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America's Private Investment Companies: HOW APIC WILL WORK

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America's Private Investment Companies (APICs) will provide capital to large-scale businesses in low and moderate income areas, both urban and rural.[1] Just as America's support for the Overseas Private Investment Corporation (OPIC) helps promote growth in emerging markets abroad, the APIC program will encourage a dramatic increase in private investment in this country's untapped markets. It will be jointly administered by the **U.S. Department of Housing and Urban Development (HUD)** and the **U.S. Small Business Administration (SBA)** to combine HUD's expertise in large-scale revitalization with SBA's venture expertise and financing tools. APIC is part of the **New Markets Initiative** announced by The White House in January of this year.

The APIC program is designed to address the capital needs of a broad array of firms and industry sectors, including commercial real estate. For example, an individual APIC could help finance:

- Establishment of a new facility, such as a call center, data processing "back office," or factory, by a large company (or small company joint venturing with a large one).
- Expansion of an existing facility (or "campus"), the upgrading of equipment , or the expansion of staff by a mid-size manufacturing company seeking to increase production.
- Expansion of the service area of a mid-size service company, such as a trucking company, building contractor, or home health care firm.
- Development of a multi-tenant shopping center, or opening or expanding a large retail company in a new geographic area.
- Buyout of a company to be revitalized in its existing facility.
- Acquisition of the property of a departing large company and development of an incubator or industrial park.
- And more.

A requested budget authority of $36 million in credit subsidy for Fiscal Year 2000 will guarantee an estimated $1 billion in debt. Combined with $500 million in private equity, the program would have a total impact of $1.5 billion per year or $7.5 billion over the next five years. Designed to fit hand-in-glove with the proposed **New Markets Tax Credit**, an APIC selected to receive an allocation of tax credits could offer investors a tax credit on their equity (up to 6% per year over 5 years for a net present value of up to 25%).

[1]Eligible areas include those census tracts in which 20% or more of the population was in poverty or in which the median family income for the tract was less than 80 percent of the area median family income. For rural (nonmetropolitan) communities, "area" refers to the statewide median.

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The Steps: How the Program will Work

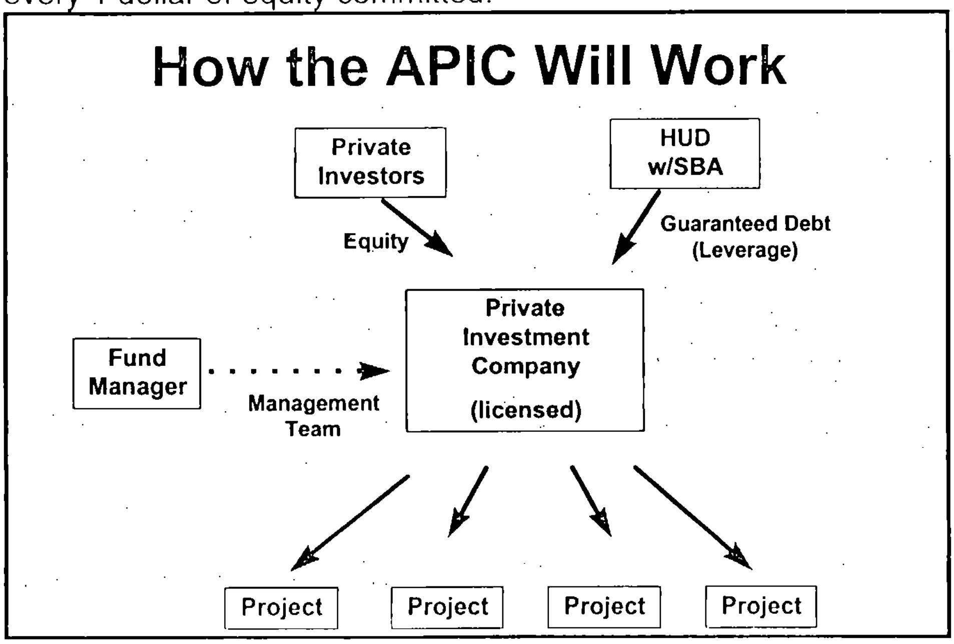
The APIC program is not a direct loan or grant program from government to the businesses. Instead, modeled after the successful SBA Small Business Investment Companies (SBICs) and OPIC Investment Funds programs, APIC will create a new generation of large-scale private investment companies that find and invest in promising untapped market opportunities in distressed areas. Low and moderate income areas of urban and rural America are especially starved for equity capital—the first money into a deal and the first at risk. APIC is designed to address that equity gap, in particular, although the investment companies will be able to invest both equity, debt and, if they choose, securities that combine the features of debt and equity.

Here's how APIC will work, step-by-step...

Step 1

The fund manager lines up potential investors willing to invest in an APIC.

Fund managers seeking to license and operate investment companies under the APIC program will begin by obtaining commitments of private equity capital. The program offers government-guaranteed leverage on that equity at a ratio of 2 dollars of debt for every 1 dollar of equity committed.



Who will these investors be? What's in it for them? APIC is designed to appeal to a wide array of investors—individuals as well as institutions. Investors could include:

- Corporations

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- Banks (such investments could receive favorable consideration under the Community Reinvestment Act)
- Insurance companies
- Pension funds
- States and local governments, plus other public and quasi-public economic development entities
- Individual investors, including "social investors"
- Foundations (as program-related investments)
- Other nonprofits

Benefits to the Investor, Protection for the Tax Payer. The program offers debt at favorable, government-guaranteed rates, which improves the return on investor equity. In addition, for individuals and for tax-paying institutions, an allocation of the New Markets Tax Credit could further boost return. The private equity investment, in turn, act as a "shield" for the tax payer dollar—every dollar of equity capital must be lost before any of the government-guaranteed debt is lost. This structure has created a tremendous financial discipline in the successful SBA and OPIC programs after which APIC is modeled—and leveraged significant job creation at very low cost to the tax payer.

How big will the funds and the deals they finance be? With a minimum equity capitalization of $25 million and an expected maximum of $150 million, APICs will create large-scale investment companies with combined capital (private equity plus government-guaranteed debt) of $75 - $450 million. It is expected that each APIC would carry about 9-12 large-scale deals (of about $5 - $50 million apiece) in its portfolio, diversifying and spreading risk across those projects. Finally, the investors' return is the blended return across these deals.

Together, the new and existing tools in the Administration's **New Markets Initiative** address the wide range of financing needs, from start-up through mature companies, and all are eligible for the New Markets Tax Credit:

Program	Agency	Business Target	Features
New Market Venture Companies	SBA (proposed)	Start-ups and existing businesses	Technical assistance, guaranteed debt
Small Business Investment Companies/LMI Investments	SBA (launched)	Small businesses up to $18M in net worth	Guaranteed debt and participating securities
America's Private Investment Companies	HUD/SBA (proposed)	Large, mature companies	Guaranteed debt
New Markets Tax Credit	Treasury (proposed)	*All of the above*	Tax credit on equity invested

Many prospective APICs will probably begin to identify deals before they have applied for a license—as part of developing an investment strategy and information network.

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Step 2

The Secretary of HUD invites applications for APIC licenses.

HUD will issue a "call for proposals" announcing selection criteria that will guide the licensing of each APIC. The key criteria will be:

- Quality of the management team (track record in direct equity investment and portfolio management, including expertise in community development settings).
- Quality of an investment strategy—a kind of "business plan" that describes how the APIC will focus its activity.
- A plan to achieve its public purpose goals that address such performance targets as high-wage jobs and community development impacts.

The first two criteria —financial expertise together with a strong plan – are the key factors driving licensing of SBICs by SBA and of OPIC's Investment Funds. The third criterion reflects the public policy aims of the APIC program: to create jobs and promote the development of low and moderate income areas.

Step 3

HUD and SBA jointly review proposals, and HUD selects those APICs that best respond to the call for proposals. The chosen investment companies receive a license, an allocation of credit subsidy commitments and, if further designated, an allocation of New Markets Tax Credits.

Each selected APIC will receive a license to operate under the terms of the program and receive: (a) an allocation of credit subsidy commitment (enough to guarantee debt up to twice the amount of the APIC's equity capital); and (b) APICs selected to also receive an allocation of New Market Tax Credits could offer investors tax credits on their equity investments.

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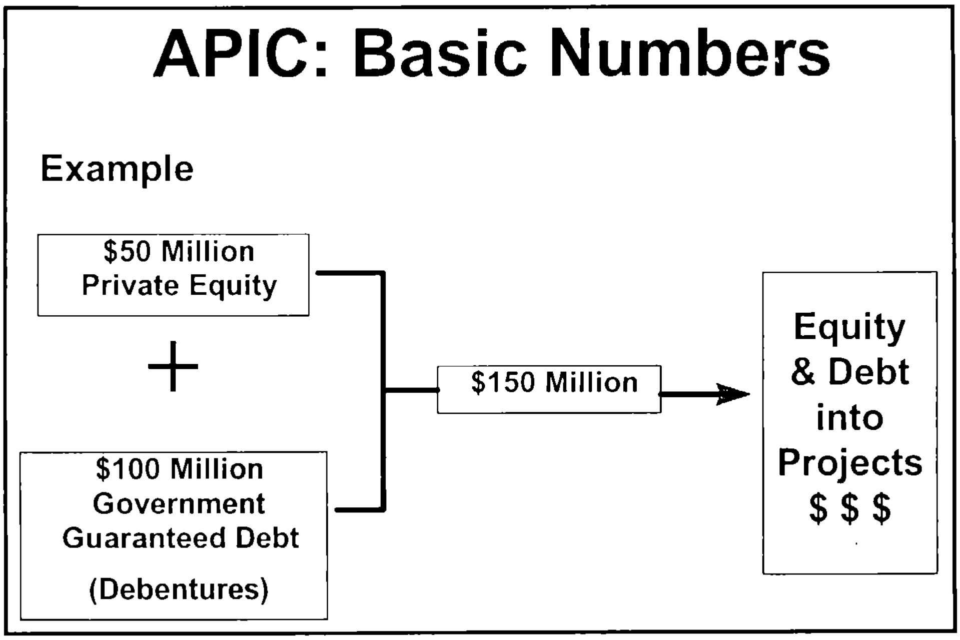

Step 4

The APICs find qualified investment opportunities (deals) in low and moderate income areas.

What will these deals look like? Just as APIC is designed to appeal to a wide array of investors, it is also designed to address the capital needs of a broad array of firms and industry sectors, including commercial real estate. The diversity of the potential financing deals highlighted on the first page show the range of ways that an APIC can promote growth in emerging markets.

Will state or local governments or other public entities play a role? Public and quasi-public entities with economic development objectives can play a number of important roles in the APIC program. As we've begun to outline above, they can assist by:

- Finding interested fund managers and encouraging them to develop an APIC proposal that addresses the needs of a particular region or sector.
- Investing as an equity partner in an APIC.
- Helping licensed APICs identify promising investments—acting as part of the APIC's information network. In this way, APICs will provide state and local governments and other stakeholders with a market-savvy vehicle to vet a wide variety of large-scale business development proposals.

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On the other hand:

- The program will not encourage states and localities to "pirate" large employers from one jurisdiction to another. The APIC legislation has been drafted to include an anti-pirating provision to ensure that the investment companies are helping to grow the economy and help businesses expand, not make unprofitable investments simply to move a firm from one place to another.

Step 5

The APIC prepares to issue debentures (debt) in order to raise funds to invest in a deal.

When an APIC has found a deal or deals that it wishes to invest in, the APIC will submit to HUD four basic certifications that the investment or investments meet program guidelines:

1. The project is in an LMI area.
2. The project meets the terms of the New Markets Tax Credit (is in a real operating business that employs people, for example).
3. For any debenture issue that includes an APIC's first funding of a project (but not for subsequent funding of the project), that the project meet the requirements for review under the National Environmental Policy Act (or is one of the broad array of "exempted" or "excluded" investment types not likely to have a significant impact on the human environment).
4. Beyond the features of the individual investment, the APIC itself must be in compliance with the terms of its license.

Like OPIC and SBA for their analogous programs, HUD will not conduct a project-by-project review of the APIC's proposed investment—HUD will not look at financial projections, for example, since the equity investors themselves will be focused on the potential financial risk and reward. The certifications, and HUD's expedited review of the same, are merely to ensure that the government guarantee on debt, which will enable large-scale investments that may have significant economic and human impacts, is indeed being extended to activities in keeping with the aims of the program.

Where the "leverage dollars" come from. Following HUD's review for sufficiency of the APIC's program certifications, the APIC would issue debentures, that the U.S. government would guarantee, to a financial intermediary (e.g., the Federal Home Loan Bank of Chicago plays this role in SBA's SBIC program). Upon buying the debentures, the intermediary would transfer the proceeds, less fees, to the APIC. Periodically, the intermediary would pool the debentures, and issue a trust certificate backed by the pool. The certificate would also be guaranteed and it would then be sold to investors on Wall Street. If less expensive than this market financing, the Federal Financing Bank in the U.S. Treasury is authorized to perform these debenture financing roles.

Step 6

The APIC provides capital to the business, contributing to job creation and community development, and begins to repay the debentures.

The APIC is now in full operation with fund invested in active businesses. HUD expects to set terms of the debt financing (debentures) that respond to the cash flow realities of many promising investments in low and moderate income areas—especially the most distressed rural and inner-city communities. Favorable terms might include "zero coupon" or other features that defer interest payments early in the life of the investment to give it a chance to grow, or participating securities that include repayment features based on the APIC's overall profitability.

"Rolling over" investment proceeds. What if an APIC wishes to sell its interests in a given deal and "roll over" the proceeds into new qualified investments in targeted areas, instead of repaying the debenture right away? An APIC with significant "deal flow" (strong investment prospects outstanding) could re-invest in a new deal by following these steps. The APIC would first purchase Treasury securities with the proceeds of the sale of its investment. It would then submit to HUD the same certifications that apply to a new debenture issue, according to Step 5 above. Upon review for sufficiency and approval by HUD, the APIC would then sell the securities and apply the proceeds to the new investment. This manner of roll over of proceeds avoids the need to issue new debentures. It would also allow the APIC to maintain a larger, more risk-diversified portfolio than it would have if, when it sold off an investment, it had to repay debenture(s) outstanding.

Step 7

The APIC will regularly collect data on its investments and report progress.

Like any well-run private investment company, the APIC will collect data on the performance of the businesses in which it has invested. Periodically, each APIC will be reviewed by HUD for sound financial management practices, for financial solvency and exposure, and for performance against the APIC's self-defined public purpose goals—the goals defined at the time of the APIC's successful application for a program license.

Breaches of sound financial management, as well as fraud or mismanagement or violations of license terms, may lead to penalties. On the other hand, high performance consistent with APIC's public purpose goals may be rewarded, for example with the opportunity for greater leverage of the APIC's equity – perhaps 3 dollars of debt for every 1 dollar of equity committed.

Step 8

The APIC "winds up"—selling its investments, paying off debentures, and returning profits to its investors.

The "life cycle" of an APIC will vary. If the SBICs are any indication, some APICs will make investments, watch them mature, and sell them off—perhaps long before the maximum debenture period of 21 years. Others will sell off their interests in particular businesses earlier still and then "recycle" the proceeds into new businesses that meet the program's targeting criteria. Ultimately, however, the APIC will sell off all interests, fulfill any remaining debt obligations, and return profits to its investors.