Hearing on Improving Capital Access Programs within the SBA
U.S. House Small Business Committee
Subcommittee on Economic Growth, Tax & Capital Access
May 19, 2015

Testimony by Brett Palmer, President, Small Business Investor Alliance
On behalf of the Small Business Investor Alliance
www.SBIA.org

Good morning Chairman Rice, Ranking Member Chu, and Members of the House Small Business Subcommittee on Economic Growth, Tax & Capital Access.

Thank you for holding this hearing today to examine the effectiveness of the Small Business Administration's capital access programs, including the Small Business Investment Company (SBIC) program. The Small Business Investor Alliance (SBIA) represents investors in domestic small businesses, including nearly all active SBICs. The SBIC program is an effective and important program for enhancing access to capital for domestic small businesses. On behalf of our Members, I appreciate this opportunity to appear today to provide our views and recommendations to the Subcommittee.

My testimony will cover three areas:

- The SBIC program is a market-driven effort that serves an important public purpose of facilitating investment in domestic small businesses while operating at a zero subsidy.
- Legislation to increase the Family of Funds limit is the most important issue and should be passed immediately.
- Improvements can be made to ensure the SBIC program is operating more efficiently.

SBICs Provide a Critical Source of Capital for Small Businesses

The SBIC program was created by the Small Business Investment Act of 1958 to "improve and stimulate the national economy…by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply."[1]

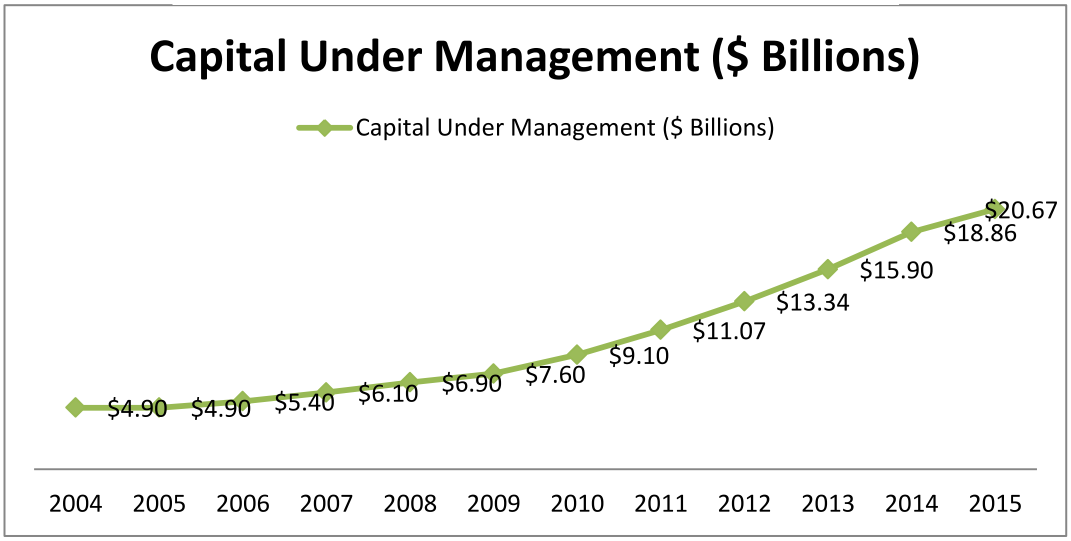
What was true in 1958, when the SBIC program was created, is still true today. It is much harder for small businesses to access capital than it is for larger businesses. This is particularly true for accessing patient capital – capital that is not called back at a moment's notice – that is available for helping businesses survive and thrive in the face of the unexpected bumps in the road.

The importance of SBIC capital was abundantly clear in the financial crisis and the recession that followed. While most financial institutions were cutting off capital to small businesses and recalling loans, SBICs were throttling up and filling the capital void. Demand for capital from SBICs has grown dramatically since the financial crisis and continues to grow. This growth is not driven by government directive, but by the market needs of small businesses and the opportunities being recognized by private investors. It is important to note that the SBIC program has facilitated record amounts of private capital into SBICs and, in turn, into the small business economy. From Fiscal Years 2011-Present, SBICs have made $17 billion in investments in over 5,400 small businesses in almost every state. In 2004, the SBIC debenture program had $4.9 billion

[1] Public Law 85-699, as amended

in assets under management, growing to currently over $20.67 billion. With the continued support of Congress, the Administration, and the private sector, this program will help grow more small businesses than ever before.

SBIC Debenture Program: Total Capital by Fiscal Year



Since the creation of the SBIC program, SBICs have invested more than $73.3 billion in over 118,000 domestic small businesses. In Fiscal Year 2014, SBICs invested $5.46 billion in businesses that employ approximately 113,000 workers across the U.S. SBIC backing is important because private equity funds, and SBICs especially, are important to job creation. According to a 2012 Pepperdine University study, private equity-backed establishments generated 129 percent more revenue growth and 257 percent more employment growth than their non-private equity counterparts. According to the National Center for the Middle Market, employment prospects for smaller businesses entering 2015 continue to be robust with job creation projections greater than four percent.

The SBIC Program is a Market-Driven Program That Increases Small Business Investment

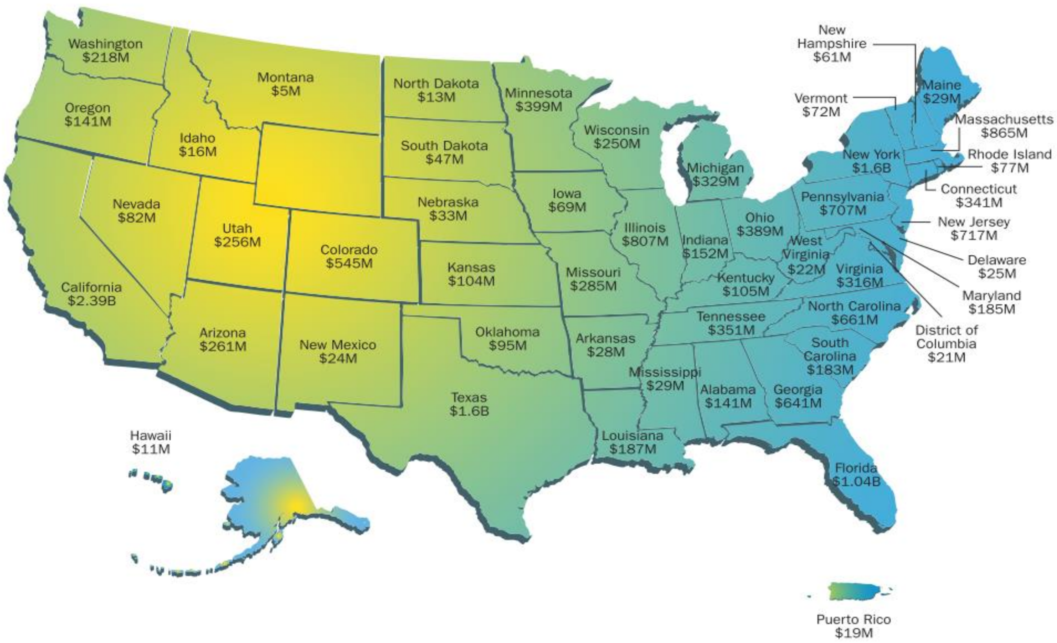
The SBIC program is effectively a market-driven money multiplier for the small business economy – increasing the amount of capital available for small business investment. The SBIC program helps fill the gap created by all the scale and reputational biases against smaller businesses. What makes this program so effective and so distinct is that the private sector leads and the SBA leverage follows to enhance the impact of the private investment.

The way the program works is private capital is raised by proven small business investors first. If investors cannot pass this market filter, they are unable to obtain an SBIC license. Once investors have successfully raised private capital, the next step is an extensive background and performance check before qualifying for an SBIC license. While the exact number varies from year to year; in general, only about 25% of the fund managers initially seeking an SBIC license are able to qualify for one. Proven investors that succeed in obtaining a SBIC license are able to enhance the amount of capital available for small business investing by up to two times the amount of private capital raised with SBA-backed leverage. For example, if a group of small business investors raises $50 million (from pension funds or other accredited and institutional investors) and receives an SBIC license, it can then access a credit facility that unlocks an additional $100 million for small business investment. The SBIC program effectively triples the amount of investment capital available – 100% of which will go to domestic small businesses

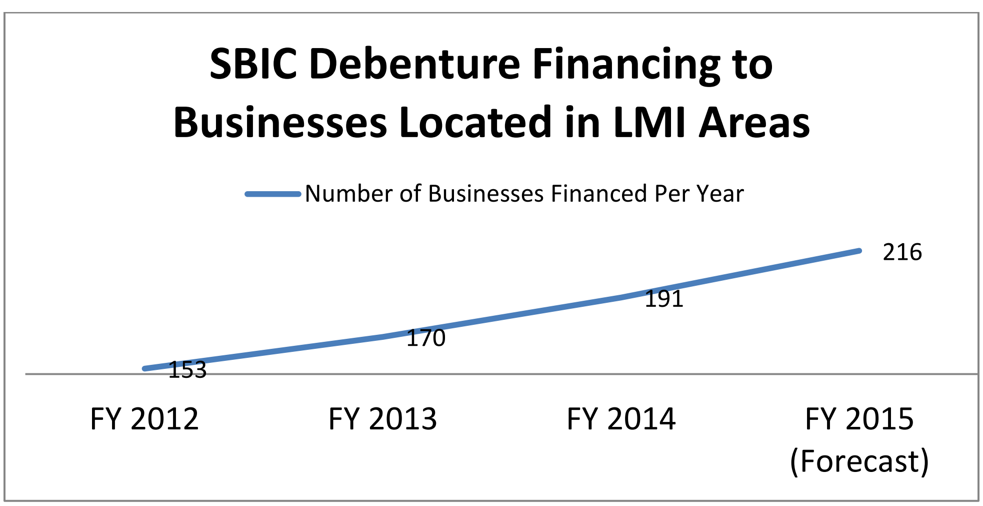
Some of the SBIC-backed small businesses have since grown into icons of American free enterprise including Apple, Intel, Callaway Golf, and many others. There are also thousands of other fantastic SBIC-backed businesses that are lesser known, but are mainstays of local economies – some of which will grow to be the industry leaders for the next generation. There are currently 195 debenture SBICs nationwide, many in places where traditional private equity funds do not have a significant presence, such as Arkansas, Ohio, Louisiana, and Tennessee. Most private equity investments (51 percent) are concentrated in 15 U.S. counties. While over 75 percent of SBIC investments fall outside those top 15 U.S. counties according to the Fiscal Year 2013 SBIC Annual Report.[2]

[2] Small Business Investment Company Program, Annual Report for Fiscal Year Ending September 30, 2013 at 17. *Available at:* https://www.sba.gov/sites/default/files/files/Final_SBIC_Annual_Report_FY_2013_signed_06092014.pdf

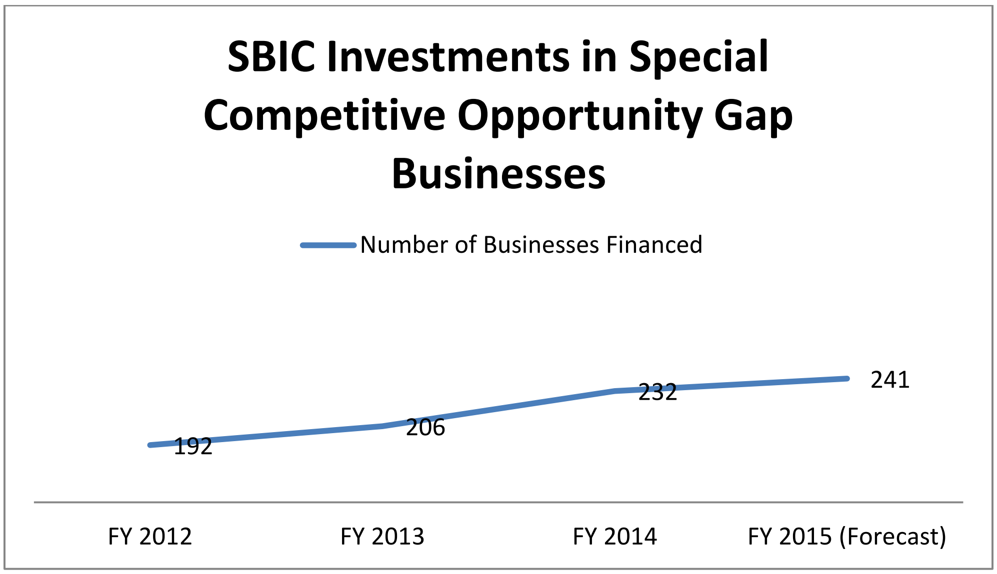
Total Small Business Investment Companies
Investments by State (FY 2010-2014)



SBICs invest in small businesses in geographically diverse regions of the country that often do not have access to private equity capital. SBICs are proud to invest in businesses located in many low-to-moderate income (LMI) areas. In fact, SBIC investments in businesses located in LMI areas have grown over the past three years and are on track to grow again in Fiscal Year 2015.



In Fiscal Year 2014, approximately 25 percent of the businesses invested in by SBIC were reported as businesses in what SBA calls "special competitive opportunity gaps." Special Competitive Opportunity Gaps refer to businesses owned by "groups that own and control little productive capital because they have limited opportunities for small business ownership."[3] These groups are identified as minorities, women, and veterans, or those conducting business in rural or distressed urban areas. Businesses whose owners identify with these special categories are deemed to face special competitive opportunity gaps. The number of special competitive opportunity gap businesses being financed by SBICs has been rising steadily in the past three years and is forecasted to grow again in Fiscal Year 2015.



SBIC "Family of Funds" Legislation (H.R. 1023)

SBIA urges the Committee to pass H.R. 1023, the Small Business Investment Company Capital Act, bipartisan legislation introduced by House Small Business Committee Chairman Steve Chabot (R-OH) and Representative David Cicilline (D-RI). Passing this bill would increase the amount of capital available for small businesses and not increase federal spending or the zero subsidy rate according to the Congressional Budget Office (CBO).[4] More capital for small businesses without additional federal spending is good policy.

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[3] Small Business Administration, 2004. "Fiscal Year 2005 Congressional Performance Request."
[4] http://www.cbo.gov/sites/default/files/s511.pdf

We appreciate the support of the eight bipartisan cosponsors, many of which are on this Committee, including Small Business Committee Vice Chairman Blaine Luetkemeyer (R-MO), and Reps. Mike Bost (R-IL), Judy Chu (D-CA), Richard Hanna (R-NY), Carlos Curbelo, and Steve Knight (R-CA), and also Reps. Renee Ellmers (R-NC) and Chris Collins (R-NY). Bipartisan companion legislation (S. 552) was introduced in the Senate on February 24, 2015, by Senators Jim Risch (R-ID) and Ben Cardin (D-MD), with Senators Kelly Ayotte (R-NH) and Jeanne Shaheen (D-NH) co-sponsoring that bill.

SBICs that hold multiple licenses under the same management umbrella – otherwise known as "Family of Funds" – are currently restricted from accessing SBIC leverage above a statutory cap of $225 million. This statutory cap is currently restricting proven small business investors from accessing new SBIC leverage. Approximately 30% of debenture "Family of Funds" in the SBIC Program are hitting the cap or risk hitting the cap if they raise their next fund. I am regularly asked by SBIC fund managers if this limit will be raised because they are long-term investors and planners who need to plan now for their future small business funds. If Congress increases this cap, SBIA estimates that SBICs will facilitate up to $750 million a year in new small business investing.

In 2009, Congress made a similar modification to the SBIC program, resulting in a substantial amount of capital becoming available to small businesses. The increase in the Family of Funds limit in 2009 allowed proven fund managers to continue managing SBICs. Since that change went into effect, SBICs have made $17 billion in investments in 5,917 small businesses (from Fiscal Years 2010-2014). The influx of this capital saved tens of thousands of jobs and created many more new jobs.

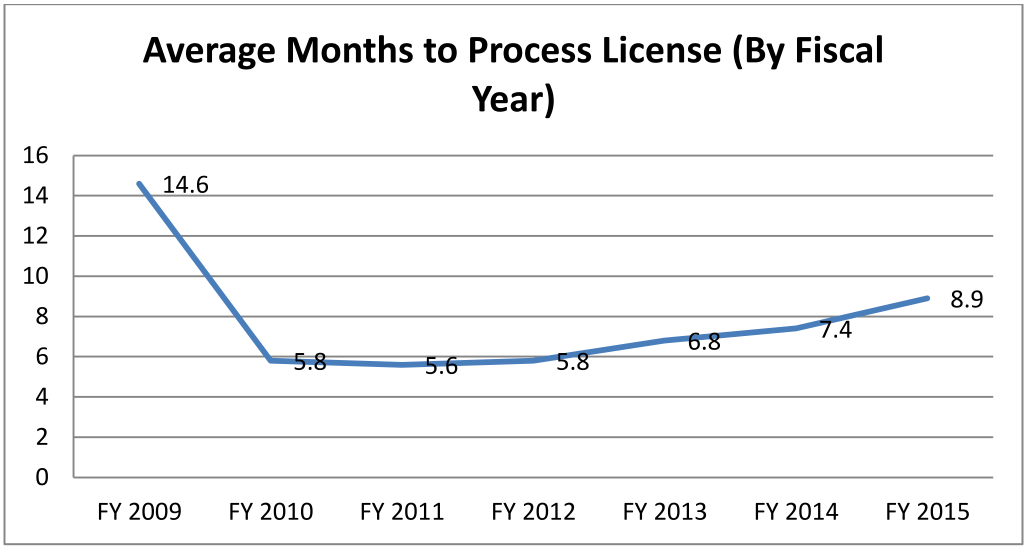
It should be emphasized that increasing the Family of Funds limit actually reduces the risk in the SBIC program. The only fund managers affected by this limit are those who have been successful at small business investing across multiple SBIC funds. The people accessing the expanded leverage are proven small business investing professionals. Again and again, they have passed the private market filters needed to raise a fund and have succeeded in a highly regulated environment. These are the fund managers that policymakers should want to keep in the program.

Challenges and Opportunities for Improvement

Every organization, both private and public, has room for continuous improvement and SBA's Office of Investment is no different. There have been many improvements made to the SBIC program and our comments here should not detract from the many areas where SBA has improved or is in the process of improving.

Licensing

The licensing process is the foundation of the SBA efforts to protect the taxpayer, but it is also at the core of access to capital. If the licensing process is too slow, too onerous, too expensive, or too unpredictable, then investors will leave the program resulting in less capital flowing to small businesses. The current trend in licensing is heading in the wrong direction, but it can be remedied without lowering standards or taxpayer protections.



The licensing process was a mess in the mid-to-late 2000s, plagued with delays and ambiguities. Standards were high, but the process was so broken and erratic that private investors were giving up on the SBA's ability to function and were walking away from the program. This graph above illustrates the major improvements made since that low point, but also shows a recent worrisome trend upwards in the number of months to process a license. The current number for FY 2015 is artificially low because it includes several non-levered funds and impact investment funds that have been fast-tracked for licensure. Debenture licenses, even for repeat SBICs, are averaging well north of the reported 8.9 months.

SBA should streamline the licensing process for successful repeat SBIC funds. If an SBIC team has passed the private market test of raising new capital for an additional SBIC, is pursuing a similar investment strategy, and has earned clean regulatory audits, then there is no reason why they should not be able to get a new license in a matter of weeks, not a year. The only new requirements should need are, proof of private capital raised, a new FBI background check, and an approval of the new legal documents. Repeat licenses have are known entities and have proven themselves.

Streamlining the licensing process would do several critically important things. It would let SBA move its limited resources to vetting thoroughly new funds before they enter the program. It would allow proven SBICs to plan for their next small business investment fund. Finally, with more resources dedicated to reviewing new fund managers, the SBA would have the time to better understand fund managers from different backgrounds than they currently can consider. In the 111th Congress, Congressman Kurt Schrader (D-OR), sponsored the Small Business Investment Company Modernization Act of 2009 (H.R.

3854, Section 402) that would have made these reforms. The House passed this measure with an overwhelming bipartisan vote. This language would provide a very good starting point for reforms.

Second, the SBA should establish clear benchmarks and reporting processes at each stage of the licensing process. SBA should provide certainty in the “green light” letter by explicitly stating the requirements and expectations for earning a license, including amount of private capital the fund must raise. Consolidating the multiple licensing phases and redundant processes would also be a meaningful improvement. Increased clarity of expectations combined with a less redundant process would not reduce any taxpayer protections, but would help immensely.

Modernize SBA Technology

For a myriad of reasons, SBA’s technology is a hindrance both to SBA staff and to the SBICs that are interfacing with SBA. The SBA’s technological resources are terrible to the point of stifling the ability of staff to serve the public effectively. There are two significant technology improvements that would help remove inefficiencies.

First, SBA should stop requiring any paper documents. They should accept electronic documents and electronic signatures, as is currently required under existing law. Currently, paper documents are commonly required as the IT systems are so antiquated that they cannot store electronic documents and often cannot even receive them via email. Our association with a handful of staff has more secure, cloud-based storage than the SBA and I would wager that we are paying a whole lot less for it. As a result applications or other important documents being “delayed” in SBA’s “mail room” for days or weeks, before being received by the receiving party. It also frustrates and minimizes the effectiveness of the SBA staff tasked with running the program, getting capital to small businesses, and protecting the taxpayer. Eliminating the physical filing requirements and providing basic IT infrastructure would eliminate these unnecessary delays and increase the effectiveness of SBA.

Second, SBA should consider allowing the use of “virtual data rooms” for the licensing and operations processes. Investing professionals, legal professionals, and many others commonly use a “virtual data room” to share and protect critical documents. SBA should adopt this approach as a cost-effective and efficient way to provide access to documents by SBA staff and applicants. SBA has proven its inability to provide basic IT infrastructure. Rather than create a unique SBA system, it should use off the shelf technologies that are readily available.

Updating the technology tools through accepting electronic documents, providing basic IT infrastructure, and utilizing virtual data rooms will result in significantly less physical paper at the SBA, faster turnaround times in the program for SBICs, more effective SBA staff and an updated program for the 21st century. The SBIC program is a success and with your continued support it will continue to help small businesses grow.

Thank you for your consideration of our views. I would welcome any questions you might have.