



Testimony before the

U.S. House Financial Services Committee

*America for Sale? An Examination of the Practices of Private
Funds”*

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Chairwoman Waters and Ranking Member McHenry, thank you for the opportunity to testify today and for holding this hearing, “*America For Sale? An Examination of the Practices of Private Funds.*” I am Brett Palmer, President of the Small Business Investor Alliance (“SBIA”).

SBIA was formed in 1958 to represent Small Business Investment Companies, the original American venture capital and private equity funds. As the small business investing market grew more complex, so did SBIA. SBIA now includes Small Business Investment Companies (SBICs), Rural Business Investment Companies (RBICs), Business Development Companies (BDCs), conventional private equity funds, private debt funds and other funds investing in American private small businesses. These private equity funds pursue a wide range of strategies including, but not limited to: venture; venture lending; growth equity; minority equity; control equity; mezzanine and other private debt; unitranche; and other strategies. We also represent the institutional investors (e.g. university endowments, pension funds) who invest into these small private funds because we strongly believe in the importance of maintaining a strong and healthy alignment of General Partners and Limited Partners. The partnerships in private equity must be real and mutually beneficial. Our association’s purpose is to represent the entire lower middle market investing ecosystem, both General Partner and Limited Partner. It is an alliance for professional fellowship, business opportunities, innovation, regulatory expertise and market data. As such, our public policy goals are balanced and focused on maintaining a robust, healthy, and competitive market for investing in American businesses. Our members grow businesses and are rightfully proud of what they do, how they do it, and the benefits their actions have on people and communities.

What is Private Equity

Private equity is a very broad category of capital providers who are commonly misunderstood and often misrepresented to be: solely massive in scale; bad for the economy; non-productive; job destroying; creatures of Wall Street or Silicon Valley; and even economic “vampires”. The truth is investing by private equity is a powerful force for good.

Private equity is a positive force for job creation, innovation, and expanding prosperity to the people and places that are not yet fully benefitting from our system of free enterprise. The profits from private equity fund the retirement security of millions of pensioners and provide the scholarship money used to provide educational access to a new generation of college students. These private equity investments are commonly made in areas of the country that are otherwise passed over or passed by. Most of our member funds are located in Little Rock, Indianapolis, Buffalo, Omaha, Kansas City, and many other places that far from Wall Street or Silicon Valley. Regardless of investing style, private equity investors in small and medium-sized businesses make money by helping the businesses grow and succeed. The idea that private equity funds make money by having businesses

fail is utter nonsense. As one of our members told me “I have been an institutional limited partner into private equity funds for almost 20 years - working at pension funds and private investment firms and I have had literally thousands of pitches given to me. I have NEVER, not once, had someone pitch a “buy a company and break it up” strategy. NEVER! That does not exist. Companies sometimes fail. Yes, sometimes companies are over-levered (or become over-levered as they start to fail) but Private Equity firms don’t ever want a company to fail.”

Private equity helps business grow by not only providing critical, patient capital that conventional banks cannot, but also by helping the smaller business learn how to grow and make big leaps forward that they otherwise would not have been able to achieve on their own. The only way to be a successful private equity fund in the lower and middle market is to find smaller businesses and help them grow into bigger, better businesses.

To put it in the simplest of terms, private equity funds are investment vehicles that pool capital (largely from institutional investors like pensions and endowments) and then invest in businesses that are not publicly traded to help them grow.

Legislation

This Committee has a long bipartisan history of working together to promote the expansion of economic opportunity. We appreciate that history and the ongoing goals of continuing that work. There are several legislative proposals that are on the agenda for this hearing. Most of these proposals we have only recently been exposed to so I will be happy to discuss the concepts and issues in the question and answer sessions. We will follow up with more detailed and technical written comments once our members have had a chance to provide a deeper review.

However, there is one piece of legislation that is founded on such a profound misunderstanding of what private equity is, what private equity does, where private equity is investing, and the impacts of private equity that we feel obligated for our testimony to include a primer on private equity, particularly as it relates to small and medium-sized business investing. The “Stop Wall Street Looting Act” would unintentionally cause serious harm to small businesses’ ability to access capital while hindering private equity funds’ ability to invest in small and medium-sized businesses. Further, it would harm university endowments and pension funds that benefit from private equity investing. It would harm Main Street much more than it would harness Wall Street. It is bad legislation based on an incorrect concept of investing.

The best economic public policy attracts capital and ensures flexibility to increase the capital options available for a company’s success, whether the company is a startup proving its products in a competitive market, a small family owned business managing through generational succession, or a larger company (like those in the retail sector) that are trying to adapt to new competitive threats from technology and e-commerce. Not having the

resources to help these companies deal with change puts them more at risk. The more capital options a company has and the more professional and aware the ownership and management teams are of these options, the better chances for success and survival. This translates to more jobs for our economy.

If Congress can agree on one thing, it should be that regulatory and tax policy should promote and empower private equity to invest in growing more American businesses. Congress should reject any policies that make it harder for private equity to provide access to capital, particularly to smaller and medium-sized business that already face disproportionate challenges to capital access.

The Private Equity Continuum

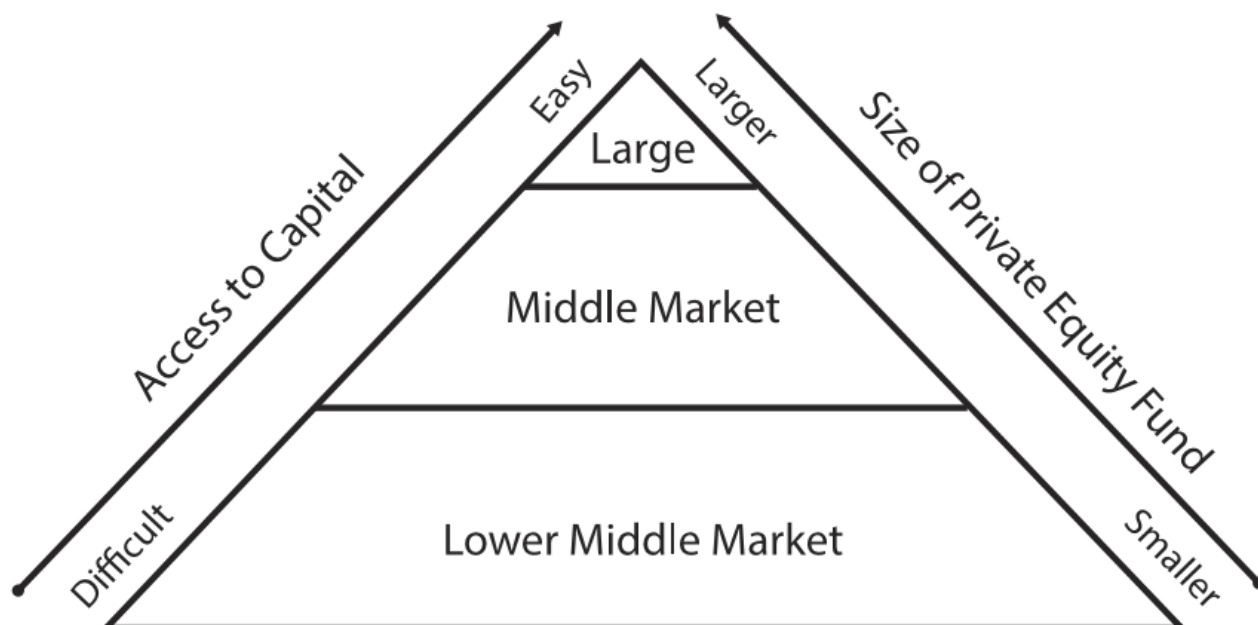
Private equity is a continuum that spans from the very early-stage small angel investors to the largest buyout funds and everything in between. A robust economy requires every segment of this continuum to be healthy. Without angel investors there would be less venture investing, with less venture investing there would be less venture lending; with less venture lending there would be less growth equity investing, and with less growth equity there would be less small buyouts and small spin off investing; and so on. While we segment these investing styles for the sake of simplifying and explaining them, the reality is that they are interconnected parts of the private equity continuum that commonly overlap. Each segment is inextricably interconnected. In a healthy economy every segment of this private equity continuum must exist and be allowed to work. Policymakers cannot harm any segment of the continuum without damaging the health of the whole investing market and reducing the positive benefits of private equity on the American economy.

The private equity continuum reflects the incredible diversity of American businesses and their capital needs. There are tens of millions of businesses in the United States, but the vast majority of them are individuals and sole proprietors. The pool of privately-held and public companies narrows significantly as they get larger. There are many more smaller businesses than there are large ones. Because of the effects of scale, smaller private equity funds are more likely to invest in smaller businesses, thus smaller funds have a far larger choice of businesses to invest in. It must also be noted that like the small businesses they invest in, the smaller the private equity fund the more painful and time-consuming regulatory burdens are. Many of these small business private equity funds are 3-5 people in middle America.

While there is more investing choice because there are a greater number of smaller business, investing opportunities are more difficult to make because smaller businesses require a far greater degree of hands on work by the private equity funds to make that growth happen, and have an inherently higher risk of failure because they do not have the “cushions” that larger businesses have.

What is commonly called “the middle market” contains less than 3% of all American businesses, approximately 200,000 American businesses. These middle market firms account for about one third of both the private sector employment and the private sector GDP.¹ Middle market firms loosely fall into three subsets: lower (\$5-\$150 million/annual revenues) (small businesses); middle (\$150-\$500 million/annual revenues); and, upper (\$500 million-\$1 billion/annual revenues) (the larger end of small businesses to medium-sized businesses). The large-company market has fewer businesses and includes the publicly-traded companies. Despite being the segment with the fewest number of firms, this large segment gets almost all of the public policy and media attention. Small business private equity invests in businesses just entering the lower end of the middle market and in small businesses growing up and into this middle market. Very few of these growing companies want to become publicly-traded companies and very few will ever have an IPO.

For all companies, small and medium-sized business in particular, access to capital is a distinguishing feature that often determines success or failure. Community and regional banks generally help finance small businesses with a stable revenue history and that have assets to borrow against. Local bankers, business brokers, independent sponsors, and investment bankers work with small businesses. The smaller and more rural the businesses the more difficult it is to access capital. Smaller businesses are seen as too risky for most banks and larger financial institutions. Smaller businesses need hands-on help to manage growth; navigate changes in the competitive landscape and generational changes; which is the kind of help that only private equity can provide.



¹ National Center for the Middle Market
https://www.middlemarketcenter.org/Media/Documents/NCMM_Info%20Sheet_2019_web.pdf

Generational changes deserve a special mention because private equity plays a critical role in successfully managing these changes, particularly for SBIA's funds. Most small businesses are "lifestyle businesses" that provide a fulfilling career and support a family, but the business will end when the owner ceases working. But there are also a large number of business that are meant to continue on past their founder's time and many of these founders are aging. There are hundreds of thousands of successful businesses, commonly small businesses, that were founded by baby boomers or post-baby boomers, whose owners need to retire and whose business still has its brightest days ahead. In many of these businesses the founder/owner does not have a child who is willing or able to take over this business. Without a buyer, often a private equity fund or a management team backed by a private equity fund, many of these otherwise successful small businesses will simply shut down – harming their employees, the economy, and their communities.

When these businesses facing generational transfer are sold to a private equity fund or to a private buyer these business grow. The new owners invest for the longer term – investing in new equipment, new technologies, new products, new selling into new markets, and hire new employees. These businesses innovate like a startup but do so with the critical advantage of a proven business model. It is common for the family or founder of the business to retain a minority ownership stake in the business and therefore participate in the ongoing success of the now growing business. The failure rate of these investments is low and the growth rate (both profit and employment) is high.

Change can be disruptive, but in the middle market it is far from heartless or callous to the human impacts of change. Embracing change keeps businesses alive and employing people while failing to change kills businesses and their ability to employ. Not surprisingly, a 2018 report by the National Center for the Middle Market found that the top concerns of middle market business leaders going through transitions were focused on the business' survival and growth because if the business failed then all the other concerns become moot. But 36% of these leaders managing change had "ensuring the well-being of their employees" and 26% had the "financial well-being of their employees" as their biggest concerns. It is my experience that these concerns for employees are particularly acute for smaller businesses and in areas of the country with less economic opportunity. Business owners and private equity investors both genuinely care about people.

Retirement Security and Educational Opportunities

Some of the biggest and least known beneficiaries of private equity are retirees and students. Pension funds and university endowments are some of the biggest investors in private equity because it gives them the best risk adjusted returns. These investments provide retirement securities to those with pensions and provide the capital that helps fund scholarships. Public pension systems in the United States are woefully underfunded and are a strain on taxpayers and beneficiaries alike. One of our members analyzed over 3,500 lower middle market and middle

market buyout transaction over a 20 year period and found that on average these transactions produced a 15+% Compounded Annual Growth Rate for the earnings of the companies that had a leveraged buyout. Pension plans need access to private equity investments like this if they have any chance of meeting their future financial obligations. As the Chief Investment Officer of CalPers recently stated, “We need private equity, we need more of it, and we need it now.”²

SBIA’s Private Equity Funds Invest in People

Accessing capital and empowering growth is core to what private equity is, but it is not just money. Successful private equity managers invest in people too. This is why SBIA partnered with the Fischer School of Business at the Ohio State University to train small business executives how to grow their small businesses and move them up into and through the middle market. Just this month, over 45 small businesses took part in a 3 ½ day intense training seminar NextLevel to teach them how to: attract and maintain employees; manage growth; successfully operate in a leveraged environment, create and implement successful growth strategies, etc. Again, small business private equity only succeeds when businesses grow - and small businesses need to retain employees and often need to add new people to achieve this growth.

Growing Businesses Means Growing Jobs

A 2017 study by the Research Division of the Library of Congress in conjunction with professors from Duke and Pepperdine found that businesses backed by Small Business Investment Companies created three million new jobs over the 20 year period they studied.³ This study also found that these Small Business Investment Companies supported businesses that had an additional 6.5 million jobs. These employment numbers are even more impressive when the fact that the study covered the period of the Great Recession, the Tech Bubble bursting, and the 9/11 slowdown. Small business investing is longer-term, very illiquid investing so these private equity investors are committed to making these small businesses succeed through the good times and the bad times.

According to a recent Ernst & Young report prepared for the American Investment Council, 8.8 million workers are directly employed by the private equity sector (covering the range of private equity-backed business from small to large). These workers collectively earn \$600 billion in wages and benefits. Moreover, suppliers to the private equity sector employed an additional 7.2 million workers that earned \$500 billion in wages and benefits.

² “CalPERS Not Alone on Private Equity Shift.” Pension & Investments (April 1, 2019)

³ Paglia and Robinson, Measuring the Role of the SBIC Program in Small Business Job Creation, Report for the Library of Congress, at 4 (January 2017) <https://www.sba.gov/sites/default/files/articles/SBA_SBIC_Jobs_Report.pdf>.

Where Do Companies Obtain Capital?

For the hundreds of thousands middle market companies, access to capital becomes easier with more options as the business gets bigger. Smaller businesses have a much harder time accessing loans (particularly based on cash flow) than do larger businesses. Similarly, smaller businesses do not have ready access to equity capital the way publicly traded businesses do. As a business becomes larger and more sophisticated, its revenue stream expands as do the options for capital access.

Companies in the upper-middle market have access to most of the capital market options available to large publicly-traded companies. These businesses may also attract attention from large investment banking firms, subject to their risk tolerance for the particular sectors where these upper-middle market business operate.

Commercial banks, merger and acquisition advisors, and private investment bankers often work with lower and middle-market companies. Smaller businesses can attract SBIC, VC, RBIC, BDC, or PE capital.

Women, Minorities, and Underinvested Areas

I was hired at SBIA by the first Chairwoman of the Board of any national private equity or venture capital association. In the years that followed, she has been succeeded by other women Chairs of our board. Both currently and for many years past, SBIA's board has had racial and gender diversity not only on the board, but in leadership positions, including our current chair of the board, several of our officers, and our current Northeast Regional President. We also have members of the Board from places that are not the center of financial universe. For example, our Chair of the Board is in Indianapolis. Our members regularly invest in areas of the country that are far from the financial centers, particularly for investments in manufacturing. While our leadership and membership is far more diverse than the private equity industry at large, it still does not proportionally reflect the population of America. Over time, this is changing, and we will continue to do our part to bring in more talented investing professionals into our segment of private equity.

Private Equity Fund Managers Have "Skin in the Game"

Private equity fund managers generally must invest a significant portion of their personal wealth to their fund before outside institutional investors will invest in their fund. Fund managers' interests are closely aligned with their outside investors. Fund managers lose their own money if their fund's institutional investors (pensions and endowments) lose money and they only make money if their institutional investors make money.

A sampling of private equity investments and their impact

Henderson Products, Inc. (Manchester, IA)

Henderson was founded in 1946 in Cedar Rapids, IA as a manufacturer of agricultural attachments and spreading equipment that was later moved to Manchester, IA in 1958. When Henderson received private equity investment, it was a leading manufacturer and up-fitter of heavy-duty truck equipment used by municipalities for snow removal and ice control. At the time of the SBIC investment, Henderson had full year revenue of approximately \$55.4 million and employed 225 people. Around the time of the SBIC fund's exit, Henderson had full year revenue of approximately \$66.8 million and employed 320 people.

Paragon Bioservices Inc (Baltimore, MD)

Paragon is an industry-leading contract development and manufacturing organization whose focus is the development of cutting-edge biopharmaceuticals.

In August 2018, Paragon received growth capital investments from Spring Capital Partners and Eagle Private Capital. Each Small Business Investment Company invested \$9 million in a mix of subordinated debt and preferred equity. Paragon was able to use this capital to fund the build out of a new facility near Baltimore, allowing the business to hire new employees and sign contracts with leading gene therapy companies.

The company was ultimately acquired by a publicly traded firm in 2019 for over \$1 billion and is on track to increase its employment by approximately 80 percent through the end of this year.

Televerde (Phoenix, AZ)

Televerde is a global demand generation company that provides sales and marketing solutions to help clients generate demand and nurture leads. Services include Marketing Technology Services, Strategic Engagement Planning, Data Intelligence, Demand Generation & Teleservices, and Inside Sales.

The company started out in a small trailer based at the Arizona State Prison Complex – Phoenix prison yard with eight incarcerated females as employees in its contact center. It has since expanded operations, and grown to over 500 employees, including many former inmates who are making the transition to their new, productive and independent lives. Approximately 250 members of Televerde's workforce are formerly incarcerated and who are now on path to independence

The BDC Main Street Capital Corporation has been invested in Televerde since 2011. "We are proud to partner with a company that has reduced recidivism from 68% for the general population to 6% for Televerde demand generation employees," said Vince Foster, CEO of Main Street Capital.

Private Equity Is Not One-Size-Fits-All

Private equity is a form of financing where capital, commonly pooled by from institutional investors (ranging from high-net worth individuals to state and local employee pension funds and university endowments) that seek strong and stable returns to counter current unfunded liabilities, is invested into a company in exchange for equity.

Today's PE funds are investing in a wide array of industry sectors and portfolio companies. The vast supply of those companies, moreover, are in the middle market. Baby Boomers own the bulk of those companies and many are ready to reduce their involvement in the companies that they built or transfer ownership entirely but do not have a succession plan or family member ready or interested in taking over. Without a willing buyer, those owners may have no practical option but to close operations, eliminating jobs and their economic contributions to local economies. PE fund investments create economic value for shareholders and economic growth for communities where those companies can continue to operate and create new and sustain existing jobs.

Private Equity Invests for the Long-Term

The fundamentals behind private equity are to take companies to the full potential by increasing revenue, expanding markets, increasing efficiencies, generally increasing performance, lowering the costs of doing business, and ultimately creating increased value so the business can be sold to a new buyer.

The private equity business model requires that funds eventually sell their portfolio companies at their highest valuation because this generates returns for investors in a fund. Strong returns may lead those investors to re-invest with the same fund managers. Good performance also helps attract new investors like public pension funds that have a fiduciary investment returns to help mitigate unfunded pension liabilities. The private equity process injects needed capital to continue the economic lifecycle and help more businesses that otherwise may have no other sources of capital available to them.

This improvement and growth process takes time. Generally, a private equity fund has a lifespan of about 10-12 years. The first several years are the period when the fund raises capital from investors. The fund then spends 3-5 years making investments in portfolio companies and then another 3-5 years harvesting those investments. Private equity funds are regularly buying, growing, and holding the business for over five years.

The form of a private equity fund is fairly uniform while the major types of PE investments vary:

- **Angel Investors.** These are generally wealthy individuals or groups of individuals who invest their own money into startup businesses or existing businesses with growth potential. Many angel investors were

successful entrepreneurs themselves and have a passion for sharing their expertise in growing local businesses.

- **Venture Capital.** Venture capital is regularly assumed to invest in brand new startups that do not yet have revenue. This is often true, but not universally true. Venture funds tends to invest in companies that are earlier stage, but they also invest in proven models that have not yet scaled or who have burned through the investments they received from friends/family, angel investors, or earlier round venture funds. Venture funds tend to be higher risk with a higher percentage of failed companies, but it is exactly that willingness to take on higher risk that makes them attractive to institutional investors looking for a higher reward commensurate with their higher risk. This type of investing is extremely geographically concentrated to California and the New York to Boston corridor. It is also highly concentrated in technology and biosciences. Venture funds commonly seek to take their successful businesses public via an initial public offering if they are able.
- **Venture Lenders.** Venture lenders are private debt funds that do what most bankers and lenders generally think is crazy. They loan money to fairly new companies with no assets that are losing money. These are extremely high risk loans. Getting a venture loan instead of a new equity round of investment allows a business to continue to grow without the founder and early investors being diluted. Venture lenders are generally paid back when the next equity round is received and they almost always take warrants in the business.
- **Growth Equity.** Growth equity investments seek to invest in companies that are no longer in the startup phase and could also be well-established businesses. They generally provide patient capital in the form of equity to finance growth of the businesses. A growth equity investment can be one for majority control, which is generally considered to be less risky, but sometimes less attractive to the diluted owner/founder. Growth equity can also be a minority investment. Minority investments are commonly seen as more risky because the private equity fund has less control over the company and therefore less control as to when their limited partners will be paid back for the investment. Growth equity generally does not use debt because all the available cash is being used for growth and not debt service.
- **Mezzanine Financing.** Mezzanine financing (or, “mezz-debt”) is considered a hybrid brand of PE financing because it is essentially subordinated debt paired with an equity component. It is generally unsecured and subordinated to senior bank debt and comes with a higher interest rate because of the higher risk to the lender. Typical uses for mezzanine financing by a portfolio company include acquisitions, new product launches or business unit startups, and recapitalizations. This type of capital is often attractive

to “asset light” businesses with good cash flows that cannot access conventional bank capital. Normally, once mezzanine investments are made the business is then able to access additional capital from banks.

- **Unitranche Financing.** Unitranche debt is a PE structure that combines senior and subordinated debt within a single loan governed under a single set of loan documents. First used in the United States in 2005, unitranche debt is considered an alternative credit market for middle-market companies that may not have easy access to large credit facilities from traditional financial services firms. This makes it an especially attractive instrument for lower-middle market companies that need flexible capital.
- **Turnaround.** Turnaround funds invest in companies that are in trouble and are often on a path to failure. If the business is not turned around and saved, then all the jobs will be lost. If the business is saved, then some of the jobs are saved and some jobs may even be created. These are turnarounds are not easy and some business cannot be saved despite additional capital a extensive help. Turnarounds are not predatory. Turnarounds save businesses and jobs.
- **Buyouts.** Buyout (or, “leveraged buyouts” or “LBO”) are generally change-of-control transactions where a PE fund purchases majority control in a portfolio company using its own capital and debt that has recourse only to the target company.⁴ This strategy is best fit for portfolio companies that generate adequate cash flows necessary to service the debt incurred to purchase the company. Buyouts can be used to handle generational transfers, purchase of the company by employees, purchase of the business by a private equity firm, purchase of the business by a larger business, etc. Buyouts do not mean job losses. Buyouts regularly create jobs and aid innovation with the company under new management.
- **Rural Business Investment Companies.** Commonly called “RBICs” are private equity funds that are licensed and regulated by the US Department of Agriculture and invest nearly exclusively in rural areas.
- **Small Business Investment Companies.** Commonly called “SBICs” are private equity funds that are licensed and regulated by the Small Business Administration. SBICs invest exclusively in domestic small businesses.
- **Business Development Companies.** Commonly called BDCs are a form of private equity that is regulated by the Securities and Exchange Commission. BDCs must invest at least 70%, but commonly invest 100%,

of their assets in domestic companies that have less than \$250 million in enterprise value. BDCs tend to invest in small business, but larger BDCs can invest in medium-sized businesses.

Like any large industry, there are examples of failure, which get all the attention. However, the overwhelming record of private equity is positive. Private equity is a powerful force for good in our economy and for our nation.

Thank you for the opportunity to testify before the Committee and I would be happy to take questions.

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