

The SBIC Program — An Alternative Source of Capital for Private Investment Funds

PENpoints

Recent regulatory enhancements demonstrate the government's commitment to the Small Business Investment Company program, providing qualified fund managers with access to government-guaranteed financing at favorable rates.

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%);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

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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 (i) making passive investments, (ii) investing in real estate businesses, banks, investment companies, insurance and finance companies and certain other businesses, (iii) financing projects (rather than ongoing businesses) or (iv) 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% for a loan (i.e., a straight debt instrument with no equity element) and 14% 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% for any financing, and a closing fee is capped at 2% for a loan and 4% 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: non-payment 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,

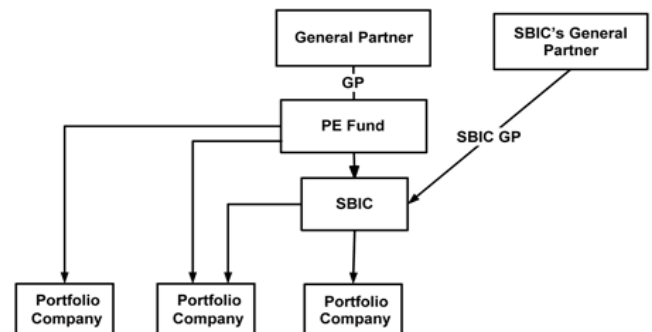
while an SBIC may generally distribute net realized profits less unrealized depreciation in the value of its investments, distributions may not reduce capital by more than 2% per year without prior SBA approval. This effectively means that (in general) an SBIC may not make full distributions of capital 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% to 2.5% 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). A sample structure is set forth below:



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.

1 http://www.sba.gov/idc/groups/public/documents/sba_program_office/inv_pooled.pdf

2 http://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% 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).

If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

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A "Harbinger" of Courtroom Remedies in Deal-Jumping Situations

The normally quiet holiday period in the Delaware courts was interrupted by an important decision on a motion to dismiss claims for damages by NACCO arising from a failed merger with Applica in 2006, following a topping bid from funds affiliated with Harbinger. The ruling provides important guidance for the conduct of sellers and buyers, including topping bidders, in a competitive deal environment. In particular, the decision highlights the importance of current and accurate disclosure when engaged in a public battle for control, and of good faith compliance with the terms of agreements. To learn more about this decision, please see our recent [M&A Update](#).

United States Attorney General Pledges Unprecedented DOJ Focus on Financial Fraud

Attorney General Eric Holder recently gave a speech in which he described the Department of Justice's plan to make the investigation and prosecution of corporate and financial fraud a top law enforcement priority. To learn more about that speech and recent developments in this area, please see our recent [Kirkland Alert](#).

PENnotes

Columbia Business School's 16th Annual Private Equity and Venture Capital Conference
New York, New York
January 29, 2010

The 2010 Columbia Business School Private Equity and Venture Capital conference will focus on the future of the private equity industry and the role firms will play in a changing economic environment. Kirkland partner Kirk Radke will participate in a panel titled "The New World Order: Regulatory Practices and Private Equity Opportunities."

The 2010 Private Equity and Venture Capital Conference at Northwestern University's Kellogg School of Management
Chicago, Illinois
February 10, 2010

The 2010 Kellogg School of Management's Private Equity and Venture Capital conference will provide a forum for discussing the opportunities and challenges that are currently reshaping the private equity and venture capital industries. Kirkland partner Sanford Perl will participate in a panel discussion on "Evolving Strategies for Capital Appreciation."

Kirkland & Ellis International LLP's Private Fund Manager U.S. Investment Adviser Registration Seminar
London, United Kingdom
February 11, 2010

This Kirkland seminar will discuss proposed U.S. legislation that is likely to require European (and other non-U.S.) fund managers to register with the U.S. Securities and Exchange Commission beginning in 2011. Join Kirkland partners Scott Moehrke and Lisa Cawley as they discuss what SEC registration and supervision entails. This event will be held in Kirkland's London office.

The 16th Annual Harvard Business School 2010 Venture Capital and Private Equity Conference
Boston, Massachusetts
February 13, 2010

The 16th Annual Harvard Business School 2010 Venture Capital & Private Equity Conference aims to address issues and trends relevant to venture capitalists, private equity investors, entrepreneurs and those who support the venture capital and private equity communities. Kirkland partners Kirk Radke and Andrew Wright are scheduled to moderate two separate panels.

Beecken Petty O'Keefe & Company Private Equity Conference
Chicago, Illinois
February 19, 2010

This event, hosted by the University of Chicago's Booth School of Business, is designed to give students and friends of the school an opportunity to hear from professionals and alumni in the private equity industry. Kirkland partner Bruce Gelman will moderate a panel on "Infrastructure Investing."

GoldenNetworking.com's Distressed Investing Leaders Forum 2010
New York, New York
February 26, 2010

At GoldenNetworking.com's Distressed Investing Leaders Forum, panelists will evaluate the current distressed investing landscape, review recent regulatory developments promoting the role of private investors in the disposal of financial assets from the FDIC, and discuss opportunities and pitfalls in distressed financial assets. Kirkland partner Edwin del Hierro will speak on "Opportunities and Pitfalls in Distressed Financial Assets" and partner Jonathan Henes will present on "Extraordinary Opportunities Investors Cannot Afford to Pass," at this event, which will be held in Kirkland's New York office.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. In 2009, Kirkland received the awards for Best Law Firm (Private Equity Deals) and Best Law Firm (Fund Formation) in North America from *Private Equity International*. Mergermarket has ranked Kirkland first by volume for Global and North American Buyouts in its "Global M&A Round-up for Year End 2008," and Pitchbook named Kirkland as one of the most active law firms representing private equity firms in its "Private Equity Breakdown" through Q3 2009.

For the second year in a row, *The Lawyer* magazine recently recognized Kirkland as one of the "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In addition, Kirkland's London office was named the 2008 "Banking Team of the Year" at the Dow Jones Private Equity News Awards for Excellence in Advisory Services.

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