examines the SBICs’ financial health and regulatory compliance: Leveraged SBICs are examined annually, while non-leveraged SBICs are reviewed every two years. The SBA monitors the performance of SBICs through key metrics, including portfolio company performance, portfolio values relative to leverage, and capital impairment percentages (CIP).²¹ A more detailed discussion of how LPs can monitor SBIC performance is in section IV.

SBIC Fund Cycles

Once the SBA has approved an SBIC’s license application, the SBIC typically proceeds with additional fund-raising for a specific fund.²² When the funding commitments have been obtained, the SBIC evaluates its investment opportunities, makes investments, manages the investments, and, finally, receives returns and exits the investments.²³

A leveraged SBIC fund’s limited partnership agreement (LPA) typically is set up as a 10-year partnership with renewal options. The SBIC fund, however, may not terminate its partnership without first repaying its SBA leverage in full. Because it may take up to five years to make all investments, most SBIC funds exist for 10 to 15 years before exiting the program. Many successful SBICs start a second fund before they exit fully all the portfolio firms from the first fund. If a second fund is created, a new license application must be submitted to the SBA.

²⁰ These reports include, but are not limited to, Form 468 (Annual Financial Report), Form 1031 (Portfolio Financing Report), and the Capital Impairment Percentage Worksheet. See appendixes A and B for more information.

²¹ OCC, “Small Business Investment Companies: An Investment Option for Banks,” slide 18, February 15, 2012, www.occ.gov/about/who-we-are/occ-for-you/bankers/bankers-education/2012-sbic-handout.pdf.

²² The fund-raising period typically lasts 12 to 18 months.

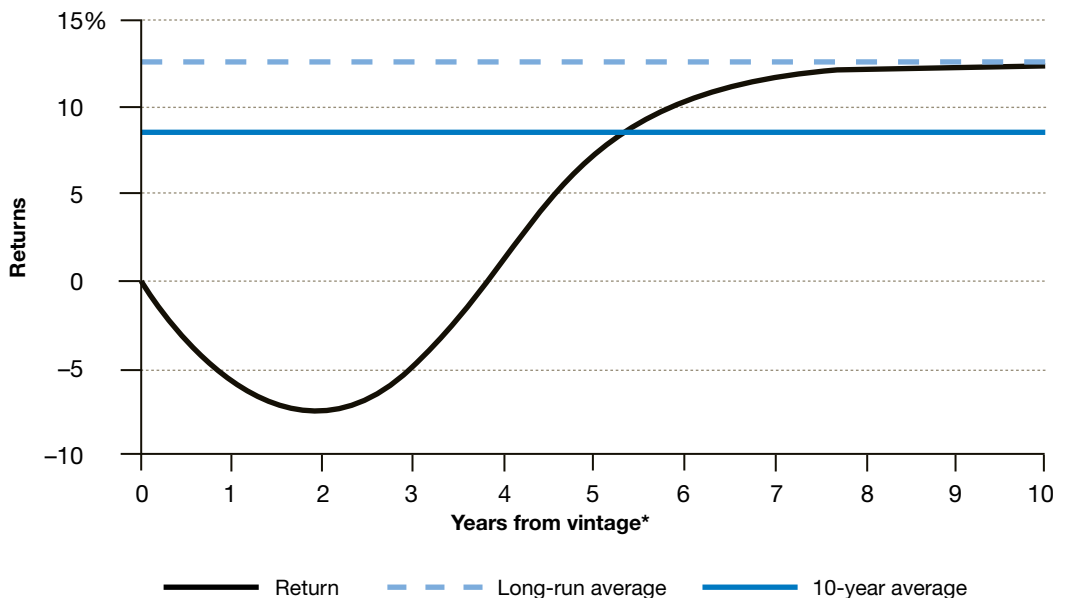
²³ Conversations with fund managers indicate that on average a typical manager reviews 100 investment opportunities before investing in one or two firms.

Investment Pay-In and Return of Investor Capital

Typically, an LP makes a one-time capital commitment to an SBIC fund but disburses funds over a number of years, depending on the GP's investment timing needs. For example, an LP could make a one-time \$1 million commitment to a fund and agree to disburse 25 percent per year for the next four years. The LP will have to be prepared, however, to disburse the entire commitment at one time if the GP needs funds quickly for immediate investment opportunities.

Since it takes time for investments in portfolio firms to produce returns, a typical SBIC may report little or no return in the first few years, because interest or dividends collected are typically insufficient to cover the interest on debentures and the fund's management fees. Depending on how the LP accounts for the SBIC investments, a loss may be reported on the LP's income statement in the initial phase. This pattern of cash flows is referred to as a "J-curve" because the net cash flows from the fund look like the letter "J." Figure 4 illustrates the hypothetical returns an LP might see over the life of a mezzanine SBIC.

Figure 4: J-Curve for a Hypothetical Mezzanine SBIC Fund



Source: OCC, "Small Business Investment Companies: An Investment Option for Banks," slide 62, February 15, 2012, www.occ.gov/about/who-we-are/occ-for-you/bankers/bankers-education/2012-sbic-handout.pdf.

*Vintage is the year the SBIC obtains the SBIC license.

SBICs that invest in the so-called mezzanine financing segment (repayment priority after senior debt instruments but before equity financing) usually engage in all-debt financing, which means they collect interest almost immediately after the investments are made. That, in turn, reduces losses in the early phase and produces a shallower J-curve than that of an SBIC fund that engages mostly in equity financing.²⁴

During the initial phase (commonly referred to as the investment period), portfolio firms are expected to pay interest or dividends, depending on whether the SBIC provided debt or equity. In the second phase (commonly referred to as the harvest period), the investments are repaid, which allows the GP to make capital distributions to LPs. The

²⁴ The shape and steepness of the J-curve varies with the debenture coupon rate, the timing and amount of payments, and whether capital gains are reinvested or not.

SBIC must pay interest on the SBA-guaranteed debentures before dividends are paid to investors. The exact distribution schedule is outlined in the SBIC's private placement memorandum or its LPA.²⁵ The following is an example of a capital distribution hierarchy:²⁶

1. Distributions to the LPs until each LP has received distributions equal, in the aggregate, to the LP's unreturned capital contributions.
2. Distributions to the LPs until each LP has received distributions equal, in the aggregate, to an amount equal to 8 percent per annum, compounded annually, of its unreturned capital contributions that are outstanding.
3. Distributions to the GP, until the GP has received 20 percent of the cumulative distributions (profits).
4. Of what remains, 80 percent to the LPs and 20 percent to the GP.²⁷

Many SBICs issuing debentures recycle investment proceeds during the investment period and invest the dollars more than once. However, most bank LPs reportedly avoid such arrangements because they prefer receiving distributions as soon as they are available.

Other Vehicles for Participating in the SBIC Program

Unleveraged SBICs

Unleveraged SBICs choose to forgo the use of SBA-guaranteed debentures and rely solely on private capital. There are several advantages to being an unleveraged SBIC, including the following:

- Unleveraged SBICs have reduced financial risk because they do not use SBA leverage and, therefore, are first in line when the debt is repaid. Also, unleveraged SBICs are not subject to the SBA's rules on capital impairment.
- Unleveraged SBICs are more suitable for funds interested in early-stage equity investments. These types of funds are less likely to be licensed as debenture SBICs by the SBA, but they can be licensed as unleveraged SBICs where the SBA has no leverage at stake.
- The SBA typically examines unleveraged SBICs every other year versus every year for leveraged funds.
- Unleveraged SBICs only have to report their required Form 468 on an annual basis versus every quarter for leveraged SBICs.
- All income received by the unleveraged SBIC may be passed directly to the LPs without regard to paying debenture interest or repaying SBA leverage.

The main disadvantage is that the unleveraged SBIC does not get the benefit of returns associated with SBA leverage (see section VI).

²⁵ The SBA has drafted a model LPA for an SBIC issuing debentures that spells out the structure of the formal relationship between the LPs and the SBIC fund. See SBA, "Model Debenture SBIC, LP," October 21, 2010, www.sba.gov/content/model-debenture-sbic-lp-model-partnership-agreement (accessed May 3, 2012).

²⁶ Commerce Street Capital, LP, "Frequently Asked Questions (About SBICs)," 2012, <http://commercestreetcapital.com/root/commercestreet/sbic-fund-raising.asp>.

²⁷ The 20 percent portion that the GP receives from capital gain distribution is commonly referred to as "carried interest." Carried interest and the distribution arrangement is designed to motivate GPs to look for and invest in portfolio firms with good profit potential in order to produce returns above the 8 percent threshold (commonly referred to as "preferred return").

Bank-owned SBICs are unleveraged. Banks sometimes prefer owning the SBIC themselves because it allows them to have more control over where the SBIC fund investments are made while avoiding risks associated with leverage financing.

Fund of Funds

A bank also may participate in the SBIC program by investing in a “fund of funds,” which invests in various investment partnerships or similar investment vehicles, including SBICs. In this structure, banks can invest in a fund that invests in a portfolio of SBICs. This fund of funds is overseen by a fund manager and holds limited partnership interests in many SBICs that may operate throughout the United States. This type of fund can help diversify a bank’s risk from investing in SBICs.

IV. Key Risks and Regulatory Considerations

Investments made in SBICs have risks similar to those made in other types of private investment firms. These risks can be mitigated by performing proper due diligence on the SBIC funds being considered for investment. The following are key issues to be considered in any risk management strategy associated with investing in SBICs.

Liquidity

SBIC investments are illiquid. Bank LPs should recognize that making investments in SBICs is similar to purchasing un-ratable and non-marketable securities.²⁸ There is no formal secondary market to provide SBIC investors with the option of selling their investments should the bank LP have an immediate need for cash.

Loss of Principal

Loss of principal is a risk of investing in small businesses. Investments in SBICs, therefore, are long-term in nature with no guarantee of repayment. Moreover, the fact that SBICs are licensed by the SBA does not in itself protect bank investments in SBICs. In fact, in the case of leveraged SBICs, this risk is somewhat heightened because the SBA is first in line for repayment. If a leveraged SBIC defaults on either the interest or the principal, the SBA makes those payments to the bondholders and has the right to liquidate the SBIC to recover its losses.

Operational Risk

SBICs are governed by a detailed set of rules established by the SBA and are audited by the SBA either annually (leveraged funds) or every other year (unleveraged funds). Bank LPs should familiarize themselves with SBA regulatory considerations on SBIC investment size and eligibility standards; affiliates and conflict of interest; qualifying and structure investments; management ownership diversity; and reporting requirements.²⁹

²⁸ For SBICs, there are no physical security documents provided to investors evidencing ownership. Ownership is evidenced by a formally executed subscription agreement and an executed LPA.

²⁹ For example, SBICs are not permitted to invest more than 10 percent of their total capital in one portfolio firm. For a summary of these considerations, see SBA, “Pre-Screening: Frequently Asked Questions,” www.sba.gov/content/pre-screening (accessed May 4, 2012).

The General Partner

During the SBIC underwriting process, a bank LP must carefully evaluate the management team serving as the GP. The individuals composing the GP team and their related experience will have a significant impact on how the proposed SBIC performs. They will be responsible for identifying portfolio companies in which the SBIC invests as well as maintaining an ongoing advisory role with these companies, with the goal of securing repayment of the SBIC's original investment plus a healthy return. The following are specific aspects of the GP that a bank LP would want to review.

Strength of Management Team

Bank LPs will want to review what experience the GPs have in small-business investment and the overall GP team coherence (i.e., how long the current management team has worked together and in what capacity). The strength of the management team also is a critical factor for the SBA during the SBIC licensing process. By reviewing the SBA's MAQ and the private placement memorandum, a bank LP can gain insight into the credentials, experience, and track record of each member of the SBIC management team.³⁰ These documents provide information about the principals' other business interests, backgrounds, pending or past litigation, and criminal history. They also contain references for the GPs and their previous business associates.

Track Record

Bank LPs will want to review the investment performance of the GP principals in previous SBICs or investment funds that they sponsored (or in which they were principals) and how their performance compares with that of managers of funds with similar investment structures and strategies.³¹ Bank LPs will want to assess how the GP's actual investment returns compare with projections made when the fund was first formed. Bank LPs may also want to examine the objectives and strategies of the current fund and determine if the GP team is leveraging the skills it demonstrated in previous funds. The track record of the principals is confirmed and thoroughly reviewed by the SBA during the licensing process. Performance of SBIC funds can be validated by using metrics reported on SBA Form 468.

Investment Strategy

Bank LPs will want to determine the investment strategy of the fund, its competitive advantage, and whether it will be pursuing investments in geographic areas and in industries with which the bank LP is familiar. Bank LPs will want to determine if these strategies are consistent with their risk profiles, business objectives, and financial conditions. The industry sectors in which the SBIC intends to invest, the intended level of asset diversification, and whether the GP will distribute the capital gains or recycle them in the fund also are important considerations.³² How actively the GP will be involved in

³⁰ If the SBIC is developing its first fund, the full MAQ is provided to the SBA. For existing SBICs sponsoring a new fund, only an abbreviated MAQ is provided to the SBA. Investors are therefore encouraged to obtain the full MAQ produced previously for the SBA by the GP for the SBIC's first fund.

³¹ Data on private-equity fund performance can be purchased from private vendors such as Cambridge Associates (www.cambridgeassociates.com), Prequin (www.prequin.com), and Thomson Reuters (<http://thomsonreuters.com>).

³² The fund's strategy with regard to recycling capital gains should be spelled out in the LPA provided to the bank LP.

the portfolio companies is another consideration.³³ Some SBICs set up an advisory board composed of independent LPs, which provide guidance on the fund investment strategy.

General Partner Financial Incentives

Bank LPs should ensure that the GP's financial interests are aligned with their own. Typically GPs earn their income in three ways: management fees, carried interest, and ownership in the fund. SBA policies establish the maximum management fee an SBIC may earn; the LPA, however, may set the management fee at any lower amount.³⁴ Because management fees can deplete a fund's investment capital, most bank LPs prefer GPs to earn their return based on the success of the fund through carried interest and fund participation.

Carried interest represents the GP's share of fund profits in excess of the amount that the manager contributes to the partnership. In many cases the manager must first return all the capital contributed by the investors, and in certain cases, the fund must also return a previously agreed-upon rate of return (preferred return) to investors.

There is no requirement that the GP contribute part of the SBIC's capital. However, interviews with both GPs and LPs indicate that a minimum 1 percent contribution, inclusive of the SBA leverage, by the GP is typically expected, and, in practice, the percentage contributed is often higher. Higher levels of ownership by the GP indicate principals have a greater personal stake in the success or failure of the fund. In today's SBIC market, we are told, many GPs invest between 1 percent and 5 percent of the SBIC's capital.

Timing of Capital Calls and Investment Period

After receiving a "green light" letter from the SBA, SBIC applicants must raise a minimum of \$5 million in private capital before submitting their license application. The applicants must raise sufficient funds to execute their business plan before the SBA will consider granting them an SBIC license. Once the fund is licensed, the SBIC will begin making investments in its portfolio companies and begin drawing down its leverage from the SBA. It is at this point that investors will begin receiving capital calls. The guidelines of these capital calls are outlined in the subscription agreement and the LPA. Agreements typically assess penalties if the capital calls are not honored when requested.³⁵

³³ Discussions with industry practitioners indicate GPs of mezzanine SBICs often seek to negotiate observation rights on a portfolio firm's board of directors, while GPs of equity SBICs often will seek to obtain a seat on the board, depending on their ownership level. For more information on control of a small business by an SBIC, see 13 CFR 107.865.

³⁴ The maximum SBIC management expense allowed by the SBA is determined according to a formula that considers a combination of factors, including the age of the fund, the size of the fund, and the assets under management. For definitions and calculations of management fee rates, see SBA, "SBIC TechNotes Number 7a," www.sba.gov/content/sbic-technotes-number-7a-revised-april-2008.

³⁵ As mentioned previously, the SBA has a model LPA for debenture SBICs. It includes sections on capital commitments, SBA rights, valuation, distributions, and dissolution and windup of the fund. The SBA's Office of General Counsel reviews all LPAs in the licensing process. The SBA must approve changes to the LPA. Boldfaced provisions of the agreement cannot be changed. See SBA, "Model Debenture SBIC, LP," October 21, 2010, <http://www.sba.gov/content/model-debenture-sbic-lp-model-partnership-agreement> (accessed May 3, 2012).

Documentation Checklist and Review

There are several documents that a bank LP should request before deciding whether to invest in an SBIC. They include the following:

- LPA
- Subscription agreement
- Private placement memorandum
- MAQ
- SBIC's investor presentation
- Audited financial statements (for previous funds sponsored by the GP)

SBA Leverage

Bank LPs should know whether the SBIC will be leveraging debt from the SBA and in what amount. This information should be available in the private placement memorandum or other investor marketing materials. There is credit risk associated with leverage in that repayments from portfolio companies must go toward interest payments on the debentures before LPs can receive returns. Likewise, when debentures mature, they must be repaid before LPs receive their return of capital. If the SBIC fund experiences losses in its underlying investments, the use of leverage can reduce returns or even increase losses experienced by the LPs. Losses in underlying investments may result in a condition of capital impairment.³⁶ Capital impairment and defaults on leverage may result in the SBA transferring the SBIC to the SBA's Office of Liquidation. If an SBIC is transferred to the Office of Liquidation, the SBA will take priority until it is repaid.

Profit and Loss Distribution

Bank LPs should determine how the SBIC will allocate profits and losses, the terms and timing of distribution of returns, and whether preferred returns are being provided to LPs and on what terms. The PPM should outline whether distributions from the portfolio companies will be reinvested or returned to investors.³⁷

Asset Management/Portfolio Monitoring

Before investing in an SBIC, bank LPs' senior management responsible for overseeing investments in SBICs should establish a sound process for evaluating the financial performance of the SBIC. Typically, SBICs conduct an annual in-person meeting with the GP and LPs. Bank LPs may also want the GP to keep them apprised of all new SBIC investments by obtaining copies of the reports the GP provides to the SBA identifying each new portfolio company in which the SBIC fund invests.³⁸

Audits and Financial Reports

Before investing, bank LPs may want the SBICs to identify the type and number of reports the LPs will receive from the GP. Bank LPs also may want to review reports submitted by the SBIC to the SBA. These include the financial report (SBA Form

³⁶ See appendix B for an example of a CIP worksheet.

³⁷ The SBA places no limitations on the SBIC's distributions of profits to investors. When it comes to distributions of invested capital, however, an SBIC may not distribute more than 2 percent of its private capital, unless it receives the SBA's prior approval. For regulatory guidelines on this issue, see 13 CFR 107.585.

³⁸ The Portfolio Financing Report (SBA Form 1031) is a one-page report on the demographics and financing of companies in which the SBIC has invested.

468), which is a comprehensive review of the SBIC's financials; the Retained Earnings Available for Distribution (READ) Worksheet, which delineates the status of retained earnings and distributions; and the Capital Impairment Percentage (CIP) Worksheet, which constitutes an early-warning report about the SBIC's capital position.³⁹ More information on how to use READ and the CIP Worksheet is provided in appendixes A and B.

Regulatory Considerations

National banks and federal savings associations may make investments in SBICs using one or more of the authorities discussed below.

Small Business Investment Act

National banks and federal savings associations have authority under the Small Business Investment Act of 1958 (as amended) to invest in SBICs. Specifically, under 15 USC 682, national banks and federal savings associations may invest in one or more SBICs, or any entity established to invest solely in SBICs.⁴⁰ Under this authority, total investments in SBICs by any one bank or federal savings association may not exceed 5 percent of the institution's capital and surplus.

Bank and Thrift Special Authorities

In addition to the authority above, national banks may make investments designed primarily to promote the public welfare under 12 USC 24 (Eleventh).⁴¹ The OCC's regulations for national banks (12 CFR 24) define eligible public welfare investments to include investments that would receive consideration as a "qualified investment" under the CRA (12 CFR 25.23). Qualified investments under the CRA include "organizations, including, for example, Small Business Investment Companies (SBICs), specialized SBICs, and Rural Business Investment Companies (RBICs) that promote economic development by financing small businesses."⁴²

Federal savings associations have limited authority under 12 CFR 160.36 to make investments of the type permitted for national banks under 12 CFR 24.⁴³

Federal savings associations also are authorized under 12 CFR 159 to make investments in service corporations engaged in a broad range of preapproved activities, including

³⁹ See 13 CFR 107.630 for requirements for SBIC licensees to file financial statements with the SBA. Regulation 13 CFR 107.630 (a)(1) requires that the annual Form 468 must be audited by an independent public accountant acceptable to the SBA.

⁴⁰ See 15 USC 682(b)(1) and (2). Also see OCC Interpretive Letter #832, August 1998, which clarifies that a national bank may invest in an SBIC that is in the process of organization as well as in one that has already been organized, approved, and licensed by the SBA (www.occ.gov/static/interpretations-and-precedents/aug98/int832.pdf).

⁴¹ Investments made under the requirements of 12 USC 24 (Eleventh) and 12 CFR 24 are limited to 5 percent of capital and surplus without prior, written approval of the OCC. National banks, however, may exceed the 5 percent limit up to a maximum of 15 percent if they obtain prior OCC approval. All investments are subject to certain notice and filing requirements set forth in 12 CFR 24.

⁴² See 2010 Interagency Questions and Answers, 75 Fed. Reg. 47 (March 11, 2010).

⁴³ Investments made under 12 CFR 160.36 are limited to the greater of 1 percent of total capital or \$250,000.

certain investments related to community development and activities that involve investments in “small business investment companies ... licensed by the U.S. Small Business Administration.”⁴⁴

Transactions With Affiliates

Additional risk management and compliance issues may arise when a bank has a business relationship with a portfolio company of an SBIC. In some instances, the portfolio company may constitute an affiliate of the bank under sections 23A and 23B of the Federal Reserve Act. Lending and other business transactions between a bank and a portfolio company that meets the definition of an affiliate under 12 CFR 223.2(a)(9) must conform with section 23A and be negotiated on an arm’s-length basis pursuant to section 23B.

Capital Treatment

Depending on their size, national banks and federal savings associations are subject to minimum risk-based capital requirements as calculated under either the general risk-based capital rules or the advanced approaches. Under the general risk-based capital rules for national banks, SBIC investments that do not exceed 15 percent of Tier 1 capital are assigned a Tier 1 capital requirement of 8 percent. SBIC investments that are greater than 15 percent of Tier 1 capital are subject to partial deduction from capital in amounts prescribed under the regulation. For federal savings associations, SBIC investments are risk-weighted at 100 percent. For national banks and federal savings associations subject to advanced-approaches capital rules, and using the simple risk-weight approach for equity exposures, SBIC investments that do not exceed 10 percent of Tier 1 plus Tier 2 capital may be included in the “non-significant equity exposure” bucket and risk-weighted at 100 percent. SBIC investments in excess of 10 percent of Tier 1 plus Tier 2 capital, on the other hand, are risk-weighted at 400 percent.⁴⁵

Additionally, investments in SBA-guaranteed debentures issued by SBICs are risk-weighted at 0 percent.

Accounting Treatment

Bank LPs should be familiar with the fund performance reports and financial statements that will be provided to investors and the SBA. Bank LPs should have clearly articulated methods for valuing SBIC investments for financial reporting purposes and are encouraged to discuss them with their external accountants prior to investing. These reports will allow the bank LP to properly value the SBIC on its financial statements and determine when valuation write-downs should be taken.

Investments in SBIC funds will be accounted for by one of three primary methods of accounting: (1) cost, (2) equity, or (3) consolidation. Banks making investments

⁴⁴ For the type of activities preapproved for service corporations, see 12 CFR 159.4(g). A federal savings association’s aggregate investments in all service corporations is limited to 3 percent of assets, and any investment that would cause aggregate investments to exceed 2 percent of assets must serve primarily community, inner-city, or community development purposes, as defined in 12 CFR 159.5(a). Moreover, investments in service corporations are subject to certain geographic and ownership limitations set forth in 12 CFR 159, as well as certain notice and approval requirements.

⁴⁵ For capital treatment under the general risk-based rules (Basel I), see 12 CFR 3, appendix A, section 2(c)(5). For capital treatment under the advanced approaches (Basel II), see 12 CFR 3, appendix C, part VI. For more information on the minimum capital ratios, see http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=22095e8fa3010dba67abd8a3ab1ed2ab&tpl=/ecfrbrowse/Title12/12cfr3_main_02.tpl.

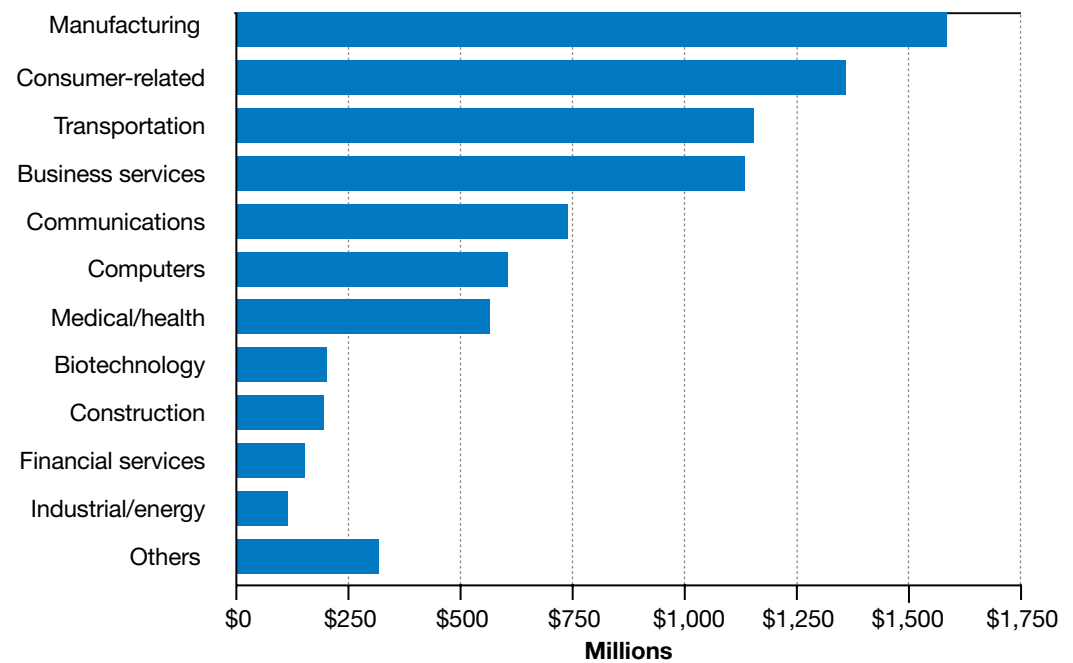
in SBIC funds should refer to the call report instructions (“Glossary: Equity Method of Accounting and Subsidiaries”) and generally accepted accounting principles (GAAP) for guidance on accounting for these investments.⁴⁶

V. Who Is in the SBIC Business Today?

The SBIC industry includes approximately 300 SBICs served by a host of brokerage firms, consulting firms, law firms, and trade associations. The main professional association for the SBIC industry is the Small Business Investor Alliance (SBIA).⁴⁷

Financial institutions that invest in SBICs vary by size and charter. They include some of the largest banks in the nation and some community banks, and they are widespread geographically. For example, nearly 50 percent of the debenture portfolio resides in the SBA’s New England, Middle Atlantic, and South Atlantic regions.⁴⁸ The SBIC investment portfolio covers all sectors of the economy, though manufacturing, transportation, and consumer industries account for 55 percent. Figure 5 illustrates the distribution of the SBIC debenture portfolio by industry.

Figure 5: SBIC Program Debenture Portfolio by Industry, FY 2007–2011



Source: Office of Investment, SBA.

Additionally, the SBA recently announced two new initiatives that use the existing SBIC infrastructure to encourage further investment in the nation’s small businesses. The first, the Early Stage SBIC Initiative, commits \$1 billion over the next five years to help finance early-stage small businesses facing difficult challenges accessing capital, particularly those without the necessary assets or cash flow from traditional bank

⁴⁶ Financial Accounting Standards Board, Accounting Standards Codification 323-30, “Investments—Equity Method and Joint Ventures—Partnerships, Joint Ventures, and Limited Liability Entities” (formerly, EITF issue no. 03-16, “Accounting for Investments in Limited Liability Companies”).

⁴⁷ For more information, see www.sbia.org/.

⁴⁸ SBA, “Program Statistics and Administrative Performance,” www.sba.gov/content/statistics (accessed July 31, 2012).

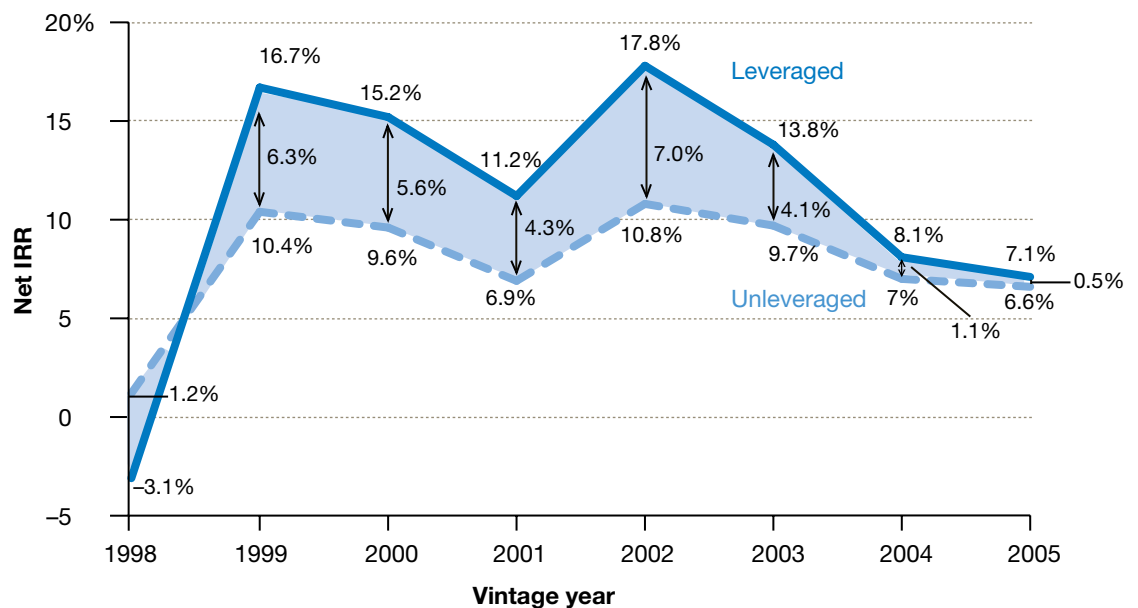
funding.⁴⁹ The second, the Impact Investment SBIC Fund, allocates another \$1 billion to areas of critical national priority, including underserved markets and communities facing barriers to credit and capital. These investments will focus on small businesses that are located in underserved areas; the employment of low- to moderate-income residents; or industries involving national priorities, such as clean energy and education.⁵⁰ Both of these initiatives will provide additional investment opportunities for banks.

VI. What Are the Typical Returns on SBIC Investments?

The main advantage of leveraged SBIC funds is their potential for producing competitive returns, compared with similar classes of investment funds, as a direct result of employing low-cost SBA-guaranteed debentures to supplement the funds' private capital.

SBA data indicate that private capital invested in leveraged SBIC funds has produced higher returns historically on average than that invested in unleveraged SBIC funds. This SBA analysis looks at the internal rate of return (IRR) on private capital for SBIC pooled leveraged and unleveraged funds.⁵¹ Figure 6 shows that for mature vintages (in this case, funds formed before 2004) the SBA leverage added between 4 percent and 7 percent in returns on a pooled basis.

Figure 6: IRR Comparison for Leveraged and Unleveraged SBIC Funds



Source: Office of Investment, SBA. See appendix D for data, computations, and definition of terms.

Performance data on individual SBICs are not publicly available. However, the SBA's Office of Investment has compared the fund performance of debenture SBICs with fund indexes published by private aggregators. Overall, according to the SBA, debenture SBIC funds' average returns compare well with selected industry average returns.⁵² Figure 7 illustrates pooled SBIC returns by vintage compared with private-equity pooled funds.

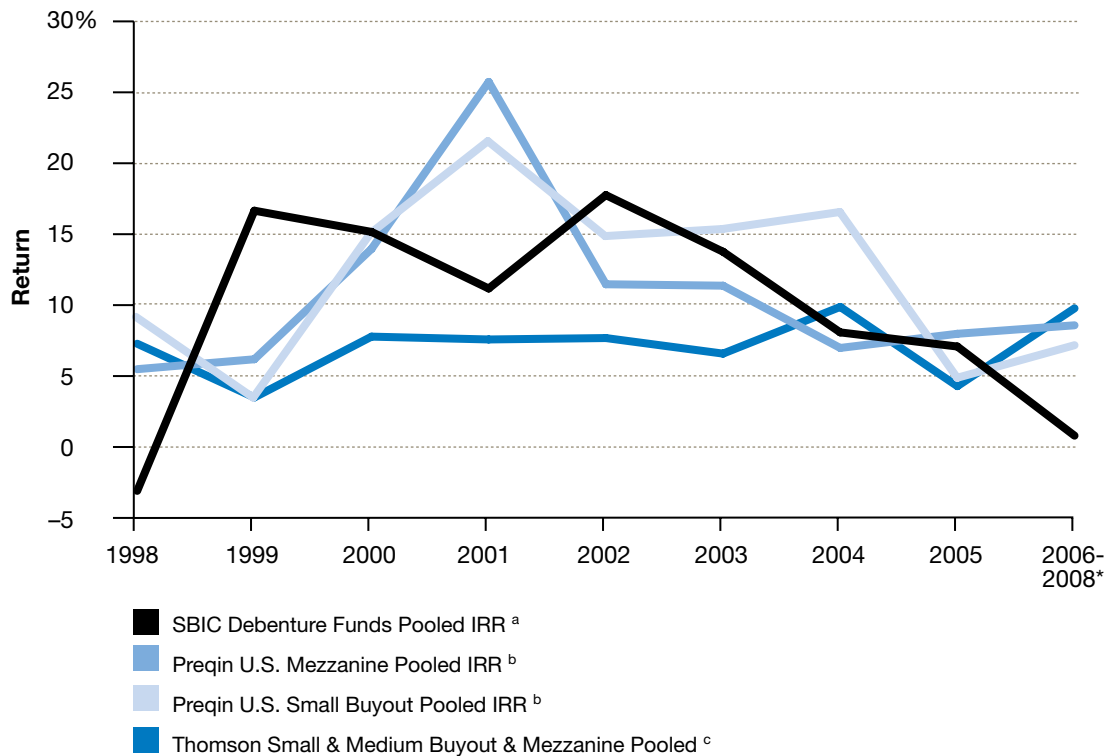
⁴⁹ SBA, "Early Stage Small Business Investment Company (SBIC) Initiative," www.sba.gov/inv/earlystage (accessed September 6, 2012).

⁵⁰ SBA, "Impact Investment Initiative," www.sba.gov/content/small-business-investment-company-sbic-impact-investment-initiative-2 (accessed September 6, 2012).

⁵¹ Appendix C defines IRR and gives an illustrative example on what is involved in its calculation.

⁵² SBA, "Performance Data: Benchmarking SBICs," www.sba.gov/content/performance-data (accessed July 31, 2012).

Figure 7: Pooled SBIC Historical Returns, 1998–2008



Source: Office of Investment, SBA.

Note: The 2006–2008 data are presented as an arithmetic mean of the pooled IRRs for those years.

^a SBIC vintage year determined by date of license. Data as of December 31, 2010; returns calculated based on information collected as part of annual financial statement submissions to the SBA; returns include an assumed 20 percent carried interest payment to the GP after LPs have received distributions equal to paid-in capital.

^b Data include most-up-to-date figures (Preqin, www.preqin.com, accessed December 12, 2011); benchmark may include some funds licensed as SBICs.

^c Data as of December 31, 2010; data include U.S. funds from \$5 million to \$500 million categorized as small buyout, medium buyout, or mezzanine (Thomson Reuters, <http://thomsonreuters.com>).

In assessing an SBIC’s performance, banks may wish to compare performance to appropriate benchmarks maintained by vendors such as Cambridge Associates, Preqin, and Thomson Reuters.

VII. What Are the Barriers to Bank Participation?

There is general agreement that SBIC program participants—and investors in particular—would benefit from additional publicly available performance data. Due to proprietary constraints, however, performance data on individual SBICs cannot be made public. And while there are private firms that publish private-equity market data for a fee, smaller community banks may find the subscription cost to be expensive. As a result, many SBIC program participants operate as an informal network, with information collected and exchanged by experienced GPs and LPs.

Additionally, the negative legacy of the Participating Securities Program, which was discontinued in 2004, has left some potential bank LPs apprehensive about participating in the SBIC program. By contrast, the debenture program has had a solid performance and is moving the SBIC program forward.

Finally, potential bank LPs need to have appropriate resources and experienced staff to manage SBIC investments in a safe and sound manner.

VIII. Conclusion

The goal of the SBIC program is to encourage the flow of private investment capital into dynamic small businesses that will innovate, grow, and create jobs. Many times these small businesses' financing needs are not suitable for traditional bank credit products, but the growth of these companies is vital to the health of the U.S. economy. The government helps facilitate the flow of private capital into these businesses by guaranteeing a large portion of the total private capital employed using SBA-backed leverage.

The advantage for banks of using the SBIC investment vehicle is the opportunity to generate favorable financial returns, develop their small-business portfolios, and potentially earn CRA consideration.

Appendix A

How Banks Can Use the READ Form

SBICs typically submit a READ⁵³ form to the SBA annually as part of the Annual Financial Report (Form 468), which is designed to give an overall picture of the fund's financial health.⁵⁴ The form, which also can be submitted quarterly, generally is examined in conjunction with the Statement of Partners' Capital and the Schedule of Delinquent Loans and Investments.

READ is relevant because it gives the bank LP an indication of the fund's earnings available for distribution and, in turn, expected income from the investment.

The hypothetical example below shows a simplified Statement of Financial Position with assets and liabilities. In this case, the SBIC fund collected \$4 million in private capital and \$8 million in SBA leverage. In the investment period (typically, years one through three), the fund produced negative net earnings and did not draw all of its debenture leverage. Consequently, the READ was negative, meaning not enough interest or returns would be available to distribute to investors. Later, in the harvest stage (typically, years five through seven), earnings increased and the full SBA leverage was drawn, resulting in distributed gains, as shown in the positive calculated READ figure.

Table 1: Hypothetical Example of an SBIC's READ During the Investment and Harvest Periods

Statement of financial position	Investment period (typically years 1–3)	Harvest period (typically years 5–7)
Assets		
Loans and investments	\$3,500,000	\$11,500,000
Current and other assets	\$4,500,000	\$2,500,000
Unrealized depreciation	(\$50,000)	(\$500,000)
Total assets	\$7,950,000	\$13,500,000
Liabilities		
Long-term liabilities (debentures)	\$3,975,000	\$8,000,000
Limited Partner's capital	\$4,000,000	\$4,000,000
Undistributed net realized earnings	(\$25,000)	\$1,500,000
Total liabilities	\$7,950,000	\$13,500,000
READ calculations		
Undistributed net realized earnings	(\$25,000)	\$1,500,000
Minus: unrealized depreciation	\$50,000	\$500,000
READ	(\$75,000)	\$1,000,000

⁵³ The Code of Federal Regulations defines READ as “the Undistributed Net Realized Earnings less any Unrealized Depreciation on Loans and Investments (as reported on SBA Form 468), and represents the amount that a Licensee may distribute to investors (including SBA) as a profit Distribution, or transfer to Private Capital.” See 13 CFR 107.50 at www.access.gpo.gov/nara/cfr/waisidx_09/13cfr107_09.html.

⁵⁴ SBIC funds typically employ GAAP when producing financial reports to LPs. The SBA, on the other hand, requires reports using regulatory guidelines, which in some cases differ from GAAP standards.

Appendix B

How Banks Can Use the CIP Worksheet

Leveraged SBICs are required to submit a CIP Worksheet to the SBA each quarter, to report potential exposure from capital losses. The worksheet gauges the capital condition of a leveraged SBIC and serves as an early-warning indicator to alert the SBA before the fund's capital losses become too large to recoup the leverage extended.⁵⁵

SBA regulations outline the maximum CIP allowable for a leveraged SBIC depending on its ratio of equity investment to outstanding leverage. Low equity investment and high leverage represent higher capital impairment risk, so the lower the ratio of equity investment to outstanding leverage, the lower the maximum CIP allowed by the SBA.⁵⁶

The maximum permissible CIP ranges between 35 percent (for funds with low equity capital and high leverage ratio) and 70 percent (for funds with high equity capital and low leverage ratio).

If the SBIC fund is not experiencing any losses, the CIP is zero and its calculation is not required. If, on the other hand, the fund is experiencing losses, it is required to calculate and report its CIP to the SBA.

The following hypothetical simplified example illustrates two scenarios in which a leveraged SBIC fund incurs losses. In the first scenario, the CIP falls within an acceptable range, while in the second it does not. In both scenarios, the regulatory capital is \$10 million.

Table 2: Hypothetical CIP Example for Two Scenarios

		Scenario 1	Scenario 2
		Acceptable CIP	Unacceptable CIP
Line 1	Undistributed net realized earnings	-\$25,000	-\$2,500,000
Line 2	Includable non-cash gains	\$0	\$0
Line 3	Unrealized gains on securities held	-\$100,000	-\$2,000,000
Line 4	Total (lines 1 + 2 + 3)	-\$125,000	-\$4,500,000
Line 5	Regulatory capital	\$10,000,000	\$10,000,000
Line 6	CIP (line 4 ÷ line 5)	1.25%	45%
Line 7	SBA maximum permissible CIP	35%	35%

⁵⁵ The CIP can be shown as the ratio of (undistributed net realized earnings + includable non-cash gains + adjusted unrealized gains on securities held) ÷ regulatory capital.

⁵⁶ Because of the importance of the equity position to the impairment calculations, the CIP Worksheet is typically more relevant to funds using participating securities, not the debenture program.

Appendix C

The Internal Rate of Return

The IRR of an investment is the discount rate that makes the net present value of costs (negative cash flows) of the investment equal the net present value of the benefits (positive cash flows) of the investment. The higher a project's IRR, the more desirable it is to undertake the investment.

In the SBIC context, capital calls on the LPs are treated as negative cash flow, while distributions to the LPs and the residual value at the end of the investment period are treated as positive cash flows. Most commonly used spreadsheet programs can calculate the IRR from the cash inflows and outflows. Some bank LPs request these spreadsheet calculations from the GPs in order to validate the reported IRRs on previous funds, and to determine, in the case of future funds, if IRR projections are realistic.

The major variable with IRR calculations in the context of SBIC investments lies in the estimation of the net asset value (residual) at the time of exit from the investment. Depending on the valuation method and the actual performance, the final IRR can vary.

The table below illustrates how, keeping the paid-in capital and distribution flow the same, the IRR changes as the net asset value changes. In the first hypothetical scenario, the estimate of the net asset value is \$55 million and the resulting IRR is 10.1 percent. In the second, the estimate of the net asset value is reduced to \$45 million and the resulting IRR is 7.5 percent. In both examples, all cash flows are net of expenses, fees, SBA leverage, carried interest, and other liabilities.

Table 3: Hypothetical Example Illustrating IRR Calculations in Two Scenarios

Year	Take-downs/ paid-in (in millions)	LP distributions (in millions)	Scenario 1 Net IRR: 10.1%		Scenario 2 Net IRR: 7.5%	
			Net asset value (in millions)	Net cash flows (in millions)	Net asset value (in millions)	Net cash flows (in millions)
2002	-\$7.0			-\$7.0		-\$7.0
2003	-\$8.0	\$0.2		-\$7.8		-\$7.8
2004	-\$8.0	\$0.5		-\$7.5		-\$7.5
2005	-\$9.0	\$1.0		-\$8.0		-\$8.0
2006	-\$3.0	\$2.0		-\$1.0		-\$1.0
2007	-\$5.0	\$2.0		-\$3.0		-\$3.0
2008		\$3.0		\$3.0		\$3.0
2009		\$3.0		\$3.0		\$3.0
2010		\$5.0		\$5.0		\$5.0
2011			\$55	\$55.0	\$45	\$45.0
Total	-\$40.0	\$16.7		\$31.7		\$21.7

Note: The first year (vintage) is 2002. The terminal year is 2011.

Appendix D

Debenture Fund Statistics, Computations, and Definitions of Terms

Debenture Fund Statistics

(for Funds Licensed From 1998 Through 2010 and Issued Debenture Leverage Only)
As of December 31, 2010

Year ^a	Number of funds	Number transferred ^b	Private capital (in millions)	SBA leverage (in millions)	Total capital (in millions)	Private pooled (leveraged) ^c			Combined pooled (unleveraged) ^d		
						DPI	TVPI	Net IRR	DPI	TVPI	Net IRR
1998	10	6	182.8	257.4	440.2	0.6	0.8	-3.1%	0.9	1.1	1.2%
1999	10	1	162.2	388.7	550.9	1.6	2.5	16.7%	1.1	1.6	10.4%
2000	14	3	200.5	298.4	498.8	1.4	1.9	15.2%	1.2	1.5	9.6%
2001	9	2	128.0	226.8	354.8	0.9	1.7	11.2%	1.0	1.4	6.9%
2002	8	0	132.1	225.0	357.0	1.0	1.9	17.8%	0.7	1.5	10.8%
1998 to 2002	51	12	805.6	1,396.2	2,201.8	1.1	1.8	10.9%	1.0	1.4	7.6%
2003	9	0	348.8	592.2	941.0	0.7	1.6	13.8%	0.6	1.4	9.7%
2004	4	0	103.4	194.0	297.4	0.4	1.4	8.1%	0.4	1.3	7.0%
2005	9	0	276.8	475.1	752.0	0.2	1.2	7.1%	0.2	1.2	6.6%
2006	12	0	445.8	807.1	1,252.9	0.1	1.0	-0.1%	0.1	1.1	4.2%
2007	8	0	304.1	496.4	800.5	0.1	1.0	1.9%	0.1	1.1	5.3%
2003 to 2007	42	0	1,478.9	2,564.9	4,043.8	0.3	1.2	7.6%	0.3	1.2	7.1%
2008	7	0	154.3	233.8	388.1	0.0	1.0	0.6%	0.0	1.0	4.8%
2009	8	0	175.8	228.6	404.4	0.0	0.8	-27.7%	0.0	1.0	-10.5%
2010	10	0	223.5	255.9	479.4	0.0	1.0	n/a	0.0	1.0	n/a
2008 to 2010	25	0	553.6	718.3	1,271.9	0.0	1.0	-10.3%	0.0	1.0	2.3%

Source: Office of Investment, SBA.

Note: Some figures do not total due to rounding.

^a Year the fund was licensed.

^b Number of funds from vintage year pool that were transferred to the SBA's Office of Liquidation.

^c Private pooled statistics were calculated by pooling private investor cash flows (draws, distributions, and net asset value) from all funds in each vintage year group and calculating the metrics as follows:

- Distributions to paid-in capital (DPI): Total private distributions minus estimated 20 percent carried interest on any profits divided by private paid-in capital.
- Total value to paid-in capital (TVPI): Total private distributions plus net asset value minus estimated 20 percent carried interest on any profits (realized and unrealized) divided by private paid-in capital.
- Net IRR: IRR of the net cash flows by year, excluding fund management expenses, where draws are negative cash flows and distributions minus estimated 20 percent carried interest on any profits are positive cash flows. The last cash flow also includes the net asset value minus estimated 20 percent carried interest on any profits (realized or unrealized). Also includes the net asset value minus estimated 20 percent carried interest on any profits (realized or unrealized). IRR cannot yet be calculated for 2010.

^d Combined pooled statistics were calculated by pooling the cash flows from all funds in each vintage year and computing industry metrics. The cash flows include both cash flows associated with private investors and SBA leverage. "Combined" treats SBA leverage as if it were private investor capital, and fees, interest, and principal repayment to the SBA as if they were private investor distributions. Thus, paid-in capital includes both draws from private investors and issuance of leverage. Distribution includes all distributions to private investors, plus fees, interest, and leverage payments to the SBA. Net asset value is the residual value of the fund plus the outstanding balance of SBA leverage. Performance metrics are computed as follows:

- Distributions to paid-in capital (DPI): Total distributions minus estimated 20 percent carried interest on any profits divided by paid-in capital.
- Total value to paid-in capital (TVPI): Total distributions plus net asset value minus estimated 20 percent carried interest on any profits (realized and unrealized) divided by paid-in capital.
- Net IRR: IRR of the net cash flows by year, excluding fund management expenses, where draws are negative cash flows and distributions minus estimated 20 percent carried interest on any profits are positive cash flows. The last cash flow also includes the net asset value minus estimated 20 percent carried interest on any profits (realized or unrealized). IRR cannot yet be calculated for 2010.

Appendix E

Resource Directory

Dilger, Robert Jay, and Oscar R. Gonzales, “SBA Small Business Investment Company Program,” Congressional Research Service, 7-5700, R41456, June 23, 2011
www.loc.gov/crsinfo/

Institutional Limited Partners Association

<http://ilpa.org/>

Pepper Hamilton LLP

Staebler, Michael B., “An Overview of the Small Business Investment Company Program,” January 3, 2011
www.pepperlaw.com/publications_article.aspx?ArticleKey=13

Private Equity Glossary

<http://mba.tuck.dartmouth.edu/pecenter/resources/glossary.html>

Private Equity Industry Guidelines Group

www.peigg.org/

Semmes, Bowen & Semmes

“A Summary Guide to Early Stage Small Business Investment Companies”
www.sbiclicense.com/pdf/summary-guide-es-sbic.PDF

“A Summary Guide to Small Business Investment Companies”
www.sbiclicense.com/pdf/SBIC_SummaryGuide.PDF

Small Business Administration

“Frequently Asked Questions About Small Business Finance,” Office of Advocacy, September 2011
www.sba.gov/sites/default/files/Finance%20FAQ%208-25-11%20FINAL%20for%20web.pdf

Office of Investment
www.sba.gov/about-offices-content/1/2890

“SBIC Program”
www.sba.gov/inv

Small Business Investor Alliance

www.sbia.org/

“Small Business Resource Directory,” Office of the Comptroller of the Currency
www.occ.gov/topics/community-affairs/resource-directories/small-business/index-small-business.html

13 CFR 107, “Small Business Investment Companies”

www.access.gpo.gov/nara/cfr/waisidx_09/13cfr107_09.html

Ammar Askari was the primary author of this report. Also contributing were William Reeves and Barry Wides. *Community Development Insights* reports differ from OCC advisory letters, bulletins, and regulations in that they do not reflect OCC policy and should not be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. The use of this information, however, does not constitute an endorsement of its accuracy by the OCC.