Early Stage Small Business Investment Company (“SBIC”) Initiative

Overview

As part of President Obama’s “Start-Up America Initiative” SBA is implementing the Early Stage SBIC Initiative that intends to commit up to $1 billion in SBA guaranteed leverage over a five year period to selected early stage venture funds using its current Debenture program authorization. This initiative is intended to promote American innovation and job creation by encouraging private sector investment in job-creating early stage small businesses.

Early stage small businesses face difficult challenges accessing capital, particularly those without the necessary assets or cash flow for traditional bank funding. For high-growth companies, the gap is particularly acute for financing rounds between $1-4 million, commonly referred to as the “Valley of Death”. Since January 2006, less than 10% all U.S. Venture Capital dollars went to seed funds investing at those levels, and 69% of those dollars went to three states: California, Massachusetts, and New York (ThomsonOne Moneytree).

The Early Stage SBIC Initiative will target this gap, by licensing and guaranteeing leverage to funds focused on early/seed stage investments.

Small Business Investment Company Program
What is the SBIC Program? SBIC Frequently Asked Questions Early Stage Frequently Asked Questions

Proposed Early Stage SBIC Quick Facts	
SBA Total Commitment	Up to $1 Billion over 5 years
Maximum leverage per SBIC	Up to $50 million at a maximum of 1 to 1 match with private capital
Early Stage SBIC Focus	Early and seed stage
Licensing Process	Annual call
Estimated Start Date	May 2012 See timeline

Final Regulations and Call Notice

Early Stage SBIC final regulations and the accompanying Call Notice may be found in the Early Stage SBIC docket folder at www.regulations.gov by clicking here.

Early Stage SBIC Key Terms

Terms	Early Stage SBIC Description Per Final Rule
Licensing	Annual Call Aggregate SBA Leverage Commitments limited to $150 million in 2012 and $200 million per year thereafter up to $1 billion total SBA has right to diversify across years & geography
Regulatory Capital	$20 million minimum **(**See 13 CFR 107.50 for the definition of Regulatory Capital)
Investments	50% of investment dollars into early stage. (A business is considered early stage if at the time of the SBIC's initial investment the small business being financed has not yet achieved positive cash flow from operations for any prior fiscal year.)
Maximum Leverage	Up to 1 tier of leverage, no greater than $50 million.
Term	Ten year maturity that may be repaid in full at any time without penalty
SBA Fees	1% Commitment Fee 2% Draw Fee Annual fee set at commitment (typically under 1%) and paid quarterly with interest Licensing Fee: $25,000 Examination Fees per 107.692 of proposed rule
Leverage Description	**Discounted Debenture:** • Interest & charges discounted for first 5 years • Quarterly after first 5 years or **Standard Early Stage Debenture:** • Interest & charges due and payable Quarterly • Requires 5 years interest reserve (may be held as unfunded private capital commitments or in restricted cash)
Distribution Rules	Per § 107.1180 of Proposed Rules, but in general: • Interest & charges must be paid prior to distribution • Pro Rata on cumulative basis except under the following conditions: 1) SBIC's Highest Leverage Ratio (Leverage/Leverageable Capital) is greater than 0.5 AND Capital Impairment Percentage ("CIP") is at or above 50% CIP or 2) SBIC's CIP at or above maximum allowable CIP Under either of these conditions, SBA has distribution priority.
Other Key SBA Rights	Annual Examinations Above 50% CIP: SBA has specific right to require valuations on your investments. Above Maximum Allowable CIP: SBA has right to promptly transfer SBIC to Office of Liquidation

SBA Early Stage SBIC Selection Criteria

The final rule section 107.305 discusses the criteria that SBA proposes to use to select Early Stage SBICs as follows:

- Manager Qualifications
- Track Record
- Proposed Investment Strategy
- Proposed Fund Structure and Economics

SBA reserves the right to diversify across vintage years and geography as part of its licensing process. SBA also reserves the right to not license any SBIC if no applicant meets the qualifications.

Early Stage SBIC Frequently Asked Questions by Topic

This page contains frequently asked questions ("FAQs") regarding the Early Stage Small Business Investment Company ("SBIC") Call for Venture Funds. If you have any questions regarding the Early Stage SBIC Call Process, please submit them to startupamerica@sba.gov. SBA will try to post answers to questions here. SBA will not accept questions past May 18, 2012.

A. FAQs Regarding the Call Process

1. Question: How will the Early Stage Call Process work and what is the timing?
2. Question: When does an applicant need to have raised its private capital?
3. Question: Can a portion of the private capital come from government (other federal, state, or local)?
4. Question: Is there a standard Limited Partnership Agreement ("LPA") for Early Stage SBICs.
5. Question: How do you see the geographic allocation with respect to licensing working?
6. Question: Are new funds encouraged, not just existing funds?
7. Question: If an Early Stage SBIC applicant is denied, can they apply in a subsequent round?

B. FAQs Regarding Early Stage Leverage

1. Question: How will Early Stage Debenture leverage work?
2. Question: Can you please provide an example of how the payment stream works on a discounted early stage debenture? For example, if a fund wants to make a $5 million investment into an early stage company how much private capital would need to be invested and how much would the debenture draw be?
3. Question: Can an Early Stage SBIC draw down both standard and discount debentures?
4. Question: If an Early Stage SBIC elects to use Early Stage discount debentures, can it use private capital to pay interest due on its debentures after 5 years?
5. Question: Since there is limited leverage associated with the Early Stage SBICs, how will the leverage be allocated in any given year?

C. FAQs Regarding Operating as Early Stage SBIC

1. Question: What are the regulatory requirements that must be met, besides the requirement that businesses be "early stage" (not have positive cash flow from operations in any prior year)?
2. Question: What are the reporting requirements for an Early Stage SBIC?
3. Question: At what point must an Early Stage SBIC need to have met the 50% investment into Early Stage? Can a fund make later stage investments?
4. Question: Are the SBA valuation guidelines for investments likely to be the same as in the current participating securities program and how will that effect the number of SBICs that may encounter Capital Impairment Percentages (CIPs) >50%?

D. General FAQs

1. Question: Why would a fund manager pick the Early Stage SBIC program over the standard SBIC program?

A. FAQs Regarding the Call Process

1. Question: How will the Early Stage Call Process work and what is the timing?

- **Answer**: The Early Stage SBIC Call Notice describes the process and timing in detail. In general the process will include: A) Call Period; B) Initial Review; C) SBIC Fundraises and Finalizes Documents; and D) Licensing.

  In order to expedite applicants that have already raised sufficient capital, SBA has established two "tracks" for the Early Stage SBIC Licensing Process as follows:

  - Track 1 – Applicants with Capital: This includes all applicants that have signed commitments for at least $15 million in Regulatory Capital and the remaining capital needed to achieve the minimum $20 million in Regulatory Capital for Early Stage SBICs "soft-circled". Track 1 applicants that receive a Green Light will need binding unconditional commitments of at least $20 million in Regulatory Capital when they file their Licensing Application on or before July 30, 2012.

  - Track 2 – All Other Applicants.

  The following table provides the key milestones for each track.

Milestone	Track 1 – Applicants with Capital	Track 2 – All Other Applicants
FAQ Process Closed	5 p.m. Eastern Time ("ET") on May 18, 2012	
Initial Review Period		
• Management Assessment Questionnaires ("MAQs") Due	5 p.m. ET May 25, 2012	5 p.m. ET June 19, 2012
• Interview Period	June 6, 2012 – June 13, 2012	July 23 2012 – August 3,, 2012
• Anticipated Green Light Decision	June 29, 2012	September 28, 2012
Licensing Period		
• Licensing Applications Due with at least $20 million in Regulatory Capital	5 p.m. ET July 30, 2012	5 p.m. ET May 15, 2013
• Anticipated Licensing Date	September 28, 2012	September 30, 2013

Notes:
- *SBA will notify applicants with Green Light Letters of any further Licensing periods.*
- *SBA reserves the right to change these timelines as needed. SBA will update this website should these dates change.*
- *SBA expects to issue additional calls for Early Stage Fund Managers on an annual basis. SBA will announce these calls via a call notice in the Federal Register.*

2. **Question: When does an applicant need to have raised its private capital?**

    - **Answer:** As discussed in Question 1, Track 1 applicants must have signed commitments of at least $15 million in Regulatory Capital when they submit their MAQs (May 25, 2012) and at least $20 million in Regulatory Capital when they submit their Licensing Applications (July 30, 2012). Track 2 applicants must have at least $20 million in Regulatory Capital when they submit their Licensing Applications (May 15, 2013). If applicants have not raised $20 million in Regulatory Capital by the start of the first licensing period after receiving a Green Light letter, they may apply in the next licensing period.

3. **Question: Can a portion of the private capital come from government (other federal, state, or local)?**

    - **Answer:** The sources of private capital for SBICs, including Early stage SBICs, are described in 13 CFR 107.230.

4. **Question: Is there a standard Limited Partnership Agreement ("LPA") for Early Stage SBICs.**

    - **Answer**: Yes. All Early Stage SBICs must use the Early Stage Model LPA as a template, which you may download by clicking here. Section IV of the Call Notice provides special instructions regarding the LPA.

5. **Question: How do you see the geographic allocation with respect to licensing working?**

    - **Answer:** SBA has not developed a specific algorithm on how it expects to allocate based on a geographic basis. All Early Stage SBICs must first meet SBA's basic licensing criteria. After those criteria are met, SBA reserves the right to maintain diversification among Early Stage SBICs with respect to geography.

6. **Question: Are new funds encouraged, not just existing funds?**

    - **Answer:** New funds are encouraged to apply, but the team must demonstrate some cohesion and there must be at least two Principals with a sufficient number of successful, analogous investments that they took from investment to realization.

7. **Question: If an Early Stage SBIC applicant is denied, can they apply in a subsequent round?**

   - **Answer**: Applicants may reapply. However, SBA would expect that a meaningful change has occurred (such as an addition to the management team or improvement in track record through additional realizations).

B. FAQs Regarding Early Stage Leverage

1. **Question: How will Early Stage Debenture leverage work?**

   - **Answer**: Similar to the regular SBIC Debenture program, Early Stage SBICs first receive a leverage commitment. The Early Stage SBIC must pay a 1% commitment fee at the time of commitment. (No other leverage charges are incurred until the Early Stage SBIC issues leverage.) SBA Debenture commitments are good through the end of the fourth fiscal year after the commitment was approved. For example, if you received an SBA commitment on September 25, 2012, the commitment would end on September 30, 2016. During that timeframe, the SBIC may issue Debentures at any time, barring regulatory issues.

   - Early Stage SBICs must pay a 2% draw fee at the time of draw. Unlike the standard SBIC Debenture, Early Stage Debentures will not be pooled. The Federal Home Loan Bank of Chicago ("FHLBC") has agreed to purchase all Early Stage Debentures and hold them until maturity. Interest rates for this debenture will be determined by FHLBC on the draw date as a spread over the FHLBC's cost of funds.

   - Early Stage SBICs will be eligible to utilize two types of Early Stage Debentures:

     1. Standard: Interest and annual charges will be due on a quarterly basis. Early Stage SBICs are required to maintain a 5 year interest and annual charge reserve (which may be held as unfunded private capital commitments or in restricted cash).

     2. Discounted: Leverage will be issued at a discount based on 5 years of interest and annual charges. After the fifth year, SBICs will be required to pay such interest and charges on a quarterly basis.

2. **Question: Can you please provide an example of how the payment stream works on a discounted early stage debenture? For example, if a fund wants to make a $5 million investment into an early stage company how much private capital would need to be invested and how much would the debenture draw be?**

   - **Answer:** The Early Stage Discount Debenture is expected to be very similar to the 10 year LMI Debenture. There may be different pricing based on differences in Early Stage distribution rules and terms associated with Early Stage Discount Debentures (such as quarterly payments after 5 years) versus those for LMI debentures. However, the following link describes the LMI Debenture and provides a link to the LMI Calculator. Link: www.sba.gov/content/low-or-moderate-income-lmi-debentures. Although interest rates and annual charges are subject to change, this calculator should help you understand the proceeds you might expect when issuing an Early Stage Discount Debenture.

3. **Question: Can an Early Stage SBIC draw down both standard and discount debentures?**

   - **Answer**: An Early Stage SBIC may draw down both ***Early Stage*** standard and discount debentures. However, Early Stage SBICs will not have access to the regular program's Debenture leverage. Similarly, SBIC's licensed through the standard debenture program will not have access to Early Stage Debenture leverage.

4. **Question: If an Early Stage SBIC elects to use Early Stage discount debentures, can it use private capital to pay interest due on its debentures after 5 years?**

   - **Answer**: Yes. Early Stage SBICs may use investment proceeds or private capital draws to pay interest on its debentures.

5. **Question: Since there is limited leverage associated with the Early Stage SBICs, how will the leverage be allocated in any given year?**

   - **Answer**: SBA Early Stage commitments depend on the amount of leverage available in any given fiscal year. If leverage is available, Early Stage SBICs may receive their full commitment (1 tier up to $50 million) at licensing. Otherwise, SBA will allocate the leverage across all approved eligible recipients. SBA has not decided on any particular methodology for allocating leverage.

   - By creating periodic application windows, SBA will be able to gauge the overall demand for leverage and allocate the available funds among all successful applicants. Up to a maximum of $50 million per fund, SBA intends to make one full tier of leverage available to each licensed Early Stage SBIC (unless the SBIC requests less) and will stop licensing new funds. Depending on demand, SBA may need to commit leverage to Early Stage SBICs in tranches spread over several years, rather than providing a full one-tier commitment at the time of licensing.

- Example: Early Stage SBIC is licensed with $25 million in Private Capital. They only receive a $15 million leverage commitment when licensed due to allocation issues. The SBIC may apply in another year for an additional $10 million leverage commitment.

C. FAQs Regarding Operating as Early Stage SBIC

1. **Question: What are the regulatory requirements that must be met, besides the requirement that businesses be "early stage" (not have positive cash flow from operations in any prior year)?**

   - **Answer**: All businesses must qualify as a U.S. "small business" to receive SBIC financing.

     - Small businesses are generally defined as businesses with a tangible net worth < $18 million **AND** average after-tax income for prior two years of < $6 million

     - **OR** Businesses that qualify as "small" under SBA's N.A.I.C.S. Industry Code standards (generally under 500 employees)

   - 13 CFR Part 107, Subpart G further defines the rules regarding eligible SBIC financings. A few of these are listed in the chart below.

Other Major SBIC Investment Requirements		
Area	**SBICs May Invest**	**SBICs May NOT Invest**
Investments	• Loans • Debt with Equity features • Equity	• More than 10% of the proposed total fund size in a single company without SBA approval
Use of Proceeds	• Small businesses in non-prohibited areas	• Project Finance • Real Estate • Financial Intermediaries
Geography	• In businesses located anywhere in the U.S. or its territories	• In businesses with over 49% of their employees located outside the U.S.

2. **Question: What are the reporting requirements for an Early Stage SBIC?**

    - **Answer**: The reporting requirements are the same as in the regular SBIC program. SBIC reporting requirements are governed by 13 CFR Part 107, Subpart F. Key reporting includes annual financial statements (Form 468) and for leveraged SBICs (SBICs with either outstanding leverage or leverage commitments) quarterly financial statements (short Form 468). SBICs must also provide a Portfolio Financing Report (Form 1031) within 30 days after the close of each financing.

3. **Question: At what point must an Early Stage SBIC need to have met the 50% investment into Early Stage? Can a fund make later stage investments?**

    - **Answer:** When a fund's investments (in dollars) are at least equal to the Early Stage SBIC's Private Regulatory Capital, SBA will review the portfolio to see whether the Early Stage SBIC meets the test of 50%. This does not prohibit an Early Stage SBIC from making later stage investments. As a reminder, all follow-ons into a portfolio company defined as "early stage" (not operating cash flow positive in any prior fiscal year) at the initial financing will be considered an early stage investment.

4. **Question: Are the SBA valuation guidelines for investments likely to be the same as in the current participating securities program and how will that effect the number of SBICs that may encounter Capital Impairment Percentages (CIPs) >50%?**

    - **Answer:** The valuation guidelines will be the same. However, SBA made two key changes in its final rule:

    - **Change 1 – Allowances for Leverage Ratios Below .5:** If an Early Stage SBIC takes down less than half a tier of leverage (leverage less than or equal to .5 x leverageable capital), SBA will not take priority in distributions until the SBIC is over their maximum allowable CIP. It should be noted that with only half a tier of leverage, the SBIC would need to have extensive losses before it reaches its maximum allowable CIP (typically 70%). This change encourages Early Stage SBICs to manage their risk by taking down less leverage.

    - **Change 2 – Extension of Class 2 Appreciation Expiration**: The CIP definition only allows certain classes of appreciation to offset realized losses. In particular, Class 2 appreciation arises when an SBIC holds an investment in a company that subsequently receives a new round of financing at a higher price, provided the new round includes a substantial investment by a sophisticated, new, non-strategic investor in an arm's length transaction. SBA regulations allow Class 2 appreciation (discounted by 50 percent) to offset realized losses in the CIP computation, but in most cases only for 24 months after the new round of financing takes place. Historically, this has been the primary reason that an otherwise financially sound SBIC has been impaired.

Therefore, SBA's final regulations provide that at the end of the initial 24 months, an Early Stage SBIC with "expiring" Class 2 appreciation will be able to request an extension based on an independent third-party valuation of the investment or other information acceptable to SBA. In certain instances, based on the valuation of the investment, SBA will permit the Early Stage SBIC to use the Class 2 appreciation in its CIP computation without the 50 percent discount. Full details of these changes are discussed in the section-by-section analysis under new § 107.1845.

D. General FAQs

1. **Question: Why would a fund manager pick the Early Stage SBIC program over the standard SBIC program?**

    - **Answer**: As part of its licensing process, SBA looks closely at the fund's strategy and its compatibility to the Debenture leverage. As a result, SBA typically doesn't license applicants to issue leverage if they intend to perform a large percentage of early stage investments. This is because the Debenture leverage requires semi-annual interest payments, which is typically incompatible with early stage investing. In addition, the risk profile associated with Early Stage tends to make it inappropriate to the standard SBIC Debenture program. SBA's final rule provides for several measures to make it more compatible with early stage investing.

    - Applicants that are not interested in leverage may find several benefits to the SBIC program as a non-leveraged SBIC, including the following:

        - Only annual financial reporting (Form 468) is required versus quarterly for leveraged SBICs.

        - Fewer examinations; typically once every 2 years versus every year for leveraged SBICs.

        - Lower private capital requirements; $5 million in private capital versus the proposed $20 million for Early Stage SBICs.

        - No distribution restrictions.

        - Non-leveraged SBICs have the same regulatory benefits as any SBIC, including:

            - **SEC Registration Exemption Benefits:** *SBICs are exempt from SEC registration requirements. Yet, LPs benefit from the careful monitoring done by the SBA, greatly reducing the risk for fraud and abuse.*

- **Volcker Rule Exemption Benefits:** *Bank investments into SBICs are exempt from the 3% cap set forth by the Volcker Rule enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL-111-203)"*

- **Community Reinvestment Act:** *Investments in Small Business Investment Companies are presumed qualified for Community Reinvestment Act credits.*