THIRD WAY

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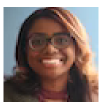
Four Ways to Modernize the SBA's Small Business Investment Company Program



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Takeaways

Launched in the late '50s, the Small Business Investment Company Program fills an important role in the capital markets for businesses that have outgrown SBA's flagship 7(a) loan program. But the program could be doing more to cut a wider path for investors of color as well as underrepresented founders. In this report, we unpack the SBIC program and explore four ways to modernize the program:

1. Increase the number of diverse managers licensed under the SBIC program.

2. Encourage equity investments over debt.

3. Ensure businesses in low-to-moderate income areas are served.

4. Serve a wider geographic footprint to better help rural businesses.

The Small Business Investment Company Program has been responsible for helping household names like Costco, Whole Foods, and Apple get their start.[1] By investing in businesses while they are small, this US Small Business Administration (SBA) program helps companies tap into capital needed to expand and create jobs. Yet, within this important effort, women, minorities, and rural communities struggle to access not just funding, but control of the capital that flows through Small Business Investment Companies (SBICs).

To address this issue, the SBA is working to finalize a rule to significantly reduce the barriers new fund managers face when investing in underserved communities and geographies.[2] That's an important step, and there's a legislative role for Congress to play as well in order to modernize the SBIC Program. In this report, we explore how the SBA can expand access and strengthen diversity in the SBIC program, which in turn can expand access to capital, particularly for diverse-owned businesses.

Four Basics to Know

For those not familiar with the SBIC program, here are four things to know:

The program was designed to link public and private investment: The program was launched in the late '50s to fill a gap in the capital markets for businesses that have outgrown the SBA's flagship 7(a) loan program.[3] Through this program, SBA provides funding to qualified private-sector investment firms who, in turn, invest their own capital and SBA funds, borrowed at favorable interest rates, to qualifying small businesses unable to access traditional sources of funding.

Public capital leverages private capital: In 2021, SBA committed $4 billion to the program which, when paired with $3 billion from private investors, led to more than $7 billion in long-term funding for high-growth potential businesses across the country.[4] Access to capital through the SBIC program has helped thousands of businesses expand, implement upgrades, and hire workers.

Investments in majority-minority areas and disadvantaged businesses are on the rise: Per the Fiscal Year 2022 (FY22) SBIC Program Overview Report, 1,217 companies were financed by SBICs and the number of financed businesses located in low-and-moderate income (LMI) areas saw a 32% increase over the previous year (from 200 in FY2021 to 263 representing 22% of total SBICs). The number of women, minority, veteran-owned businesses that received SBIC funding also increased by 9%—from 75 to 82, representing just 7% of total SBICs.[5]

The number of minority-owned small businesses and investment firms missing out on this funding is still significant: Yet, due to application hurdles, regulatory challenges, and insufficient incentives, the SBIC program still struggles to tap the vast and growing network of diverse investors rising up in American cities. Without addressing the challenges current and prospective program participants face, SBA cannot meet the program's core policy objective: to maximize private financing sources for under-resourced businesses.

A Path to a Modern SBIC

To strengthen diversity and expand access, we must increase the number of diverse managers licensed under the SBIC program, encourage equity investments, incentivize banks to fund SBICs operating in lower-income communities, and broaden the geographic footprint of this market. Here are some thoughts on how to do that.

1. Have more diverse managers licensed under the SBIC program.

Right now, too many diverse fund managers are being shut out of the SBIC program. To start, many minority- or woman-led equity firms are classified as "emerging," as they control a smaller share of capital and operate with a smaller team. But this designation can often place firms at a disadvantage when raising investment capital and applying for the SBIC program. There is a noticeable difference in the rate of success for emerging funds applying for SBIC licenses. Emerging funds are accepted at less than half of the rate of more established applicants. It's no wonder first-time applicants decreased 43% at the end of FY22. [6]

Further, the application process can be a barrier for new fund entrants. While an application should be rigorous to ensure government resources are used effectively, first-time applicants tend to have little knowledge and experience with the process. Current requirements also stipulate that investment firms have multiple seasoned fund managers on staff, as well as significant capital on hand for the pre-application questionnaire, which can cause smaller investors to be shut out.

SBIC Fee	Cost (effective Oct. 1, 2022)
Initial Licensing Fee (paid in conjunction with the submission of the Management Assessment Questionnaire)	$11,500
Final Licensing Fee (paid in conjunction with the submission of the License Application)	$40,200

Note: Not inclusive of the $5 million of regulatory capital, $20-$25 million of private commitments needed at the time the application is filed
Source: "SBIC Licensing and Examination Fees Inflation Adjustment." Federal Register, 24 Aug 2022. https://www.federalregister.gov/documents/2022/08/24/2022-18167/sbic-licensing-and-examination-fees-inflation-adjustment. Accessed 6 Feb 2023.

These problems are notable because emerging and diverse managers have a direct connection to the level of capital that finds its way into minority communities and their businesses. According to a study conducted by the Knight Foundation, diverse-owned asset management firms are at least three times more likely to have diverse investment staff compared to non-diverse asset management firms. [7] Other studies have also found that having a diverse investment team means greater attention paid to founders of diverse backgrounds. [8]

To get more diverse managers licensed in the SBIC program, Congress should take the following steps:

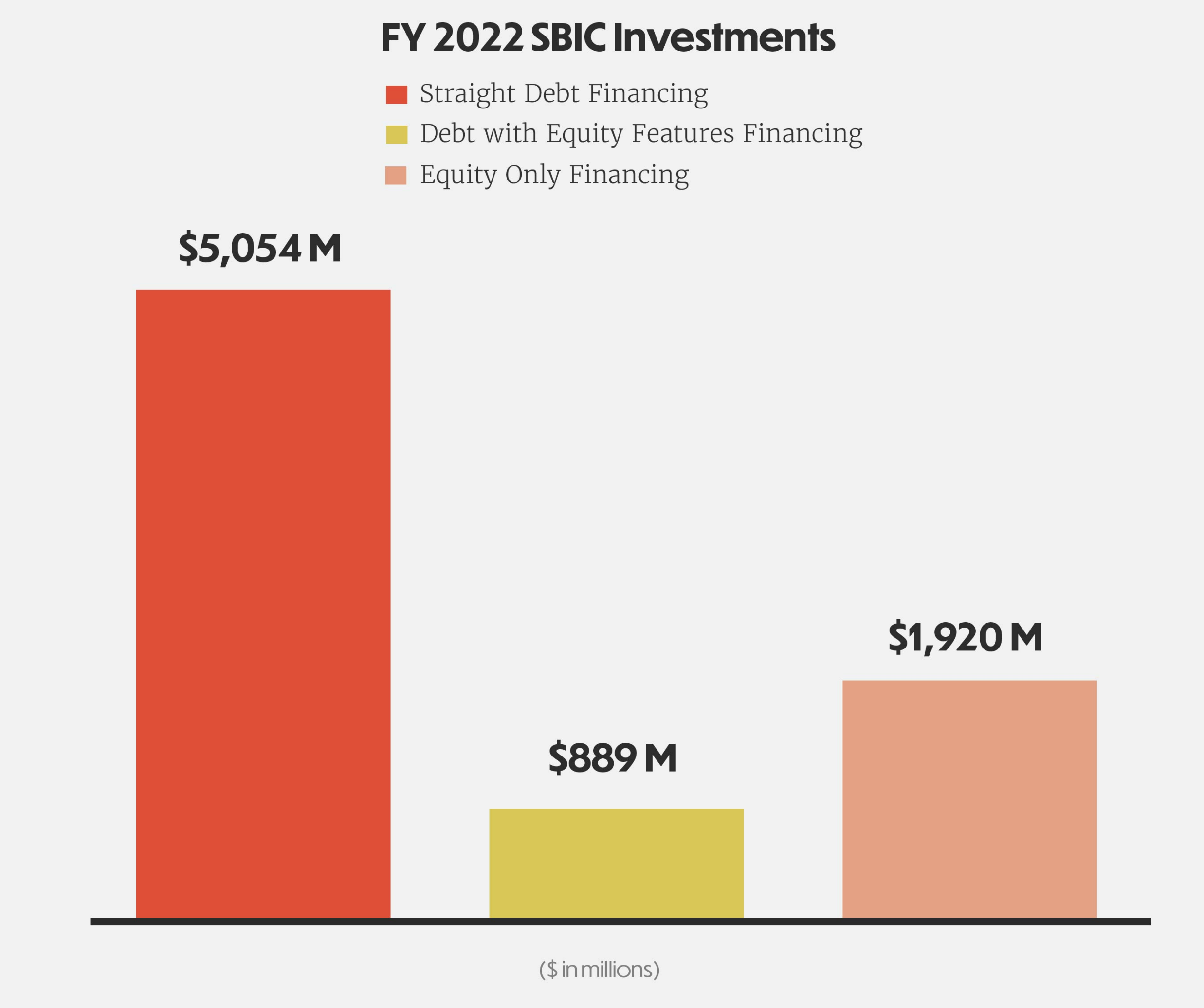
- **Support less-experienced, first-time applicants with an SBIC emerging managers program**, as proposed in Senator Cardin's SBA Reauthorization package introduced last December. This would establish a new license type and pair prospective entrants to the program with highly experienced SBIC managers who can provide guidance and advice. [9] To qualify, firms must have less than 10 years of experience, a focus on underserved markets, and an investment team that is at least 50% from underrepresented communities. By eliminating a key obstacle—access to knowledge and assistance—this proposal would diversify not only the composition of program participants but also the location of SBIC funds.

- **Expand outreach funding for diverse funders**. For example, an approach taken by the House-backed version of the Build Back Better Act would educate and engage prospective licensees on SBIC licensing procedures, further diminishing the knowledge and information gaps we see today.

"We see thousands of promising underrepresented startup founders seeking capital every year, and the opportunity to tap into a more diverse pool of founders is real. So, the founders are out there, but most VCs just are not looking, and even when funds do encounter more diverse founders, they often don't see the opportunity because either the founder or their business doesn't fit into their box of what they predict will be successful." -Brittany Davis, General Partner, Backstage Capital [10]

2. Encourage equity investments rather than long-term debt.

Currently, most SBIC investments to small businesses are straight debt financing. SBA provides funds to SBICs in the form of 10-year unsecured loans with semi-annual interest payments. Most SBIC firms take that capital and structure their investments to small businesses predominantly as loans. For example, only 18% of SBIC financings between 2016 and 2021 were in the form of patient capital—providing time for businesses to grow prior to repayment. [11] In FY22, over $5 billion of SBIC investments were completely debt-driven with no equity features at all. [12]



Source: Small Business Investment Company (SBIC) Program Overview Report for the Fiscal Year Ending September 30 2022." U.S. Small Business Administration, 30 Sept 2022. https://www.sba.gov/document/report-small-business-investment-company-sbic-program-overview-report-fiscal-year-ending-september-30-2022. Accessed 6 Feb 2023.

The problem is, it's not uncommon to see early-stage, high-growth potential startups operate without a positive cash flow for several years until reaching profitability. Because SBICs must cover interest payments back to SBA, most firms tend to finance matured small businesses with significant cash flow. Thus, promising young companies, including those founded by women and people of color, are often overlooked.

To expand capital for minority-owned small businesses, SBA should take the following step:

- **Lessen interest payments due back from SBICs and encourage more investments using equity-focused patient capital**. This can be done by creating an alternative borrowing structure called Accrual Debentures and establishing Accrual SBICs as a new licensing class as proposed by the Biden-Harris Administration. These funds would put 75% of total financings toward equity capital investments, allowing SBICs to explore more venture capital and growth equity investments over a longer term. This could result in an increase of equity capital to small business while lowering the personal debt accrued to fund the business. [13]

Spotlight: Della Clark, Innovate Capital Growth Fund

Della Clark is the President and CEO of the Enterprise Center and has spent the past three decades supporting women and entrepreneurs of color by connecting them to sources of capital and revenue sources like government contracts with the commonwealth of Pennsylvania, where the company is based, or with larger businesses in the region. This led to her establishing her own SBIC called the Innovate Capital Growth Fund, which focuses on investing in companies owned by women, people of color, or veterans.

The reasoning? "Many of these funds do not have fund managers that look like me, and you tend to invest with those whom you feel most comfortable. That's why we need more minority-led SBICs, because you cannot grow to size and scale with just debt. You need both debt and equity. And I think what has happened in America is that we've only put debt in these low-wealth communities. Most minorities don't even know about the SBIC program." [14]

Clark is wagering that with an equity investment from the new Innovate Capital Growth Fund on their balance sheet instead of personal debt, minority- or women-owned businesses will be able to use their assets as collateral for gaining access to small business loans. Businesses can use some cash to make direct investments in the company, pay off debt, or just hold more equity on their balance sheets, so they look more attractive to larger lenders and other investors.

3. Incentivize banks to invest in SBICs Serving Low- to Median- Income Communities.

Unlike Debenture SBICs that borrow money from the SBA, unleveraged SBICs do not. Banks typically choose to launch these funds to access Community Reinvestment Act (CRA) credits. The CRA gives banks special recognition for helping meet the credit needs of the localities in which they serve. These credits are used to determine a bank's performance, which impacts their applications for branches, mergers, acquisitions, and other actions that require regulatory approval.

The CRA counts a bank's ownership or investment in an SBIC toward its CRA rating. Currently, over 500 banks, ranging from small community banks to large banks, are investors in SBIC funds.[15] Further, the CRA requires banks to have a physical presence in the low-to-moderate income (LMI) area in which the SBIC is located. The issue is that an SBIC doesn't necessarily have to distribute funds in that specific LMI area. They are allowed to invest in a much broader "assessment" area and still allow banks to meet CRA criteria.[16]

To expand credit to disadvantaged areas, policymakers should take the following step:

- **Update CRA criteria to help fund businesses in LMI areas**. As regulators look to modernize the CRA and expand access to credit and investment services in LMI areas, it will be important to consider where a bank backed SBIC distributes its funds. The CRA credit was established to increase banking services and investments in LMI areas and reverse the effects of decades of redlining. SBICs backed by banks receiving this credit should follow the same guidance.

Just recently, the House passed H.R. 400, the Investing in Main Street Act, introduced by Reps. Judy Chu and Andrew Garbarino. The bill would amend the Small Businesses Investment Act of 1958 to increase the percentage of capital and surplus that a bank or federal savings association may invest in Small Business Investment Companies (SBICs) leading to increased access to capital.[17]

4. Serve a wider geographic footprint.

In FY21, every state but Wyoming saw at least 1 business secure SBIC financing.[18] In total, 2,500 businesses got financing totaling over $7 billion. And yet, rural states continue to lag far behind others. While economic powerhouses like California, Texas, and New York received a significant amount of financing, more rural states like Iowa, Kansas, Kentucky, Mississippi, New Mexico, and others did not. Further, while there were 51 SBIC funds in New York, 27 in California, and 16 in Texas, many states—from South Carolina to Iowa to Arizona—had just one fund.[19] This leaves rural businesses at a big disadvantage.

Unfortunately, to fully determine the impact of SBICs in concentrated areas, more data is needed. In 2020, the SBA released a rural assessment citing that current "datasets are deficient in trying to identify the reasons 'why' such a gap exists or quantify 'how much' capital is needed by small businesses in the rural areas."[20]

To better serve small businesses in rural areas, Congress should take the following steps:

- **Require and fund better data collection**. Policymakers need a much better sense of the needs of businesses in rural areas as well as how SBICs are performing in rural areas.

- **Recruit rural financing experts**. Congress can establish an SBIC advisory committee to advise the SBA with policy and program recommendations aimed at increasing the number of SBICs investing in both rural and low-income areas.

- **Boost resources to rural small businesses**. Following the recommendation of the Rural Capital Access Act previously introduced by Senators Shaheen, Fischer, and Thune, Congress could provide SBICs with access to additional federally backed leverage—that is exempt from the current statutory cap—for investments made to qualifying small businesses located in rural areas.

Conclusion

Although the SBIC program is meeting its mission of funding small businesses, the program could be doing more to support investors of color as well as underrepresented founders. The Administration’s pending rules will be a positive step in the right direction, and even more could be done if Congress works to increase the program’s reach and impact. With proper investment and opportunities, the SBIC program can expand the overall growth potential of the US economy and secure the future for America’s thriving small businesses.

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