Portfolio Media, Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@portfoliomedia.com

The SBIC Program — An Alternative Source Of Capital

Law360, New York (February 09, 2010) -- In this challenging fundraising environment, private equity ("PE") managers have shown increased interest in obtaining capital through the Small Business Investment Company ("SBIC") program, which provides attractive loans to PE firms licensed by the Small Business Administration (the "SBA") for the purpose of financing small businesses.

Benefits of the SBIC Program

The SBIC program offers a PE fund access to SBA leverage, enabling the PE fund to:

- Borrow at rates generally lower than traditional lending sources (September 2009 SBA leverage was priced at just over 4 percent);[1]

- Increase the size of its fund (to the sum of limited partner ("LP") capital plus SBA leverage);

- Reduce the number of capital calls from LPs (by drawing SBA leverage for interim capital needs); and

- Thereby enhance LP returns.

The February 2009 American Recovery and Investment Act, commonly referred to as the Stimulus Bill, increased the maximum amount of SBA leverage available to an SBIC from approximately $137 million to $150 million (or $225 million for a group of affiliated SBICs).

Because an SBIC may generally borrow two (and possibly three) times its committed capital, a $50 million fund may become a $150 million (and possibly $200 million) fund through SBA leverage.

Licensing Process

To access SBA leverage, a fund must obtain an SBIC license, which includes filing a license application, submitting to background checks and attending SBA meetings. This process generally takes between eight and 12 months.

As part of the licensing process, the SBA considers the fund managers' investment and managerial experience and track record, as well as the fund's strategy. In general, the SBA prefers (among other things):[2]

- Experienced fund managers who have worked together;

- A realized track record of superior investment returns that are consistent with the applicant SBIC's business strategy;

- Evidence of strong deal flow in the SBIC's proposed investment area;

- Managerial, operational and/or technical experience that adds value at the portfolio company level; and

- A demonstrated ability to manage cash flows in order to provide assurance that the SBA will be timely repaid.

Regulatory Regime

Once formed, an SBIC is subject to various regulatory requirements governing (1) the types of portfolio companies ("PCs") in which the SBIC may invest, (2) financing terms the SBIC may provide to, and transaction fees it may charge, the PCs, (3) capital requirements and distributions to LPs, (4) management fees chargeable to LPs and (5) SBA audit and reporting requirements.

1) Restrictions on PCs. An SBIC may invest only in a "small business," defined as a business that meets at least one of two size tests:

- Financial Statements Test: The PC (together with its affiliates) must have both (a) tangible book net worth not in excess of $18 million and (b) average net income not in excess of $6 million for the prior two fiscal years; or

- Revenues/Employees Test: The PC must meet certain employee or revenue standards for the industry in which the PC is principally engaged.[3]

In addition, an SBIC is generally prohibited from (1) making passive investments, (2) investing in real estate businesses, banks, investment companies, insurance and finance companies and certain other businesses, (3) financing projects (rather than ongoing businesses) or (4) investing in non-U.S. businesses.

2) Financing Terms and Transaction Fees. An SBIC may invest in the debt or equity of a qualifying small business, including acquiring control. However, the financing terms are subject to SBA regulation. For example, generally:

- A financing must be for a duration of at least one year;

- A financing may not exceed a 20-year term;

- The interest rate (together with points, discounts, royalties, profit participation and certain fees) is currently capped at 19 percent for a loan (i.e., a straight debt instrument with no equity element) and 14 percent for a debt security (i.e., a debt instrument with a provision for acquiring or converting into equity securities);

- A PC's application fee may not exceed 1 percent for any financing, and a closing fee is capped at 2 percent for a loan and 4 percent for a debt or equity security; and

- The default rate of interest on any debt financing may not exceed seven percentage points above the contractual rate and may only be triggered by two situations: nonpayment of principal or interest and/or a failure to deliver required financial information.

In addition, because SBICs must make semi-annual interest payments on any SBA leverage, SBIC financings to PCs often include mezzanine debt with periodic interest payments to enable the SBIC to meet its own interest obligations to the SBA.

3) Capital Requirements and Limitations on Distributions to LPs. SBA regulations include certain requirements related to (a) LP capital commitments to the SBIC, (b) the diversity of the LP capital sources and (c) distributions to the SBIC's LPs.

For example, while an SBIC may generally distribute net realized profits less unrealized depreciation in the value of its investments, distributions may not reduce capital by more than 2 percent per year without prior SBA approval.

This effectively means that (in general) an SBIC may not make full distributions of capital and profits to its LPs on a deal-by-deal basis until it has repaid outstanding SBA leverage.

4) Management Fees. The SBA must approve management fees payable by LPs. The SBA formula generally allows management fees during the first five years of approximately 2 percent to 2.5 percent of the sum of the SBIC's qualifying LP commitments plus an assumed amount of SBA leverage (generally 2x LP commitments).

5) Audit and Reporting. An SBIC is subject to annual SBA audit and must comply with various reporting obligations, including quarterly and audited annual financial reports, semi-annual valuations and notification to the SBA of new investments, governance, capitalization, and other major changes to the SBIC's business plan.

SBIC Fund Structure

An SBIC may be formed as (1) a stand-alone investment fund or (2) a "drop-down" fund (i.e., a subsidiary of a traditional PE fund) investing on its own or side-by-side with its parent PE fund.

In a "drop-down" structure, the parent fund may invest (a) directly in PCs that do not meet SBA restrictions (because SBA regulations generally do not apply to the parent PE fund), (b) indirectly through the SBIC in SBA-qualifying investments, or (c) together (side-by-side) with the SBIC in SBA-qualifying investments (which may permit a larger aggregate investment in a PC than permitted by SBA regulations).

Summary

Since 1958, SBICs have invested in successful companies such as Apple Computer, Intel, Staples, Federal Express and Whole Foods Market. Recent regulatory enhancements to the SBIC program demonstrate the government's commitment to further develop the program.

For qualified fund managers willing and able to work within a regulatory environment, the SBIC program may be an excellent method for accessing government-guaranteed financing at favorable rates.

--By Margaret A. Gibson (pictured) and Waldemar Colón, Kirkland & Ellis LLP

Margaret Gibson is a partner with Kirkland & Ellis in the firm's Chicago office. Waldemar Colón is an associate with the firm in the Chicago office.

The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] www.sba.gov/idc/groups/public/documents/sba_program_office/ inv_pooled.pdf

[2] www.sba.gov/aboutsba/sbaprograms/inv/forsbicapp/ inv_application_process.html

[3] This industry-specific employee or revenue test is applied to the PC individually and to the PC and its affiliates as a group. In addition, an SBIC is required to invest at least 25 percent of its invested dollars in “smaller” PCs with tangible net worth of no more than $6 million and average after-tax net income of no more than $2 million for the prior two fiscal years (or in PCs meeting applicable, industry-specific employee or revenue standards).