BusinessLINC: Learning, Information, Networking, and Collaboration

Business-to-Business Relationships that Increase the Economic Competitiveness of Firms

A Report to Vice President Al Gore (December 1998)

Report prepared by:
US Department of the Treasury and US Small Business Administration

Case studies prepared by:
Initiative for a Competitive Inner City (ICIC)

1. Chase Manhattan Bank's Business Resource Center
2. Turner Construction's James Walker Construction Management Training Program
3. GM Minority Mentoring Program
4. McDonald's Corporation's Franchise Support Program
5. NCR Corporation's Business Advisory Programs

4. McDonald's Corporation's Franchisee Support Program

McDonald's relationship with its independent franchisees exemplifies a version of business advisory programs that is quite different in scope from many of the mentor-protege programs discussed in this report. Far from an auxiliary function, the support that McDonald's provides for its franchisees is one of its core functions.

Close to 85 percent of McDonald's 12,000 U.S. restaurants are owned and operated by individual entrepreneurs who have invested their own capital. These are independent small businessmen and women who run restaurants with average sales of $1.5 million in their local communities. On average, the typical McDonald's franchisee owns 3.5 restaurants.

In the early days of its expansion into economically distressed markets, McDonald's made an extensive effort to offer special services to inner-city operators. For example, McDonald's offered special training in the late 1960's to African-American operators in isolated inner-city neighborhoods in Chicago. This outreach began with consulting services focused on the unique challenges associated with doing business in urban environments. An Urban Operations Department was formed, and has since been incorporated into McDonald's comprehensive business development strategy.

McDonald's corporate commitment to expand into economically distressed neighborhoods demonstrates the company's core belief that market principals can be applied in these areas. The company's standard procedures in the recruiting and training of franchisees, as well as its standard support structure for franchisees, have been sufficient to develop and maintain stores in the inner city.

FRANCHISEE DEVELOPMENT PROGRAM

Recruiting

McDonald's actively seeks racial, ethnic, and gender diversity among its franchises. In the United States, women and minorities represent about 35 percent of all McDonald's franchisees, while minorities make up 65 percent of the company's candidates in training to own future franchises. McDonald's also encourages residents of the inner city and other traditionally under-served areas to work toward franchise ownership.

McDonald's has an active and continuous outreach program to attract a diverse range of individuals with the potential to own and operate a McDonald's franchise. As McDonald's CEO Jack Greenberg says, "It's not just the right thing to do from a moral and ethical point of view, it's also the right thing to do from a business standpoint." Some of the qualifications McDonald's looks for in prospective franchisees include:

- Entrepreneurial spirit and a strong desire to succeed;

- A strong business background with special emphasis on interpersonal skills and financial management;
- Willingness to devote full-time and best effort as an "on-premise" owner/operator;
- Willingness to participate in a training program that may take 12-24 months to complete. The course time can be accelerated if a candidate masters the skills more quickly.

Training

Over the years, McDonald's has developed and refined an extensive training and support program for its franchisees. The training program is one of the most rigorous in the business, including part-time hands-on training in a McDonald's restaurant interspersed with classroom training, culminating in the Advanced Operations Course at Hamburger University (HU). This course focuses on management skills such as accounting, finance, human resource management, and marketing.

McDonald's Franchisee Development Program

1. Restaurant Orientation

Learning different operations, managing food production and directing employees.

2. Basic Operations Course

A five-day class covering communications, training, food safety, product quality, customer satisfaction and other areas of restaurant operations.

3. Hands-on Restaurant Training

Includes managing crew shifts.

4. Basic Management Course

The four-day class includes tests in handling customer issues, employee hiring, equipment knowledge, time planning and basic management practices.

5. Intermediate Operations Course

A four-day course covering such areas as improved restaurant performance, managing costs and crew labor and training.

6. Restaurant Training

Addressing advanced supervision, planning, quality, service and cleanliness, people skills and financial management.

7. Advanced Operations Course

A six-day course at Hamburger University focusing on effective people practices, staffing and retention, management skills and building market share.

As part of the training program, applicants must master all of the crew and management functions at the restaurant. The training in restaurants is free-of-charge, and participants work without compensation. This training is the same for all applicants, and applies equally to urban, suburban, and rural restaurant settings.

McDonald's makes a number of other training courses available to its franchisees. Additionally, since HU is accredited by the American Council of Education, franchisees may earn up to 32 college credit hours. Franchisees who successfully complete the training are approved to acquire a McDonald's restaurant.

Ongoing Development and Support

Candidates who successfully complete the training program and become independent franchisees continue to benefit from support through the McDonald's network. McDonald's assigns a business consultant to each franchisee, who assists them in developing annual business plans and consults on the application of appropriate strategies to achieve their individual goals. Business consultants evaluate franchises on an ongoing basis, and assign their restaurants a letter grade based on their overall performance and progress during the entire year. Franchisees also have access to the expertise of a cadre of regional, divisional, and corporate staff members in marketing, operations, and finance.

Many franchisees receive personal business-to-business assistance by working with a fellow franchisee who has the needed experience and expertise. Because of the mutually dependent relationship between McDonald's and its franchisees, continuous two-way communications is a top priority. The company strongly supports the creation of franchisee advisory groups, whose individual leaders and members are elected by the franchisees. As a result, franchisees have established the National Black McDonald's Operators Association, the Women's Operators network, the Asian Operators Association, and the McDonald's Hispanic Operators Association. These independent, grass roots organizations voice the needs, concerns and ideas from the franchisee community directly to McDonald's company officials.

New franchisees can also draw support from other franchise owner-operators. McDonald's often facilitates this business-to-business assistance by pairing a franchisee in need of assistance with a fellow owner-operator who has achieved success in that geographic area.

While McDonald's makes an effort to attract restaurant owners who possess both the desire and the resources to succeed, an applicant for a conventional franchise should have a minimum of $125,000 in non-borrowed personal assets. However, candidates with a minimum of $75,000 in such assets may become eligible through the company's Business Facilities Lease (BFL) program. Through the company's Business Facilities Lease program, they enter an agreement with McDonald's whereby they lease the seating, interior restaurant decor, kitchen equipment, and outdoor signs that franchisees ordinarily buy outright. McDonald's typically grants them an option to buy these items at a later date.

McDONALD'S AND WILLIAM EDWARDS, AN OWNER-OPERATOR

On November 17, 1992, William Edwards became an owner of a McDonald's in the Northeast section Washington, DC, which at the time was a highly distressed neighborhood. Throughout the 1980s, he owned and operated a national chain service station in Miami's Liberty City.

Edwards decided that becoming a McDonald's franchisee would give him the economic stability he was looking for. When he took the first step to contact the company's franchising manager in Boca Raton, Florida, he had already decided on McDonald's. Competition to become a franchisee was very intense, Edwards was warned. McDonald's is one of the most sought after franchise companies, with more than 10,000 inquiries every year.

Over three interviews, Edwards convinced McDonald's that he had the right attributes to become a franchisee. "They were looking for people who had some business knowledge. But the thing they were most interested in was to see if I was a people person. They could teach me the business part. But they wanted to make sure I could deal with people," recalls Edwards.

Most of the training took place on site in the stores. Edwards moved around quite a bit between independent operator stores and company stores as well as urban and suburban locations, exposing him to a wide variety of issues and challenges of running a McDonald's store. He says, "I had experience running a store in a distressed area, so the exposure to the suburban clientele helped me learn to deal with a completely different type of customer."

The training progressively built up Edwards' capacity to operate a store. By the time he was in the Advanced Operations Course he was running an entire store by himself. "The operator agreed to step aside for the period I was there, and I was responsible for running the whole thing. This level of trust also put a lot of pressure on me," says Edwards.

McDonald's provided Edwards with information about McDonald's restaurants for sale, and he settled on a company-owned store in Washington, DC. To buy the $500,000 store, Edwards needed to make a down payment of $125,000. "I was $50,000 short on the down payment," recalls Edwards. McDonald's offered to give him a loan to close the deal until he could liquidate a personal asset. "I stalled a bit because I wanted to come up with all the cash," says Edwards. Unable to raise this amount in a short period, Edwards accepted McDonald's financing offer. He was, however, able to liquidate his asset to repay this note within 30 days.

"The first year of running the business was difficult, but there was a lot of support from the company," recounts Edwards. "Especially the first 90 days ... the company provided some financial assistance for instance." He continues, "There were a lot of business consultants coming in and out all the time."

While McDonald's is under no obligation to provide extra assistance to its franchisees, when McDonald's deems it appropriate, the company can offer additional financial benefits. In 1992, McDonald's helped Edwards with reinvestments in his restaurant building and facilities, as well as paying for security so that he could target his resources to help staff his restaurants. McDonald's regards this kind of assistance as an investment in good owner/operators, a targeted effort to help them build sales, make themselves more profitable, and ultimately make the company more profitable, too. This reflects a McDonald's business fundamental – the company and its franchisees enjoy a mutually beneficial relationship.

The second year, however, proved to be even more trying. "I almost went bankrupt," says Edwards. With high costs and sinking revenues, selling the store was not too distant an option. "But I had a sense of responsibility toward both my family and the people working at my store. If I sell this store, the next person coming in might decide the workers were part of the problem and get rid of them," explains Edwards. "I owed it to my family and to my workers to try to find a solution and turn the business around," he says. That's when he asked Mike Hicks, one of McDonald's field service managers, to come in and offer advice.

Mike Hicks offered to bring in a field service team for four days and assured Edwards that everything from operations to physical appearance would change fundamentally. "They came in like a storm," recalls Edwards, "and started cleaning the floors, the walls, changing equipment, ... They even changed the roof." Edwards' store was an older model. The repairs and all the changes cost more than $100,000 dollars, all of which McDonald's covered.

The presence of the field service team also helped boost employee morale at the store. "Here you had pretty high-level white managers kneeling down and scrubbing the floor, cleaning bathrooms, making hamburgers ... and they were doing all of this while being extremely courteous and friendly to all the workers and the customers," says Edwards. "This just boosted McDonald's image in the neighborhood." For Edwards, it was also comforting to learn that the company had the support structure to help him through difficulties when necessary.

Aside from the field service team's help, Edwards attributes his store's turnaround to support from local and regional operators. McDonald's encourages local councils of operators and local marketing cooperatives, which provide a strong network of information and expertise for all the operators. "Despite the problems each of us may have," Edwards says, "we take care of each other." This mutual support sometimes takes the form of providing crews that have the expertise to address targeted, specific challenges, helping each other in diagnosing problems and proposing solutions, temporarily covering for an operator who is having a personal or family crisis, "and sometimes even helping out financially," says Edwards.

The change in operations and employee morale, combined with the support from field service and other owner-operators, has helped Edwards turn his business around. This past year he generated close to $2.5 million in sales from his Northeast DC store alone. On April 20th, he opened a second store, this time a new one with brand new equipment and facilities, in the

Federal Plaza Building in DC's Southwest area. "I am hoping to own one or two more stores in the next year or so," concludes Edwards.

VALUE CHAIN ANALYSIS

Figure One illustrates the impact of the franchisee support program on the value chains of McDonald's and the Edwards franchise. McDonald's sees the program as an essential part of its marketing and after-sales service functions, since the success of its franchisees has a very direct impact on its ability to sell both its products and its franchises. For the franchisee, the program offers support for most of the major business functions, including planning, human resources, operations, and marketing.

LESSONS LEARNED

- Pairing new franchisees with other franchisees for support and advice is one of the most effective ways to help them manage the challenges of new ownership. Through a voluntary network, like-minded businesspeople can create an invaluable pool of experts and advisors.

- In the case of McDonald's, two factors contribute to the success of the voluntary networks of franchisees: McDonald's strong brand name and the similarity of issues shared by its operators have helped foster strong inter-store networking.

- The standardization of products and procedures enables McDonald's to have an "army" of experts out in the field who can move around and provide acute support to operators in need.

- Requiring candidates to commit to a rigorous training program -- which they do not pay for, nor are they compensated for -- allows the company to find the strong franchisees, and allows the candidate to make an informed business decision.

- Training of franchise candidates in multiple settings allows the trainees to become familiar with management and marketing issues and develop a wide network of relationships with fellow operators, managers, and the company support system.

- Developing a network of successful franchises requires substantial investment in training, financial support, and well-planned support systems.

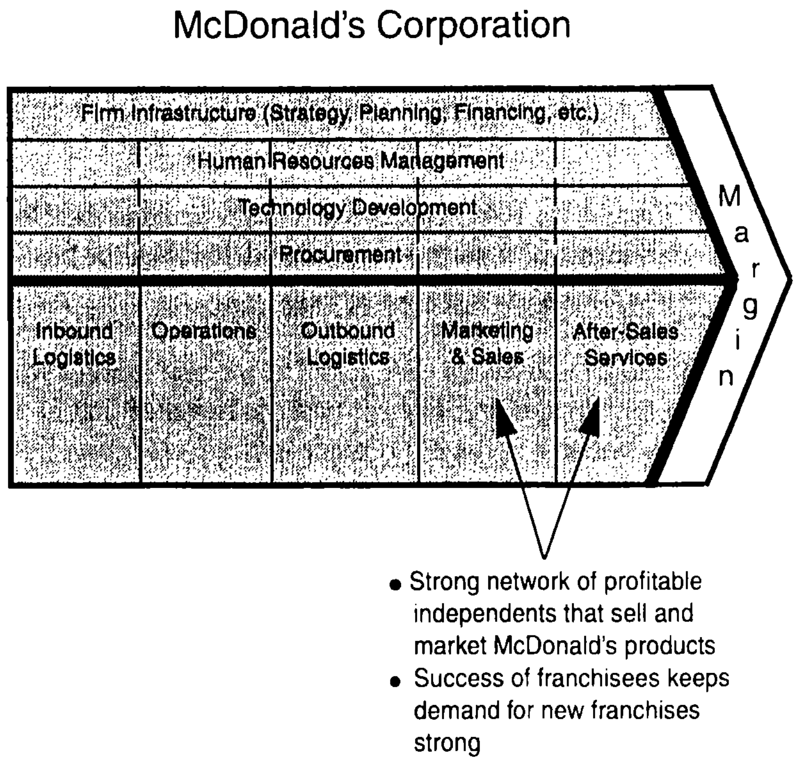
- Franchising may not be for everybody, but linking the right person with the right company can be a "win-win" business proposition.

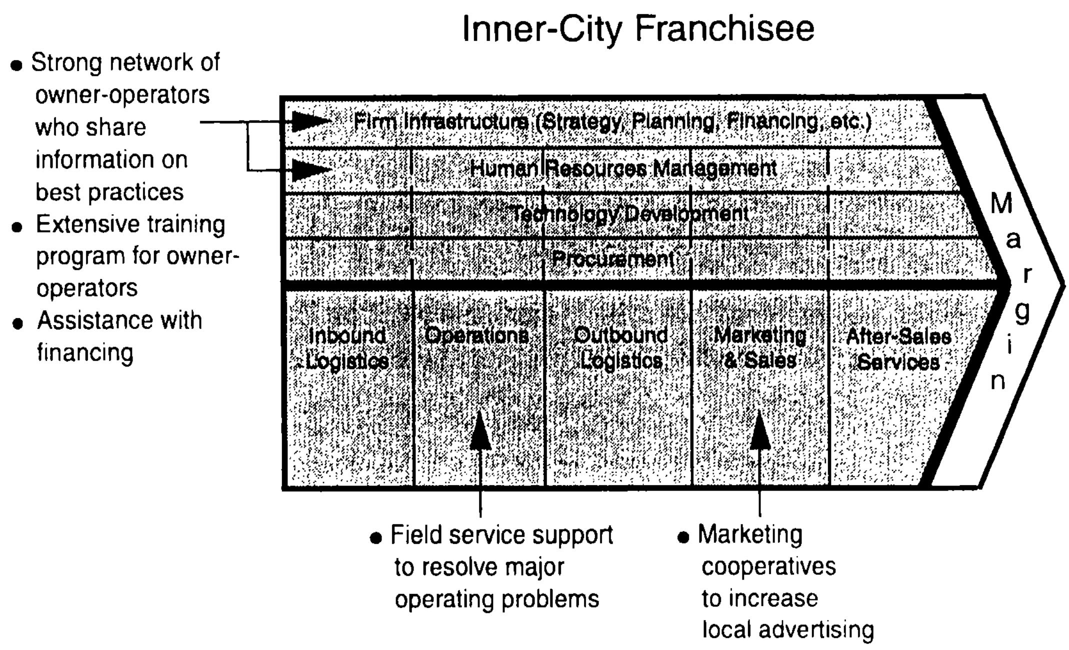
Sources:

William Edwards, McDonald's Franchisee, Washington DC
Herman Petty, McDonald's Franchisee, Chicago, IL
Robert Beavers, Senior Vice President, McDonald's Corporation
Walt Riker, Media Relations, McDonald's Corporation
Lisa Howard, Media Relations, McDonald's Corporation

Figure 1

The impact of the franchisee support program on companies' value chain





Investment
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How SBICs Are Formed & Operate

The Structure of Venture Funds

Venture capital funds do not follow customary corporate organizational structures. They are usually not infinite life entities that look to sell out or go public in order to make their investors and managers rich. They are generally limited life entities (10 years with one year extensions that usually lead to 15 year lives). Investments are made during the first five years and the majority harvested over the ensuing five to ten years. Often, especially when the stock market is booming, some investments will mature during the first five years, but this is not within the plan; it is considered "fortuitous".

For legal and tax reasons, there are usually three entities in the creation of a venture fund:

1. The limited partnership (LP) into which the investment money is placed, and this is the entity which makes all the investments. This entity has *Limited Partners* (the money investors) who put up 99% to 100% of the funds, and get about 80% of the profits. The other 20% goes to the general partners. The limiteds are insulated from personal liability for the activities of the partnership.

2. The general partners, in turn, insulate themselves from liability by forming a *General Partner* of the limited partnership, historically a corporation, but nowadays is starting to tend toward LLCs (Limited Liability Companies).

3. The third entity is a management company which contracts with the general partner to conduct the day-to-day activities of the limited partnership. Almost always, the general partners own and manage the management company. The management company also usually employs a part-time bookkeeper and an administrative assistant, and if the fund is larger, a CFO (Chief Financial Officer), associates, and junior analysts. As with the general partnership, the management company isolates both the limited partnership and general partner from the everyday liabilities encountered in the daily conduct of

business that the management company may incur.

The financial goal of investors is to obtain *cash-on-cash* returns from their investments, taking into account the time value of money. Thus, venture funds not only like to obtain high profits on their investments, they ideally like to achieve them as soon as possible, even though in their heart-of-hearts they plan on a five year time horizon, and even longer for early stage deals.

The Goals of Investors

Investors in a venture capital fund are seeking *risk-adjusted returns*. They are seeking returns that exceed those found in the stock market. Please keep in mind that all returns are relative. If stock market returns are 16%, venture investors will be seeking 23% per year internal rates-of-return (IRRs). If stock market returns are lower, a 15% IRR to investors may be sufficient. In today's world, the most successful SBICs are achieving IRRs of 30%.

While most SBICs hold out the prospect of 16% to 23% IRRs, we only expect an average of about 10.25% to be achieved overall within the program, after allowing for failures. Nonetheless, for a well-run SBIC, investors should have a low probability of suffering a loss of capital.

There is a critical difference between SBIC investing and stock market investing. In stock market investing, if a stock doesn't go up, it usually goes down, and the action of the stock is often independent of the company itself. The market may take a tumble or an industry sector may fall out of favor.

With venture investing, losses almost always flow from bad management selection, and rarely from any other reason. Profits, on the other hand, can flow not only from good management selection (or luck), but also from the pricing of a deal when it was made, as well as the overall business climate when one seeks to exit. (Exit strategies will be discussed later.)

Forming a Venture Fund

Typically, three people get together (normally middle-aged white guys) and decide to form a fund. The majority of SBICs are first funds, and the average amount of capital that is raised for a leveraged fund in FY98 was around $16 million, which included second and later funds. We don't have breakdowns, but the average first fund size is probably around $12 million of private capital.

However, a venture fund is not usually viable with less than $30 million of capital. Thus, the attractiveness of the SBIC program to a management group with only $12 million of private capital, is the prospect of $24 million of leverage which leads to economically viability. It appears that there is a glass ceiling in raising venture capital. When you go above $20 million, it becomes dramatically more difficult for a first fund than under $20 million. Why is this?

Money for larger funds, particularly those over $70 million comes mostly from institutions. In 1999, institutions are quite sophisticated in selecting fund managers and, with only a few exceptions, almost exclusively invest in second or later funds where the management team has been together for a few years and *have a demonstrated track record as a team*. (In the SBIC program, we demand demonstrated individual competence, but not a team track record.)

The money for first fund SBICs comes mostly from wealthy individuals who often are not as sophisticated in venture fund investing as are institutions. Furthermore, in today's world, skilled fund managers with an excellent track record are turning money away and private individuals who are not supremely wealthy would not even be accepted. For whatever the reason governing the dynamics of money raising, perhaps because of the limits of personal networks, there is a void between $20 million and $70 million in fund size (excluding SBA leverage).

Organizational Idiosyncrasies of Venture Funds

A major idiosyncrasy of venture funds is that as they become larger, they don't do more deals, the merely scale up the size of the deals they do. In other words, an SBIC with $15 million of private capital (plus $30 million of leverage) will probably make investments that center around $2 to $2.5 million, with a maximum of $3 million. During its lifetime, the fund will make around 20 investments.

If a fund raises $100 million of capital, instead of now making 40 investments, it scales up and makes the same number of investments, but each will be twice the size. Why is this?

A first fund, as previously noted, has three partners. When they add a second fund, these partners still have to spend time with investments from their first fund. They don't have to invest the 80 to 140 hours per investment that they might when leading a new investment, but they have to attend board meetings of companies in which they have invested, and they have to spend large amounts of time with companies that have problems and which they wish to save from collapse. These companies are often referred to as the "living dead".

Because some, or much of the partners' time is absorbed with prior investments, they then will add an analyst or two to their staffs, and the more promising analysts will become associates, meaning that they will not just crunch numbers and perform due diligence, but may negotiate smaller deals, and get bigger bonuses.

If this were a law firm or an accounting firm, the most capable associates would look forward to becoming partners. Not so, for most of the venture industry.

Why?

In 1995, when I took one of the country's most successful venture capitalists to visit with folks over at OMB, one of the people there asked the question, "As your funds grow, why don't you just do more deals rather than scaling up in size?" The totally honest response was, "We don't want to share the profits."

Thus, most capable associates save up their annual bonuses, and after five or more years, when they've accumulated sufficient funds and contacts, leave to form their own funds, most often SBICs. The process of raising money is grueling and expensive. The projected out-of-pocket expenses are often in the $250,000 on up range for lawyers and travel expenses. The process takes at least 18 months during which time one is drawing no salary. This activity is often referred to as "groveling", which is why so many venture capitalists wear knee pads.

Obtaining an SBIC License

At SBA, we have recently changed our licensing process to make the process more transparent, and to enable potential licensees to learn whether or not they would probably qualify for a license before they have made the huge time and money commitment previously mentioned.

Potential applicants have the option of answering an approximate 30 question questionnaire called the *Management Assessment*. This gets to the core of their competency. We do an analysis and then invite the participants to meet with us to discuss their strategies and capabilities. We then give them guidance as to their strengths and weaknesses and their likelihood of obtaining a license, all with the caveat that there are no guarantees.

There is no charge for this, and this process will normally be done when a potential applicant has about $5 million of what are termed "soft circles" on his fund. A soft circle is strong verbal interest by an investor for a certain amount of investment in the fund. When the applicant has firm commitments of $8.5 million (or $4 million if doing a debenture fund with a local orientation), the managers will file a formal application. This has a fee structure of a base of $10,000 plus $5000 additional if a partnership or LLC plus $5000 more if utilizing participating securities.

As soon as an application is received we forward the personal biography and fingerprint cards to the Inspector General's office who forwards the material to the FBI for a background criminal investigation.

There is currently a queue before other processing can begin, but once processing is begun, it is our goal to have the entire application processed within four months, although six months seems to be closer to the norm. (Responses to our questions and legal issues by the applicants and their counsel often take time. We're quite responsive once processing has begun.) The processing focuses on two primary activities:

- *Due Diligence.* We do background checks on the competency and character of the managers/general partners, as well as any non-institutional investors who own 10% or more of the fund.
- *Legal.* A partnership agreement with certain annexes that tie to leverage must be approved by the Office of General Counsel.

During this process, the fund's general managers must all attend a one-day regulations training class that we give. The Investment Division Investment Committee meets bi-weekly to discuss the status and issues regarding every applicant and potential applicant.

When all of the due diligence is completed and all the legal work is satisfactory, the application goes for a vote to the Division Licensing Committee; if it passes there, it goes to the Agency Licensing Committee, composed of the top level officers of the SBA, and finally it is sent to the Administrator for approval.

Managing an SBIC

Once an SBIC is licensed and is in operation, there are five main tasks that management must devote itself to:

- Marketing
- Due diligence
- Negotiation and deal structuring
- Oversight, and
- Exits.

Marketing. A typical venture firm makes about 4 to 5 new investments a year, and they only invest in 1% or 2% of all the proposals that they look at. Therefore, if a firm does not have around 350 deals per year to review, it is likely that they will start to make lower quality investments than their strategy calls for. This then leads to future problem companies and subsequent losses.

It used to be that one could build a deal flow network over three years and then count on it to perpetuate itself. This is no longer the case. It is now necessary for the general partners to make marketing a key and integral part of their management activities. Good deal flow leads to good deals which lead to high profits.

Due Diligence. In-depth due diligence is critical to success. There is a saying in the venture industry that there are three things that you look for when making an investment: *management, management, management.* In contrast to bankers who lend against cash flow and against assets, when bank lines are all tapped out, venture capitalists provide high-risk unsecured financing. Therefore, the quality of management of a small enterprise is the most critical element. There's another saying in the industry, "Given the choice between a superior product and mediocre management or a mediocre product and superior management, choose the latter."

The amount and depth of due diligence that is performed has a dramatic bearing upon one's investment results. For success, one is looking at 80 to 140 hours of due diligence per deal that is closed.

Before a venture capitalist will even look at a company, the entrepreneur must have prepared a credible business plan. It doesn't have to be perfect; before an investment is made, the strategies may change and the forecasts will surely be modified, but without a business plan almost no SBIC will enter into conversations. This is a dramatically different the environment in which New Markets Entrepreneur Funds would operate where the level of sophistication and preparedness is much less.

Deal Structuring. A former boss of mine used to say that "bought right is half sold". In other words, you can't afford to overpay for an investment. If you overpay, it becomes very difficult to achieve the types of returns that one seeks, even if the company is successful. The most skilled venture capitalists tend not to overpay. This is also a function of your deal flow. If deal flow is insufficient, one tends to overpay because one cannot be idle and not make investments without having unhappy investors.

Oversight. This is another element that has a heavy bearing upon one's ultimate returns. The industry is replete with aphorisms, and another one is "Twenty-five percent of your success is based upon making the investment and seventy-five percent on what takes place afterwards." Venture capitalists, although often referred to as "vulture capitalists" are actually, for the most part, amazingly tolerant of management mistakes and bad behaviour, perhaps too tolerant.

At a conference I attended in San Francisco, when a panel of the superstars of high-tech investing were discussing mistakes they had made and they talked about how they had often waited too long before sacking incompetent management, there was a big roar of knowing laughter and approval of what had been said.

Venture investors are semi-active, or semi-passive, depending upon whether you say the glass is half-full or half-empty. Above all, they do not want to run businesses, but they do provide guidance, and they should step in forcefully and take corrective action when things start to go awry. Some are good at this, and many are not. Those who are not have less ability to recover from down-drafts.

In the venture business, there are only four exit mechanisms.

§ The most common successful exit is to sell or merge the company to another firm at a profit.

§ The most highly publicized exit which can be the most profitable is through an initial public offering (IPO). Recent years have been uncommon in the number of months that IPOs have remained popular. Normally, the IPO window lasts about 18 months every few years. While IPOs gather a great deal of press coverage, they are not a common exit mechanism, and even when there is an IPO, terms of the offering often prohibit private investors from selling shares for 6 months after the offering, by which time, the stock may be below the offering price.

§ When an investment winds up in the living dead category, the exit mechanism is to sell shares back to the company. After 8 years, one tends to realize about an 8% IRR.

§ The final exit mechanism is the least desirable -- scrounge what you can from the assets after a company has failed, or sell your shares at a loss. This is to be expected and goes with the territory. At a conference that we sponsored, one highly successful SBIC manager who was a speaker said, "If you don't have failures, you're not making deals."

Directing SBICs to LMI Investments

Earlier it was stated that marketing networks were critical to deal flow and ultimately to success. One tends to network with those people with whom you are familiar -- normally other venture capitalists, investment bankers, merger and acquisition brokers, lawyers, and accountants. Practically no investments that are made come into an SBIC directly; practically all come through third parties.

Why is this? The third parties prepare the entrepreneur for the financing. They not only may assist with the business plan and with the pricing of an investment, but they also prepare the entrepreneur mentally for dealing with outside investors.

The way that SBICs will start to make LMI investments is if deals come to them through networks to LMI communities. This becomes the role of community development organizations -- to prepare the entrepreneur for a financing, and to introduce businesses with good growth prospects to SBICs. In my experience, SBICs merely want good deals -- they are not particularly choosy about where in a city a firm is located or whether a minority or woman is the principal in the firm.

They just want high growth prospects and entrepreneurs that can manage growth or be willing to hire people who can. In fact, most SBIC managers would prefer to make investments that are within easy driving distance of their offices rather than ones that require boarding a plane. Thus, insofar as SBIC managers can be introduced to community development folk, which is a prime purpose of the outreach workshops, LMI investments will start to flow naturally.

Investment
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SBIC Briefing for Gene Sperling

1/13/99

Program Purpose

The Small Business Investment Company (SBIC) program was created to address the particular needs of small *high-growth* companies which are small today but intend to become large tomorrow. The financing needs of such companies typically exceed what traditional, lending and leasing can provide. To support their growth, these high growth firms must have equity-type capital -- what is generally termed "venture capital". This involves unsecured, high risk investments where participation in the rewards of equity ownership are expected to represent a significant element of the investor's ultimate financial return.

SBICs are privately-owned and operated venture capital investment companies, organized with a minimum of $5 million to $10 million of private capital, which agree to restrict their investments to what is permitted under SBA regulations in exchange for SBA's supplementing their investment capital. The SBA's role is

§ To license them

§ To regulate their operations for compliance with the public policy objectives of the Small Business Investment Act and to protect the government's creditor interest, and

§ To supplement their private capital through public offerings of SBA-guaranteed securities (termed "leverage").

A fundamental strength of the program lies in the fact that all investment decisions are made by private investors with their own money at risk ahead of SBA's; however, this also limits SBA's ability to direct SBIC investments toward specific target areas.

SBICs tend to serve small businesses whose venture capital needs fall in the $500,000 to $5,000,000 range. This exceeds the amount usually available from so-called "angel investors" but falls short of the minimum typically required to interest institutionally-funded private venture capital firms.

A June 1996 study commissioned by the SBA Office of Advocacy estimates that the number of entrepreneurial ventures that need equity financing includes about 50,000 start-ups per year (5-10 percent of total start-ups) and 300,000 ventures growing faster than 20 percent per year (including 80,000 growing at faster than 50 percent per year). In that year, SBICs and private venture firms *together* invested in only about 4,000 firms, or just over 1 percent of the estimated need.

Program Statistics

§ During FY98, SBICs invested a record $3.2 billion in 3,456 small business financings, more than 90 percent of which were equity-oriented.

§ The smaller average investment size of $937,000 for SBICs versus more than $6.8 million for private venture capital firms, demonstrates the SBIC program's success in serving its target market.

§ Over 55% of the financing dollars were invested in businesses 3 years old or less.

§ Over the past 40 years, SBICs have provided more than $20.7 billion in approximately 118,000 financings to about 88,000 small business concerns, including such national successes as Apple Computer, Intel Corporation, Federal Express, and Cray Research, as well as America Online, Sun Microsystems, Callaway Golf and Outback Steak House which can trace their early financings to SBICs.

Less spectacular but equally important are the thousands of small concerns which have been able to develop into sound businesses as a result of SBIC funding and the contribution of experienced SBIC managers who share their knowledge as true partners, with a shared risk and commitment.

It is estimated that SBIC investments have contributed to the creation of more than one million jobs in the manufacturing and service sectors of the economy. Because all investment decisions are made by the SBIC's private management, SBIC investments address many financing needs and cover a broad spectrum of business activities.

During FY98, SBICs invested in companies located in all 50 states plus the District of Columbia, Puerto Rico, and the Virgin Islands. Ninety percent of the funds invested had equity features, and 49 percent was to firms less than 3 years old. The attached SBIC program overview provides additional detail on program financings.

1998 SBIC INVESTMENT ACTIVITY

TYPE OF SBIC	Number of Investments	Total Amount Invested ($millions)	Average Size of Investment	Median Size of Investment
Participating Security	651	$510.2	$783,000	$350,000
Debenture	1576	492.8	313,000	150,000
Bank SBICs	590	2127.0	3,605,000	1,300,000
Specialized SBICs	639	109.4	171,000	129,000
Total SBIC Program	**3,456**	**$3,239.4**	**$937,000**	**$195,000**

HISTORY

The SBIC program was created in 1958 in response to a Federal Reserve Bank of Boston study indicating a significant gap in the availability of long-term debt and equity for small business. Since institutional venture capital largely did not exist at the time, the program was an experiment without precedent on which to draw. After many years of mixed results, culminating in significant failures in the 1989-91 period, the program was restructured in 1992 and has demonstrated remarkable success since.

The Small Business Equity Enhancement Act of 1992, and its implementing regulations rejuvenated the SBIC program. Besides addressing a number of structural problems in the program, the 1992 Act created "*participating securities*" as a funding mechanism for those SBICs that concentrate on equity-type investing (where the SBIC is investing to achieve long-term capital gains and receives very little current income to defray the interest cost of its own debenture leverage). With participating securities leverage, an SBIC defers paying the quarterly interest-like costs (*"prioritized payments"*) until it realizes sufficient gains through the sale of its investments to achieve cumulative profitability.

In exchange for making the prioritized payments on behalf of the SBIC, SBA receives approximately a 10 percent participation in the SBIC's profits. Because of the increased financial risk, SBA has been very selective in the licensing of such SBICs and has generally required a $10 million minimum of private capital.

Since September, 1994, 72 SBICs with total initial private capital of $1.3 billion have been licensed to use participating securities leverage. Their average private capital was $15.3 million which compares with the $2.3 million average for SBICs licensed during the four years prior to 1994. Although the first participating securities leverage was only issued in February 1995, 20 of these licensees have already realized sufficient investment gains to be making their prioritized payments, and through January, 1999, 12 of them have also paid $16 million of their profits to SBA.

The 1994 implementing regulations also corrected a number of other program weaknesses. In addition to implementing the Act's statutory provisions, SBA's 1994 regulations significantly strengthened the licensing, oversight and administration of the program. They increased the minimum private capital required for licensing (to $5 million for SBICs utilizing debentures and $10 million for those utilizing participating securities) and required that SBIC managements have demonstrated investment experience appropriate to the proposed SBIC's operating plan.

The regulations also introduced the concept of "management/ownership diversity" which requires that, under most circumstances, at least 30 percent of an SBIC's private capital is from non-management investors. This eliminates "hip pocket" SBICs, wherein SBIC manager/owners were able to use an SBIC as their own private bank, and insures that there are investors whose interests in the SBIC's financial success complements SBA's interests as a partner/creditor. Other oversight procedures introduced in 1994 include specific guidelines for SBICs to use for valuing portfolio securities in their financial reports; a credit review process for granting leverage; more frequent, better focused examinations of licensees; and a "watch-list" for troubled licensees to insure that prompt action is taken in protecting SBA's creditor position.

Licensing Activity

Since the new program was introduced and the new regulations were implemented in FY94, 152 new SBICs have been licensed (including 40 bank-dominated SBICs) with initial private capital of $2.4 billion. *This is more than the total private capital raised by the program in the preceding 34 years.*

Combined with additions to the private capital of existing SBICs, this has resulted in a nearly tripling of private capital in the program over the past five years, from $2.26 billion at the end of FY 1993 to $6.64 billion through January 6th. At the same time, committed SBA-guaranteed leverage has increased from $860 million to $3.0 billion, bringing the program's total capital resources to $9.6 billion. *The SBIC program today* consists of 325 licensees located in 42 of the 50 states, plus the District of Columbia and Puerto Rico, with concentrations in New York, California, Texas and Massachusetts.

SBIC LICENSEES (As of 1/13/99)

TYPE OF SBIC $ in thousands)	Number	Private Capital	Committed Leverage	Total Capital
Participating Security	73	$1,312.5	$1,601.9	$2,914.3
Debenture	93	914.1	1,115.5	2,029.6
Bank SBICs	87	4372.8	50.0	4,322.8
Specialized SBICs	72	165.3	195.1	360.3
TOTAL	325	$6,664.6	$2,962.5	$9627.1

Bank-dominated SBICs are typically operated as subsidiaries of commercial banks to enable them to make equity investments otherwise prohibited by the Glass-Steagall Act. They typically do not utilize SBA leverage, and many of them are very large (several with private capital in excess of $100 million). Bank SBICs represent 67 percent of the private capital in the program, and they serve the SBIC program's public policy objectives *without a leverage cost to the taxpayers.*

Specialized SBICs were licensed under Sec. 301(d) of the Act and are restricted to investing only in companies owned by persons who are socially or economically disadvantaged. The 1996 Small Business Programs Improvement Act repealed Sec. 301(d) but grand-fathered existing 301(d) licensees.

PROGRAM FUNDING LEVELS (Committed)

Program Levels (thousands)	1995	1996	1997	1998	1999 (Estimated)
Participating Sec.	$219,940	$267,777	$410,942	$700,000	$1,000,000
Debentures	104,430	106,144	256,426	488,000	700,000
SSBIC Debentures	25,410	0	0	0	0
SSBIC Pref. Stock	5,623	0	0	0	0
TOTAL	$355,403	$373,921	$667,368	$1,188,000	$1,700,000

APPROPRIATIONS

Appropriations (thousands)	**1995**	**1996**	**1997**	**1998**	**1999**
Participating Sec.	$19,575	$24,100	$13,520	$11,582	$16,620
Debentures	15,299	16,410	8,180	8,648	3,000
SSBIC Debentures	7,077	0	0	0	
SSBIC Pref. Stock	2,423	0	0	0	
TOTAL	$44,374	$40,510	$21,700	$20,230	$20,280

SUBSIDY RATES

Subsidy Rate	**1995**	**1996**	**1997**	**1998**	**1999**
Participating Sec.	8.90%	9.00%	3.29%	2.54%	2.19%
Debenture	14.65%	15.46%	3.19%	2.30%	1.38%
SSBIC Debentures	27.85%	29.03%	--	--	--
SSBIC Pref. Stock	43.10%	42.85%	--	--	--

New legislation in FY 1996 further strengthened the program. In 1996, the Senate Small Business Committee introduced legislation intended "to insure the safety and soundness of the SBIC program as it grows." This was enacted in the Small Business Programs Improvement Act of 1996, and essentially codified into law many of the regulatory provisions that SBA had previously introduced. In addition, the legislation increased fees charged for leverage which permitted SBA to cut its appropriations in half while doubling the leverage available to SBICs. (The up-front leverage fee was increased from 2 to 3 percent and a 1 percent *annual charge* was added to all new leverage.)

Other notable provisions of the 1996 legislation included repeal of section 301(d) which created Specialized SBICs; reauthorization of the 3% SSBIC preferred stock repurchase program, with the proceeds available as budget authority for additional debenture leverage; a provision for the licensing of SBICs as limited liability companies; clarification that for size status determinations of eligible SBIC investments, the ownership by venture-type investors would be ignored; a requirement to process new license applications promptly without regard to leverage availability and to inform applicants of the status of their applications within 90 days.

Since funds for SBIC leverage are provided by private investors who purchase the debentures or participating securities issued by the SBICs and guaranteed by the SBA, a Congressional appropriation is required only equal to the "cost" of the guarantee. In FY99, an appropriation of $20.2 million will enable SBA to guarantee almost one billion dollars of SBIC leverage. Since such leverage typically requires one-half that amount in underlying private capital, the $20.5 million appropriation will have generated $1.5 billion of equity-type investments in small businesses.

Because these types of investments are almost always subordinated to bank borrowings, such levels of investment can support an additional 50% in commercial credit, providing $2.25 billion in total financing dollars, or over 100 times the $20.2 million of government "cost". By way of comparison, the $20.2 million is less than one-tenth the annual taxes paid by just the corporate SBICs ($242 million in 1996), without taking into account the taxes paid by investors in partnership SBICs, much less the small businesses themselves.

SMALL BUSINESS INVESTMENT COMPANY PROGRAM

Outline of Comments

By

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Senior Policy Advisor

U.S. Small Business Administration

FOR INFORMATION
General Telephone Number (202) 205-6510
Web Page: www.sba.gov/INV/

I. Introduction

A. In 1958, the Federal Reserve Bank under William McChesney Martin did a study of access to the capital markets by small businesses. Findings: inadequate.

B. Venture capital industry did not exist. The phrase had not even come into use. Only a dozen or so very wealthy families using professional managers, plus one public company, American Research and Development, made venture investments routinely.

C. Small Business Investment Act of 1958 was passed.

D. First SBIC licensed On March 19, 1959.

E. Public/Private partnership in which profit-driven IRRs of 15% or greater should be attainable for an SBIC over a 10 year period.

II. What Is an SBIC?

A. Privately managed venture capital firm in which the managers make all the investment decisions.

B. They must finance only small businesses and cannot, except for start-ups and when a company is heading south, control them.

C. Each SBIC management team identifies the target market they wish to reach, that is, types of industries, hi-tech or low tech, and life-cycle of the business -- early-stage or late-stage

D. Purpose of the program:

1. Meets a market need for risk capital that is typically in the $300,000 to $5 million range which is the minimum size preferred by totally private venture capitalists.-- are straight equity, preferred stock, or debt with warrants

2. 90% of investments made have equity features

3. Program designed to finance active small operating companies having no more than $6.0 million of after-tax income *and* no more than $18.0 million of net worth.

4. Goal is to finance companies that grow a minimum of 40% per year.

5. Most don't meet that target. In fact, in an SBIC or any venture firm, 20% of your investments are responsible for most of your profits; with 20% of your companies, you lose some or all of your investment, and on the other 60%, you ultimately earn about 8% per year return-on-investment.

6. In a well-run SBIC, over a 10 year period of time, you should realize an internal rate of return of 15% to 23% or more.

III. Why Invest in an SBIC

A. All investors invest in all venture firms, including SBICs, because they expect IRRs in excess of 15%.

B. They choose to invest specifically in SBICs because the SBA supplements their private capital at very cheap rates.

1. In the SBIC program, SBA supplements the private capital of investors with what is known as *Leverage* which are securities sold in the public markets through underwriters, and carries SBA's full faith and credit guarantee of principal and interest. Two types of leverage are available:

   i. *Debenture Leverage* -- up to 2X or 3X private equity capital:

      a. Has an interest rate of 75 to 95 basis points over the 10 year Treasury Rate, and

      b. Has semi-annual interest payments.

   ii. *Participating Securities Leverage* -- A preferred equity instrument -- up to 2X private equity capital:

      a. Similar interest rate spread, but

      b. Dividend payments are only made when an SBIC has positive retained earnings. This enables the SBIC to make long-term equity type investments. The SBIC also pays SBA approximately 10% of its profits.

2. For a profitable leveraged SBIC, its IRR can increase by 600 to 800 basis points. Of course, leverage can cut both ways, and below an IRR of 11% to 13%, an SBIC's investors would be better off without leverage.

3. To be a full-fledged venture firm, generally at least $30 million of capital is needed in order to support the necessary overhead, which typically is around $750,000 per year.

   i. The industry standard for management expenses for small venture funds doing growth and expansion financings is typically 2.5% of total capital.

   ii. For a full-fledged national or regional venture fund, this normally means $750,000 per annum, minimum.

   iii. For a more geographically focused lender, overhead as little as $375,000 is sometimes possible.

   iv. Such overhead expenditures imply certain minimum capital amounts. $750,000 divided by 2.5% equals $30,000,000.

   v. A glass ceiling exists: to raise above about $15 million becomes dramatically more difficult for new fund managers.

   vi. The average private capital size of non-bank SBIC applicants is around $12 million.

   vii. Therefore, firms that can only raise $10 million, but which have qualified managers, can become economically viable; and thus be able to help grow small, dynamic businesses, which is the purpose of the SBIC program.

C. Why do banks invest in SBICs?

1. The SBIC program provides an exemption to the Glass-Steagall Act, and therefore, enables banks to make investments in which they are able to own more than 4.9% of the voting equity of non-financial companies or more than

24.9% of the non-voting stock of a non-financial entity

2. In addition, banks can obtain CRA (Community Reinvestment Act) credit on the CRA investment test if they invest in SBICs.
3. Most importantly, investing in SBICs is profitable. For the 10 year period ending 1997, bank-dominated SBICs averaged an internal rate of return of 13.1%. They achieved the same IRR for the prior 10 years, too.

D. Can utilize the SBIC program for economically targeted investments ("'ETI").

1. Pension fund investors -- Calpers in California invested in a California targeted fund; New York City pension funds invested in a New York oriented fund, and a Maryland state investment was made in a Maryland based fund.
2. Any ETI oriented SBIC must still have a primary profit motivation and experienced management
3. However, no more than 33% of private capital can come from state or local funds; but state and local pension funds are considered "private capital".
4. History has a most important lesson for bankers: experience has shown that the most successful SBICs are those that are run independently of the bank.
   - i. Commercial lenders are not venture capitalists.
   - ii. Bankers look at past performance and make loans based on cash flow, financial statements, and collateral.
   - iii. Venture capitalists look at future potential and make investments based on the quality of management, because the financial statements are usually pretty weak. If they weren't, commercial lenders would provide all the financing.
   - iv. SBIC managers are usually paid more than commercial loan officers and the SBIC compensation plan must be long-term oriented in order to have the SBIC managers nurse their investments along over many years. In venture investing, 75% of success takes place after the initial closing.

IV. A Few Key Statistics:

A. In 40 years, SBICs have invested more than $20.7 billion in 118,000 financings.

B. During FY98, SBICs invested $3.2 billion in 3,456 financings totaling in excess of $3.2 billion in most all states plus some territories

C. 90% of the funds invested had equity features, and 55% went to firms zero to 3 years old.

D. As of January 13th, 1999, there were 325 licensees with $6.7 billion of private capital. 87 bank- dominated SBICs represented 66% of that with $4.4 billion. This compares with $2.2 billion of private capital at 1993 year-end before the new program was implemented, of which 70% or $1.6 billion was bank-dominated private capital.

E. That's more new capital in 5years than in the prior history of the program. Banks and private investors are demonstrating their faith in the program.

F. Committed program leverage as of January 13, 1999 was $3.0 billion compared with $860 million at the end of fiscal 1993. For fiscal 1999, $1.7

billion of leverage is estimated to be available

G. Currently, we have 44 active applications on hand representing approximately $500 million of private capital

V. **Program has had many successes.**

A. In *Fortune's* 1996 list of the 100 fastest growing companies, 18 had received SBIC funding.

B. Early examples: Federal Express, Intel, Cray Research, and Apple Computer.

C. More recent well-known companies: America on Line, Staples, Amgen, Callaway Golf, Microcom, Sierra Semiconductor, and Gymboree.

D. Was not a smooth road from 1958 to the present.

1. Program shrank during the 1980s with $600 million of gross leverage liquidations before any recoveries which are at about 60%.
2. In 1990 and 1991, at Senate hearings, the question was raised whether to eliminate the program.
3. To deal with this issue, in 1991, an Investment Advisory Council was formed, staffed with non-SBIC venture capital managers. Their findings were:
4. The program was basically sound.
5. It had a high all-in return to the taxpayer, but
6. A number of identifiable problems existed:

i. Inadequate management.

ii. Capital base of most SBICs was too small to be economically viable.

iii. Portfolio valuations were done poorly which led to inaccurate reporting and inaccurate credit evaluation by the SBA.

iv. Mis-match of funds flow, i.e., debt leverage was being used to finance equity investments.

E. These problems were corrected by new legislation in 1992, and by new regulations finalized in April, 1994, and fully re-written and modernized in January, 1996.

1. Admit only qualified management. License hard and regulate rationally. The key is: management, management, and management.
2. Minimum capital requirements now exist based on economic viability which encompasses the need for sufficient expenditures on overhead to perform adequate due diligence and continuing oversight.
3. Thus, to obtain a Participating Security equity license, $10.0 million private capital minimum is required under most circumstances. Enables the SBIC to perform sufficient due diligence, oversight, and marketing.
4. For a debenture licensee who may make loans on a smaller geographic scale, as little as $5.0 million private capital may be acceptable.
5. However, only $3.0 million of private capital is required for a non-leveraged license because the SBA is not at financial risk, and overhead is often absorbed by a bank. However, we don't recommend this little an amount.
6. The final major change was curing the mis-match of funds flow with an

equity participating security.

F. Two kinds of SBICs:

1. Regular -- 301(c) -- which is the only type that can now be licensed, and
2. Specialized -- 301(d) -- which are oriented towards financing firms owned by persons who are "socially or economically disadvantaged". These types are no longer being licensed, but existing ones are grand-fathered. In the past they had access to subsidized leverage such as 3% and 4% preferred stock which was sold to the SBA. However, this proved to be too costly to the government, costing 43 cents per dollar of leverage compared with less than two cents for the regular program.

VI. Qualifying Investments

A. Investments made only to small businesses, generally those with no more than $6 million of after-tax income and no more than $18 million of net worth.

B. Prohibited uses of funds (other than real estate)

1. Relending & reinvesting.
2. Most real estate unless a majority of the space is used by a qualified operating company.
3. Passive businesses. *Exception:* A holding company with operating subsidiaries are okay.
4. Foreign investments.
5. Activities contrary to public interest, e.g., casinos, even if legal.
6. Project financing, e.g., oil wells vs. oil development companies.
7. Financing other Licensees.
8. Farm land.
9. Associated supplier.
10. Catchall category: activities not contemplated by the Act, e.g., stock market investing.

VII. Structuring the Investment

A. Funds must be furnished directly to the small company unless through an underwriter.

B. Maximum of 20% of private capital in any one company, known as "overline limit". Provides for portfolio diversification which reduces risk.

C. Initial financings must be long-term: either equity or a minimum term of 5 years, or 4 years for an SSBIC financed investment. Bridge loans permitted under some circumstances.

D. SBA sets ceilings on interest rates, known as *Cost of Money:*

1. 6% spread above a calculated base rate on debt with equity features.
2. 11% spread on straight loans.

E. Redemption provisions -- 5 year minimum term.

F. Calls are permitted.

G. Commitment fees and closing fees allowed, with certain limitations.

H. Prepayment penalties permitted.

I. Interest rate can be boosted 700 basis points for monetary or reporting defaults.

VIII. Other Aspects of Investing

A. Control generally not permitted, including control over the checkbook. Exceptions:

1. Early stage investments to include seed capital and start-ups.
2. When a company encounters major difficulty.

B. Conflicts of Interest is a major violation of regulations

1. Self-dealing.
2. Co-investing with Associate creates problems, except that normal bank credit lines are not considered conflicts.
3. However, serving on a board is permitted.
4. Exemptions to conflicts of interest require public notice.
5. Management Services are permitted so long as rates are reasonable, and only for services actually performed.

IX. Licensing Process

A. See web site at *www.sba.gov/INV/* (Note that last three letters must be in caps.)

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SBIC Program Overview
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-- PROGRAM COMPOSITION --

	FY End 1995	FY End 1996	FY End 1997	FY End 1998	to date 1999
Number of Licensees					
Participating Sec.	31	36	54	69	73
Debenture	87	89	87	92	93
Bank SBICs	69	69	79	84	87
Specialized SBICs	90	88	80	73	72
TOTAL	277	282	300	318	325
Private Capital (millions)					
Participating Sec.	557.7	571.2	859.5	1,226.9	1,312.5
Debenture	542.3	611.0	631.4	897.2	914.1
Bank SBICs	2.184.5	3,118.3	3,468.0	4,005.4	4,272.8
Specialized SBICs	199.1	220.4	181.6	165.9	165.3
TOTAL	$3,483.6	$4,520.9	$5,140.5	$6,295.4	$6,664.6
Outstanding Leverage (millions)					
Participating Sec.	227.9	510.5	720.9	889.4	935.9
Debenture	515.1	586.9	611.1	704.8	716.5
Bank SBICs	35.0	21.0	18.5	23.5	24.5
Specialized SBICs	292.3	248.6	227.0	178.2	173.4
TOTAL	1,070.3	$1,367.0	$1,577.5	$1,795.9	$1,850.3
Total Capital Resources (millions)					
Participating Sec.	785.6	1,081.7	1,580.5	2,116.3	2,248.3
Debenture	1,057.4	1,197.9	1,242.4	1,602.0	1,630.6
Bank SBICs	2,219.5	3,139.3	3,486.5	4,028.9	4,297.3
Specialized SBICs	491.4	469.0	408.7	344.1	338.6
TOTAL	$4,553.9	$5,887.9	$6,718.0	$8,091.3	$8,514.9

Program Totals with Commitments Included

	FY End 1995	FY End 1996	FY End 1997	FY End 1998	to date 1999
Outstanding and Commited Leverage (millions)					
Participating Sec.	369.7	603.8	827.2	1,401.2	1,601.9
Debenture	522.3	586.9	624.3	997.5	1,115.5
Bank SBICs	35.0	21.0	18.5	44.0	50.0
Specialized SBICs	292.3	248.6	227.0	186.7	195.1
TOTAL	$1,219.3	$1,460.3	$1,697.0	$2,629.4	$2,962.5
Total Commited Capital Resources (millions)					
Participating Sec.	927.4	1,175.0	1,686.8	2,628.1	2,914.3
Debenture	1,064.6	1,197.9	1,255.6	1,894.7	2,029.6
Bank SBICs	2,219.5	3,139.3	3,486.5	4,049.4	4,322.8
Specialized SBICs	491.4	469.0	408.7	352.6	360.3
TOTAL	$4,702.9	$5,981.2	$6,837.5	$8,924.7	$9,627.1

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-- NEW AND RETIRING LICENSEES --

	FY End 1995	FY End 1996	FY End 1997	FY End 1998	to date 1999
New Licensees (number)					
Participating Sec.	12	6	17	15	15
Debenture	3	7	6	7	7
Bank SBICs	5	7	10	9	9
Specialized SBICs	0	2	0	0	0
TOTAL	20	22	33	31	31
Initial Private Capital (millions)					
Participating Sec.	171.3	58.9	232.0	242.4	242.4
Debenture	17.9	60.2	48.9	109.8	109.8
Bank SBICs	117.5	32.5	168.5	226.1	226.1
Specialized SBICs	0.0	9.6	0.0	0.0	0.0
TOTAL	$306.7	$161.2	$449.3	$578.3	$578.3
Liquidation Activity ($ in millions)					
Licensees Transferred	7	2	5	2	2
Leverage When Transferred	$15.8	$2.5	$20.1	$7.0	$7.0
Open Licensee Cases	186	160	137	128	128
Outstanding Leverage	$480.8	$302.3	$218.7	$197.9	$197.9
Number of Licensees Closed	15	29	28	12	0
Collections thru 8/31/98	$64.9	$65.6	$65.1	$24.4	$0.0
Write-Offs thru 8/31/98	$11.7	$118.4	$49.5	$4.4	$0.0
Surrenders					
Number	18	13	8	6	2
Ending Private Capital	$114.5	$115.1	$43.5	$37.9	$20.6
Mergers					
Number	2	1	2	4	0
Ending Private Capital	$26.7	$1.1	$2.8	$34.2	$0

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-- SMALL BUSINESS FINANCINGS --

	FY End 1995	FY End 1996	FY End 1997	FY End 1998	to 12/15 1998
Number of Financings to Small Businesses					
Participating Sec.	126	234	495	651	651
Debenture	624	603	768	1,576	1,576
Bank SBICs	318	381	536	590	590
Specialized SBICs	1,153	889	932	639	639
TOTAL	2,221	2,107	2,731	3,456	3,456
Dollar Amt. of Financing (millions)					
Participating Sec.	109.6	214.8	360.0	510.2	510.2
Debenture	282.1	312.5	360.0	492.8	492.8
Bank SBICs	703.8	972.1	1,530.7	2,127.0	2,127.0
Specialized SBICs	153.5	116.6	118.3	109.4	109.4
TOTAL	$1,249.0	$1,616.0	$2,369.0	$3,239.4	$3,239.4
Average Size of Investment					
All Regular SBICs	$1,025,738	$1,231,005	$1,251,074	$1,111,117	$1,111,117
Participating Sec.	$869,841	$917,987	$727,255	$783,723	$783,723
Debenture	$452,083	$518,167	$468,739	$312,681	$312,681
Bank SBICs	$2,213,208	$2,551,444	$2,855,753	$3,605,132	$3,605,132
Specialized SBICs	$133,151	$131,211	$126,916	$171,240	$171,240
Type of Financing (millions)					
Straight Debt	259.2	187.8	240.1	363.4	363.4
Debt with Equity Features	348.6	534.6	756.0	705.3	705.3
Equity Only	641.2	893.6	1,372.9	2,170.7	***.*
TOTAL	$1,249.0	$1,616.0	$2,369.0	$3,239.4	$3,239.4
Age of Financed Small Bus (millions)					
Under 1 year	499.7	545.0	692.9	1,220.0	1,220.0
1 to 3 years	199.6	333.2	481.8	570.5	570.5
3 to 6 years	177.0	246.0	441.2	492.8	492.8
6 to 10 years	140.6	195.2	334.0	350.2	350.2
Over 10 years	232.1	296.6	419.1	606.1	606.1
TOTAL	$1,249.0	$1,616.0	$2,369.0	$3,239.4	$3,239.4

Demographics of SBIC-Financed Small Businesses
(recorded from October 1, 1997 through September 30, 1998)

	Number of Financings	% of Total	Amount of Financing (millions)	% of Total
50% or more Women-Owned	208	6.0	$31.0	1.0
50% or more Black-Owned	315	9.1	$51.2	1.6
50% or more Hispanic-Owned	136	3.9	$43.2	1.3
50% or more Native Am.-Owned	0	0.0	$0.0	0.0
50% or more Asian Pac.-Owned	211	6.1	$30.6	0.9
50% or more Sub Asian-Owned	225	6.5	$47.6	1.5

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-- MISCELLANEOUS --

Participating Securities

	Dollar Amount	Number of Licensees
Funding (thousands)		
Total Pooled	951,280.0	54
Interim Funding Outstanding	155,095.0	
Redemptions	(134,584.0)	
Total Outstanding	$971,791.0	
Prioritized Payments by SBA (thousands)		
Historical Total	132,656.8	54
Reimbursements	(53,883.2)	
Current Outstanding	$78,773.6	
Revenue to Agency (thousands)		
Profit Participation	16,048.0	12
Adjustment Payments by SBICs	1,394.4	13
Gain(Loss) on Inkind Securities	(295.0)	4
Net Revenue	$17,147.4	

Fees Collected, Licensee Conversions & 3% Preferred Stock Repurchases

	FY End 1995	FY End 1996	FY End 1997	FY End 1998	to date 1999
Fees Collected (thousands)					
Examinations	na	na	1,326.6	1,594.0	424.9
Licenseing	na	na	380.4	1,043.0	215.6
Total			$1,707.0	$2,637.0	$640.5
Conversion from 301(d) to 301(c) (millions)					
Number	0	0	6	3	0
Private Capital	0	0	$43.6	$19.7	$0.0
Outstanding Leverage	0	0	$15.9	$34.5	$0.0
3% Preferred Stock Repurchase (millions)					
Number	19	5	10	2	2
Par Value	46.2	5.4	15.5	3.1	3.1
Amount of Discount	30.0	3.6	10.1	2.0	2.0
Amount Received by SBA	$16.2	$2.2	$5.4	$1.1	$1.1

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-- INTERNAL OPERATIONS --

	FY End 1995	FY End 1996	FY End 1997	FY End 1998	To Date 1999
Personnal (FTEs)					
Operations	18	18	19	21	21
Licensing	4	8	7	6	6
Examinations*	29	26	25	29	29
Liquidation	18	15	14	15	15
AA Staff	15	15	15	14	14
TOTAL	84	82	80	85	85
*Field Employees included in Exams above	27	24	23	27	27
Budget (actual)					
Compensation & Benefits	6,163,000	5,964,562	5,913,000	6,174,467	638,093
Travel	254,651	196,666	294,500	282,000	282,000
Other Expenses	182,185	36,450	28,000	11,378	331,878
Examination contract	--	84,338	300,000	0	0
Liquidation contract	--	66,648	50,000	--	--
Licensing contract	--	153,800	56,800	--	--
Other contracts	50,456	54,044	20,900	321,000	0
TOTAL	$6,650,292	$6,556,508	$6,663,200	$6,788,845	$1,251,971

-- EXAMINATION OF SBIC LICENSEES --

Examinations					
Exam Reports Issued	240	202	217	230	45
Exam Cycle	14.3	13.9	14.5	14.0	13.5
Licensees with Leverage	158	156	151	160	27
Exam Cycle (months)	12.8	13.5	13.0	12.4	11.9
Licensees w/o Leverage	82	46	66	70	18
Exam Cycle (months)	17.2	15.4	18.0	17.9	15.9
Reports with Findings	170	108	77	84	15
Reports without Findings	70	94	140	146	30

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-- PROGRAM FUNDING --

	FY End 1995	FY End 1996	FY End 1997	FY End 1998	Current 1999(a)	Projected 2000
Appropriation (thousands)						
Participating Sec.	19,575	24,100	13,520	11,582	16,620	
Debenture	15,299	16,410	8,180	8,648	3,000	
SSBIC Debentures	7,077	0	0	0	0	
SSBIC Preferred Stock	2,423	0	0	0	0	
TOTAL	$44,374	$40,510	$21,700	$20,230	$20,280	
Program Level (thousands)						
Participating Sec.	219,940	267,777	410,942	700,000	850,000	
Debenture	104,430	106,144	256,426	488,000	600,160	
SSBIC Debentures	25,410	0	0	0	0	
SSBIC Preferred Stock	5,623	0	0	0	0	
TOTAL	$355,403	$373,921	$667,368	$1,188,000	$1,450,000	
Subsidy Rate						
Participating Sec.	8.90%	9.00%	3.29%	2.20%	2.19%	
Debenture	14.65%	15.46%	3.19%	1.94%	1.38%	
SSBIC Debentures	27.85%	29.03%	--	--	--	
SSBIC Preferred Stock	43.10%	42.85%	--	--	--	
Program Level Utilized (millions)						
Participating	219.4	237.8	233.8	700.0	$201.1	
Debenture	129.7	106.1	138.7	461.6	$128.5	
Direct Funding	5.6	--	--	--	--	
TOTAL	$355.3	$343.9	$372.5	$1,161.6	$329.6	
Public Fundings (millions)						
Participating Pool	$227.8	$286.3	$214.2	$222.9	$0.0	
Debenture Pool	$128.0	$114.5	$125.5	$97.0	$0.0	
Outstanding Interim Funding (millions)						
Participating Security	--	--	--	$61.8	$155.1	
Debenture	--	--	--	$8.3	$51.1	
Outstanding Commitments (millions)						
Participating Security	$141.8	$93.3	$106.3	$532.7	$666.0	
Debenture	$7.2	--	$13.2	$331.2	$446.2	

a The FY 99 program levels are $800,000 for participating securities and $600,000 for debentures. The FY 99 program levels include a $2 million carryover of unused budget authority for FY 98. The FY 99 appropriation by itself would fund program levels of $758.9 million for participating securities. Budget authority from 3% perferred stock repurchases is not included.

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Investment Division
U.S. Small Business Administration

Development Venture Capital

Venture Capital to Meet the Needs of Inner Cities and Rural America

MEETING NOTES — JUNE 5, 1998

U.S. Small Business Administration
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Venture Capital to Meet the Needs of Inner Cities and Rural America

The Need

Equity type financing is not widely available to basic businesses, particularly those with modest growth prospects located in the inner cities and in rural areas, especially encompassing minority-owned companies, and service businesses which are often the type founded by women entrepreneurs.

The existing Small Business Company (SBIC) program helps to meets the needs of high growth small businesses, and provides the basis for a variation that could target the needs of the underserved markets described in the paragraph above.

The Four Components for Success

There are four components necessary to successfully accomplish the goal of providing equity type capital for the underserved markets:

1. A financing company that provides funds to the entrepreneur
2. A specialized technical assistance (TA) organization that provides targeted TA, both before and after a financing has taken place
3. A regional or local venture capital advisory organization, and
4. Federal government financial assistance, or "leverage".

The Core

The heart of the concept is a "development venture capital" fund (DVC). From a day-to-day operating standpoint, the DVC would be run just like a regular venture fund. It would:

- Have investment officers who review proposals
- Make investments on a sound investing basis with a view towards profitability
- Assist in the workouts of troubled situations
- Exit profitably from investments, and
- Perform liquidations when necessary.

However, a major difference between a DVC and a regular venture fund or SBIC would be that the structuring of a financing would not be designed to yield as high a return as within an SBIC. Due to the normal losses that occur in any venture fund, as well as the fact that most companies do not achieve plan, such a fund would ultimately have a goal of achieving an overall 8% to 10% internal rate of return for its investors, rather than the 15% to 23% of regular venture funds.

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Highlights of the SBIC Program

SBICs are privately owned and operated venture capital investment companies organized with a minimum of $5 to $10 million of private capital. SBA's role is to (a) license them, (b) to regulate their operations for compliance with the public policy objectives of the Small Business Investment Act of 1958, as amended, protecting the government's creditor interest, and (c) to supplement their private capital through public offerings of SBA-guaranteed securities (termed "leverage").

SBICs tend to serve small businesses whose venture capital needs fall in the $500,000 to $5 million range. This exceeds the amount usually available from so-called "angel investors" but falls short of the minimum typically required to interest the institutionally-minded venture capital firms. A June 1996 study commissioned by the SBA Office of Advocacy estimates that the number of entrepreneurial ventures that need equity financing includes about 50,000 start-ups per year (5% to 10% of total start-ups) and 300,000 ventures growing faster than 20% per year (including 80,000 growing faster than 50%.)

The SBIC program today consists of 315 licensees in 44 states. These licensees have total capital of over $5.9 billion, and over the past 39 years, SBICs have provided more than $17 billion in approximately 114,000 financings of small businesses. These have included such well-known companies as Federal Express, Intel, Cray Computer, Callaway Golf, America on Line, Staples, and Outback Steak House.

In fiscal 1997, there were 2731 financings totaling $2.4 billion in 47 states plus the District of Columbia and Puerto Rico. A total of 90% of the financings had equity features, and 49% went to firms less than 3 years old. During the past four years, more private capital has flowed into SBICs than during the prior 30 years.

However, the program has had its problems in the past. During the 1980s, the program shrank and $600 million of gross leverage liquidations occurred before any recoveries which are about 60%. A number of identifiable problems existed: (1) there was inadequate management, (2) the capital base of most SBICs was too small to be economically viable, (3) portfolio valuations were done poorly which led to inaccurate reporting and inaccurate credit evaluation by the SBA, and (4) there was a mis-match of funds flow as debt leverage was being used to finance equity investments. These problems were cured with legislation in 1992 and new regulations and policies beginning in 1994.

In 1972, the Minority Enterprise Small Business Investment Company (MESBIC) program was enacted into legislation. It was subsequently expanded into the Specialized SBIC program (SSBIC). At the end of fiscal 1996, congress abolished the program, but grandfathered all existing SSBICs. Congress had concluded that the program, with subsidy rates (cost to the government) of approximately 29% and 43% for various subsidized securities was too expensive relative to the benefits delivered.

Most SSBICs are too small to strongly achieve the public policy purposes of the program. The average capital of the 79 SSBICS is $2.3 million compared with $11.97 million for the 156 regular SBICs which have leverage.