Statement of John K. Paglia
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Before the

U.S. House of Representatives
Committee on Small Business

Hearing on "SBA Management Review:

Small Business Investment Company Program"

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Dear Chairwoman Velazquez, Ranking Member Chabot, and Members of the Committee on Small Business:

Thank you for the opportunity to testify before you today. Sound deployment of capital in the U.S. is central for promoting economic growth and I am grateful for the opportunity to speak to you on this important topic.

I grew up in a household where my parents owned and operated small businesses so this topic is very personal. I also worked closely with small businesses as a CPA, business appraiser, consultant, advisor and corporate director; and more recently through research studies leveraging the insights and observations I've accumulated over several decades. At Pepperdine University, where I am a Professor of Finance and Senior Associate Dean at the Graziadio School of Business, I co-founded our *Pepperdine Private Capital Markets Project* in 2007, which is the first simultaneous, comprehensive, and on-going investigation of the major private capital market segments. This research seeks to understand the true cost of private capital across market types and the investment expectations of privately-held business owners; providing lenders, investors, and the businesses that depend on them with critical data to make optimal investment and financing decisions and better determine where the opportunities to create lasting economic value may be realized. As part of this research, I also co-led the launch of our *Private Capital Access Index* – a quarterly economic indicator designed to measure the demand for, activity, and health of the private capital markets— in partnership with Dun and Bradstreet, and our *Market Pulse* report—a quarterly survey of market conditions for small businesses being sold— in partnership with the International Business Brokers Association and M&A Source. I also helped craft the vision for, and led the launch of, our *Dan and Coco Peate Institute for Entrepreneurship*. Furthermore, I was instrumental in launching our *Most Fundable Companies* initiative to help bridge the startup funding gap, and designed, led, and taught our 3-day *Certificate in Private Capital Markets* executive education program as well as our *Private Capital Markets* class.

Along the way, I've leveraged my unique direct experiences, insights, and knowledge to produce relevant research on startup companies and small businesses, including three research papers on the *Small Business Investment Company* (SBIC) program with co-author Professor David Robinson at Duke University. These were prepared by the Federal Research Division of the Library of Congress under an interagency agreement with the Small Business Administration's (SBA) Office of Investment and Innovation (OII). I'll speak to this research momentarily.

But before I do, it is important to note three points regarding small business's access to capital highlighted by the Pepperdine University studies, based on data collected from July 18 to Aug 2, 2019:

- ***56% of small business owners surveyed indicate it is difficult to raise new external equity financing; 59% indicate it is difficult to raise new external debt financing.*** When disaggregated between those with less than $5M in revenues, 61% indicate difficulty raising equity; and 62% indicate difficulty raising debt. The $5M - $100M revenue group indicates 30% equity difficulty and 29% debt difficulty. [1]
- ***60% of small business owners say the current business financing environment is restricting growth opportunities for their businesses; 54% indicate it is restricting their ability to hire new employees.*** When disaggregated between those with less than $5M in revenues, 64% indicate restrictions on growth and 57% indicate restrictions on hiring. The $5M - $100M group indicates 27% growth restriction and 25% hiring restriction.[2]
- ***39% of businesses are planning to raise financing and/or capital in the next 6 months.[3] Of them 69% cite 'planned future growth or expansion' as one of the reasons.[4] In the presence of an unsuccessful raise, 68% cite 'slower business growth', 46% indicate they'd have to reduce their number of employees.[5]*** Just 14% indicate that an unsuccessful financing and capital raising event would have no expected impact on growth, business size or hiring plans.

[1] Pepperdine Private Capital Access Index, Third Quarter 2019, Craig Everett, page 29.
[2] Ibid, page 20.
[3] Ibid, page 37.
[4] Ibid, page 38.
[5] Ibid, page 57.

So the consequences of small businesses not obtaining capital and financing are potentially severe and detrimental to overall economic health. One such program that helps with capital deployment, especially in those segments where other private institutional capital isn't nearly as concentrated, is the SBA's SBIC program.

As mentioned previously, I had the opportunity to examine three main questions, along with my coauthor and with the support of the Library of Congress, using the SBA data: 1) Is the SBIC program diverse? 2) Does the SBIC program create jobs? 3) Where does the SBIC program fit into the broader financing landscape?

1. Measuring the Representation of Women and Minorities in the SBIC Program[6][7]

The goal of this report is to contribute to a growing body of knowledge about gender and racial diversity in the venture-capital (VC) and private-equity (PE) arenas.

Key findings included:

- ***SBIC funds are more gender diverse than the broader venture capital and private equity community (VCPE).*** Approximately 11.9% of SBICs had women on their investment teams vs. 7.9% for the broader VCPE community.
- ***Approximately 10.2% of SBIC funds have at least one ethnic or racial minority on their investment teams.*** While there are various racial diversity statistics for the population of businesses in the United States, there is no such data for the private equity universe specifically.
- ***Racially diverse SBICs make more investments in minority-led and minority-owned portfolio companies, as well as in women-led and women-owned businesses than non-racially diverse SBICs.*** Approximately 12% of the investments made by racially diverse SBICs are in companies led by minority CEOs; whereas the number for non-racially diverse SBICs is about

[6] Paglia and Robinson, Measuring the Representation of Woman and Minorities in the SBIC Program, October 2016.
https://www.sba.gov/sites/default/files/aboutsbaarticle/Measuring_the_Representation_of_Women_and_Minorities_in_the_SBIC_Program_2016_10.pdf

[7] The analysis in this report is based on 1995–2015 SBIC data from SBA Portfolio Financing Report (SBA Form 1031) filings, which are submitted by SBICs within 30 days of closing on a financing, and SBA Annual Financial Report (SBA Form 468) filings, which are audited and submitted by SBICs annually. OII provided supplemental demographic information on the SBIC funds for the years 2013–15.

5%. Similarly about 19% of the investments made by racially diverse SBICs are to companies that are at least partly owned by women or ethnic or racial minorities, while about 13 percent of the investments made by SBICs without racial diversity are to such businesses.

- ***Gender-diverse SBICs make more investments in women-led and women-owned portfolio companies than non-gender-diverse SBICs.*** Gender-diverse SBICs make two to three times more investments in portfolio companies with a female CEO than male-only SBICs. Approximately 10.3 percent of the investments made by gender-diverse SBICs are in female-led companies, while the corresponding figure for SBICs with no gender diversity is 3.4 percent.
- ***There is some evidence that racially diverse SBICs direct more capital to LMI communities.***

These conclusions suggest that diverse populations are better served by and through a diverse team of fund managers. A summary of these findings are located in the appendix.

2. Measuring the Role of the SBIC Program in Small Business Job Creation[8][9]

The goal of this report is to contribute to a deeper understanding of the role that the SBIC Program has played in creating and sustaining jobs in the small business sector. The report addresses key questions concerning the number of jobs created and/or sustained by the program.

Key findings included:

- ***The SBIC-funded small businesses in the sample used in this report created almost 3 million jobs during the sample period (October 1995–December 2014).*** This figure is based on observations from 11,681 SBIC-funded firms.
- ***The SBIC-funded small businesses in the sample used in this report created or sustained almost 9.5 million jobs during the sample period.*** Jobs created or sustained is an expanded scope of job creation that includes not

[8] Paglia and Robinson, Measuring the Role of the SBIC Program in Small Business Job Creation, January 2017. https://www.sba.gov/sites/default/files/files/SBA_SBIC_Jobs_Report_0.pdf.

[9] The analysis in this report is based on 1995–2014 SBIC data from SBA Portfolio Financing Report (SBA Form 1031) filings, which are submitted by SBICs within 30 days of closing on a financing, and SBA Annual Financial Report (SBA Form 468) filings, which are audited and submitted by SBICs annually.

just the jobs that were added after a firm received SBIC funding, but also those jobs that were maintained in these businesses during the time the companies received such funding.

- ***Companies funded by non-leveraged SBICs (those that are licensed with the intent of never issuing leverage, which include bank-owned SBICs) created the most number of jobs during the sample period, at 530 jobs per firm on average. Businesses funded by SBICs in the SBA's participating securities program created the second highest, at 438 jobs per firm. Debenture-funded companies created an average of 125 jobs per firm, while businesses financed through the specialized SBIC (SSBIC) created an average of 22 jobs per firm.*** On average, employment in small businesses funded by these SBIC programs grew by 45.6 percent.
- ***On average, one new job was created for every $14,458 of funding invested through the SBIC Program, while an average of one job was created or sustained for every $4,525 invested.*** Restricting the analysis to only those firms financed through active licensees, we found that one new job was created for every $16,340 invested, and one job was created or sustained for every $4,603 of SBIC funding. Between 1999 and 2015, the net government administrative cost was about $0.0024 per dollar of funding deployed, or $2,400 of government administrative cost[10] for every $1 million of capital deployed. This, in turn, means that the average administrative cost was approximately $35 per job created, and about $11 per job created or sustained.

These findings indicate that SBIC-funded small businesses are a robust source of job creation in the U.S. economy.

3. Measuring the Role of the SBIC Program in Financing Small Businesses[11][12]

[10] SBA provided administrative costs on the SBIC program from its program overviews. Administrative costs include the direct costs from the operating budget, including contracts, compensation and benefits, but may not include agency wide costs, such as rent and telecommunications and indirect costs. SBA also provided the administrative fees it collected to offset its administrative costs. The net government administrative cost was calculated by subtracting administrative fees from the administrative direct costs identified in its program overview.
[11] Paglia and Robinson, Measuring the Role of the SBIC Program in Financing Small Businesses. July 2017. https://www.sba.gov/article/2019/aug/28/measuring-role-sbic-program-financing-small-businesses.
[12] The analysis in this report is based on 1995–2015 SBIC data from SBA Portfolio Financing Report (SBA Form 1031) filings, which are submitted by SBICs within 30 days of closing on a financing, and SBA Annual Financial Report (SBA Form 468) filings, which are audited and submitted by SBICs annually.

The goal of this report is to contribute to a deeper understanding of the role the SBIC program has played in providing financing to the small business sector. The report addresses key questions concerning the role the SBIC program plays in the overall financial industry.

- ***SBIC investments support companies that are less likely to be considered by private equity investors.*** SBICs invest in companies that are smaller than those funded by traditional private equity sources of similar size and investment focus. Because they are smaller, investing in these companies is typically less attractive to larger private equity investors.
- ***SBIC investments fund different sectors than the rest of the private equity universe.*** As a group, SBICs deployed the largest concentration of dollars—nearly half—to the B2B sector, more than double the share invested by the overall investment community. SBICs also invested considerably less in other sectors traditionally favored by the broader financial industry, including the B2C sector, which SBICs funded at half the rate of the overall investment community.
- ***SBIC investments spread capital in a more dispersed manner across the country than the rest of the private equity universe.*** The SBIC program funds deals that are more widely geographically distributed than the broader investment fund community, both in terms of the proportion of deals by region and the proportion of dollars invested by region. Displaying a far lower concentration of capital on the West Coast, the majority of SBIC funds invest in traditionally underserved regions of the United States, particularly Kansas, Minnesota, Nebraska, North Dakota, and South Dakota in the northern Midwest, and Alabama, Kentucky, Mississippi, and Tennessee in the South.

Altogether, these findings show the tangible value SBIC funds provide as a robust source of funding for small businesses in the U.S. economy. As compared to the broader financing landscape for small and mid-sized businesses—where over 35,000 deals were made and over $1.5 trillion was invested—SBICs have higher capital distribution ratios among small businesses and distribute capital more evenly among nine geographic subregions.

Overall, based on our research, the SBIC program has demonstrated relative strength with respect to diversity and inclusion, success on the job creation front, and a more balanced funding distribution in the small business financing landscape across company sizes, industries, and geographies.

I should point out that recent success is predicated on the fact that those ‘worthy’ small businesses are able to navigate the relatively opaque private capital markets successfully. ***Small business financing and capital formation would benefit greatly with increased transparency and robust educational programming.*** Small businesses have at best a moderate understanding of the types of financing and capital components available to them, the process to obtain funding, the “costs” of each type, advantages and disadvantages of each financing and capital type, how to qualify for financing and capital, which firms and entities to contact for funding, and success rates for each type. (See “*Small Business’s Level of Knowledge of Funding Components*” in appendix.) Accordingly, when small businesses need financing and capital, some ‘shy away’ from pursuit, or spend lots of time chasing opportunities that aren’t a good fit for their needs, operating characteristics, and firm profile. If they do pursue funding, their mindset is “do I qualify for funding?” versus a larger company mindset of “what is the price of funding?”

Because of this mindset and the relative lack of transparency and knowledge, small businesses make lots of mistakes when pursuing and selecting financing and capital types. In fact, according to a Pepperdine survey, across nineteen different financing and capital types, no greater than 60% of businesses that had an unsuccessful financing outcome feel the general financing and capital *type* is still a good fit for their business.[13] (See “*Confidence in Funding Category Fit after Unsuccessful Event*” in appendix for additional details.) This highlights the inefficiencies in the small company financing and capital markets and speaks to the need for increased transparency and education.

Of course, ***small businesses could also benefit by having greater capital availability and expedited access to financing and capital, especially as needs arise and their capital structures change.*** (See “*Prevalence of Funding Type by Revenue Size*” in appendix.) While due diligence is an important component of any investment opportunity review, and should be thorough, finding ways to achieve faster approvals of capital deployment would also serve to fuel job creation and economic growth. In the case of the SBIC program, having the ability to award

[13] Pepperdine Private Capital Access Index, Second Quarter 2014, Craig Everett.

licenses faster – both for initial applicants as well as those who are seeking approvals for subsequent funds— would likely produce positive benefits for small businesses and serve to further contribute to economic growth.

In summary, small businesses continue to struggle to find the financing and capital they need to grow, especially in a timely and efficient manner. The SBIC program is in a position to further address funding challenges cited by ‘worthy’ small businesses in need of financing and capital to continue to grow, hire and retain employees, and to promote economic growth.

Thank you again for the opportunity to share these points. I’m happy to answer any questions and address comments.

Sincerely,

John K. Paglia
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Appendix

<u>John K. Paglia Bio</u>

John K. Paglia, Ph.D., CFA, CPA
Senior Associate Dean; Professor of Finance
Pepperdine Graziadio Business School

Dr. John K. Paglia is senior associate dean for academic affairs and professor of finance at Pepperdine Graziadio Business School (PGBS). He is also an independent corporate director (board member) and audit committee chair for Simulations Plus Inc. (NASDAQ: SLP), and advisor to several startups. He previously served PGBS in a number of leadership roles over his near 20-year tenure at Pepperdine. Most recently, as inaugural executive director of the Dan and Coco Peate Institute for Entrepreneurship, he led pre-launch initiatives around entrepreneurial education, business incubation, and venture funding to ultimately help student entrepreneurs launch and accelerate their business ventures. He also served as associate dean for part-time (fully employed) programs, director of accreditation, chair of the accounting and finance department, and founding director of the Pepperdine Private Capital Markets Project.

A recognized expert on the topics of small business financing, business valuation, and financing and deal trends, Dr. Paglia has delivered over fifty presentations, including over a dozen keynote addresses, at key investment banking, private equity, accounting, small business, exit planning, and valuation events. He was also honored by the National Association of Certified Valuators and Analysts with the “Industry Titan” Award in 2016, the Alliance for Mergers & Acquisitions Advisors and Grant Thornton with a “Thought Leader of the Year Award” in 2012, and the Association for Corporate Growth with an “Excellence in M&A Award” in 2011. In 2016, he was also awarded with a consultancy contract with the Library of Congress Federal Research Division as a private equity and venture capital expert to conduct research on the economic impacts of the Small Business Administration’s Small Business Investment Company (SBIC) private equity program. His research has been covered in The Wall Street Journal, CNBC, USA Today, Businessweek, TIME, Bloomberg, Reuters, Inc., Forbes, Entrepreneur, MSNBC, ABC News, Huffington Post, Crain’s New York, The Los Angeles Times, The Washington Post, Financial Times, and The New York Times, among many others.

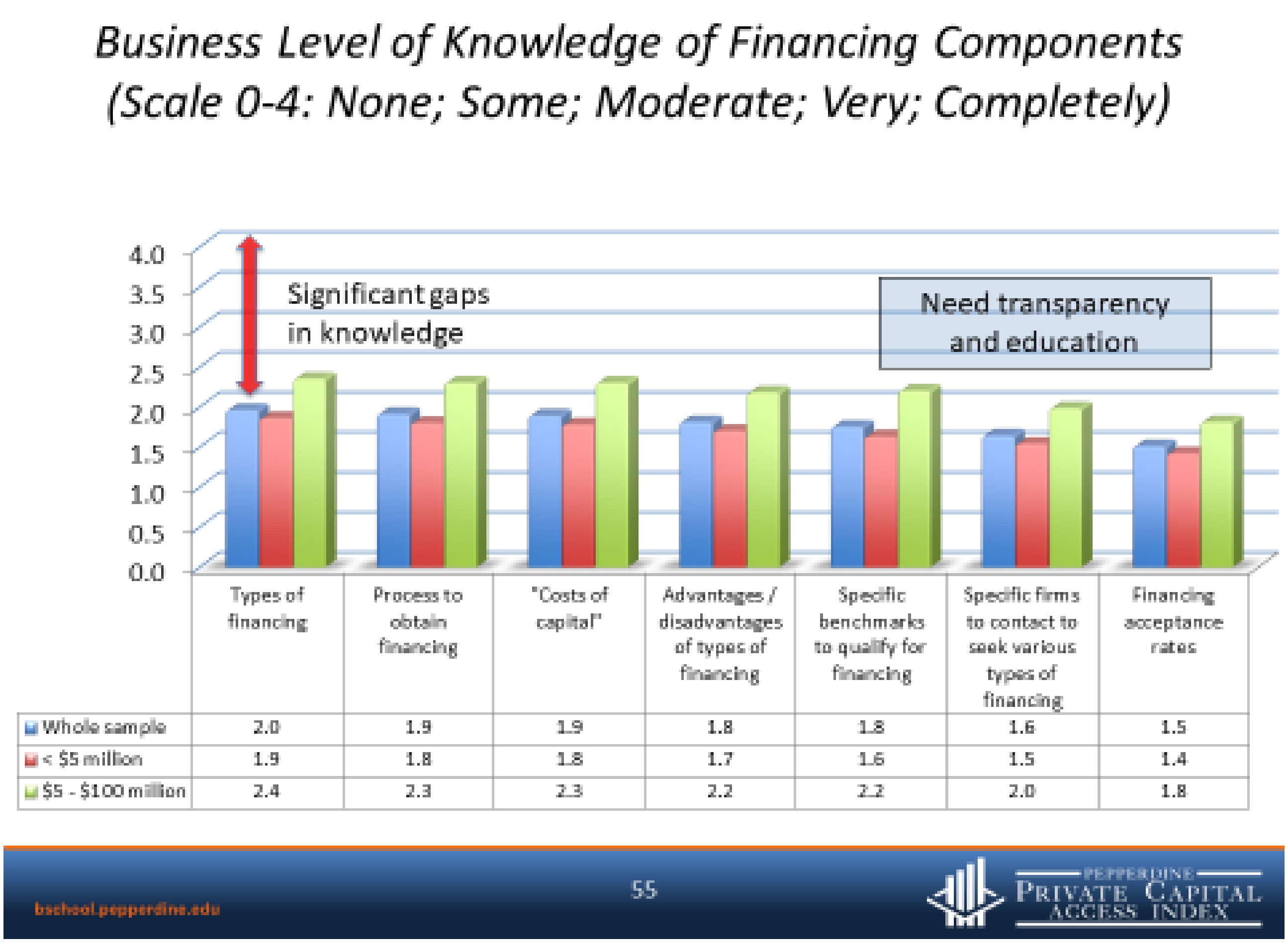
His research has been published in a number of journals including *Journal of Banking and Finance, Journal of Entrepreneurial Finance, Journal of Accounting and Finance, Journal of Business Valuation and Economic Loss Analysis, Business Valuation Review, The Value Examiner, Journal of Wealth Management, The RMA Journal, Graziadio Business Review,* and cited in Congressional testimony and SBA reports.

Dr. Paglia holds a Ph.D. in finance, an MBA, a B.S. in finance, and is a Certified Public Accountant and Chartered Financial Analyst.

Summary Results Table: Measuring the Representation of Women and Minorities in the SBIC Program

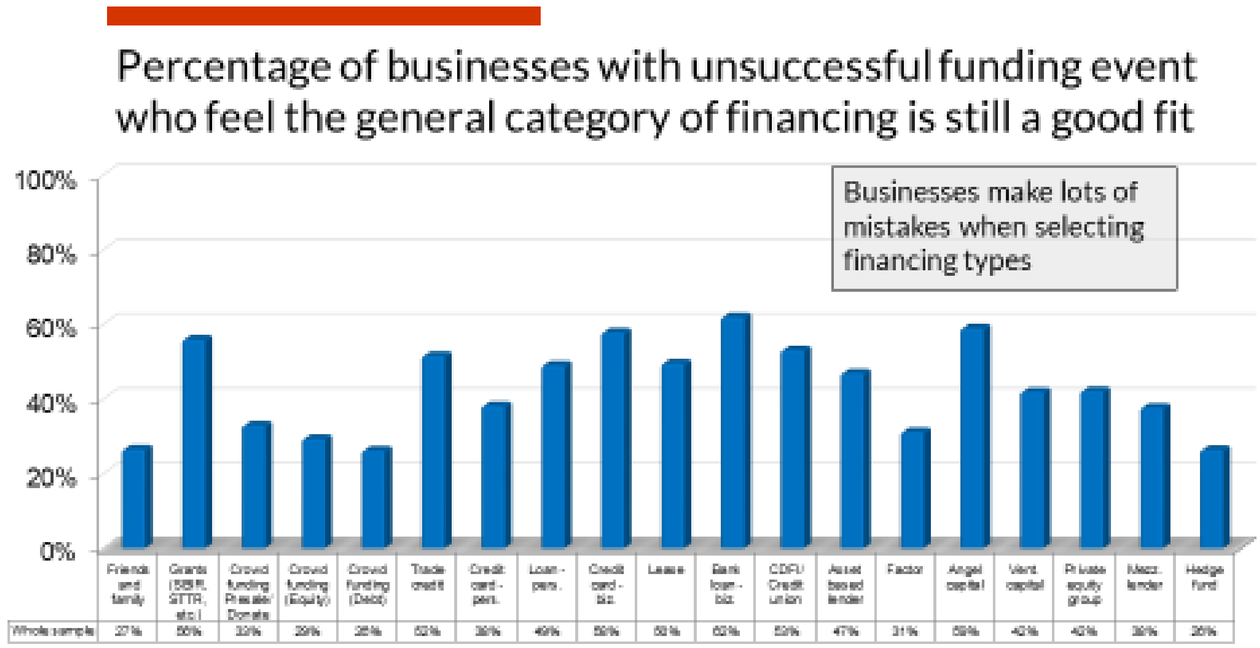
Table 1. Summary of Findings on Diversity in the SBIC Program SBIC Fund Leadership Diversity: How diverse are SBICs in terms of having women and/or ethnic or racial minorities in leadership positions compared to the broader private equity (PE) community?		
Type of diversity:	SBICs	Broader PE Community
Gender diversity	11.9%	7.9%
Racial diversity	10.2%	N/A
Racially Diverse SBIC Investment Behavior: Are racially diverse SBICs more likely to invest in diversely led or owned portfolio companies than non-racially diverse SBICs?		
If the portfolio company is:		
Woman-owned	Yes	
Woman-led	Yes	
Minority-owned	Yes	
Minority-led	Yes	
Gender-Diverse SBIC Investment Behavior: Are gender-diverse SBICs more likely to invest in diversely led or owned portfolio companies than non-gender-diverse SBICs?		
If the portfolio company is:		
Woman-owned	Yes	
Woman-led	Yes	
Minority-owned	No	
Minority-led	No	
Return on Investment by Diversely Owned SBICs: How do diverse SBICs compare in terms of investment performance to non-diverse SBICs?		
Gender-diverse SBICs	Similar	
Racially diverse SBICs	Similar	
Diversely Owned SBIC Investment in LMIs: Are diverse SBICs more likely to invest in LMI regions than non-diverse SBICs?		
Gender-diverse SBICs	No	
Racially diverse SBICs	Yes	

Chart: Small Business’s Level of Knowledge of Funding Components by Revenue Size



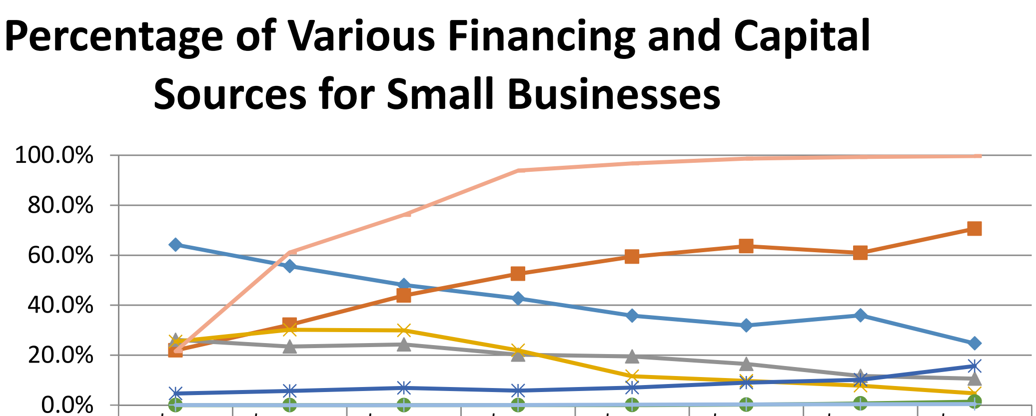
	Types of financing	Process to obtain financing	"Costs of capital"	Advantages / disadvantages of types of financing	Specific benchmarks to qualify for financing	Specific firms to contact to seek various types of financing	Financing acceptance rates
Whole sample	2.0	1.9	1.9	1.8	1.8	1.6	1.5
< $5 million	1.9	1.8	1.8	1.7	1.6	1.5	1.4
$5 - $100 million	2.4	2.3	2.3	2.2	2.2	2.0	1.8

<u>**Chart: Confidence in Funding Category Fit after Unsuccessful Event**</u>



Source: Everett, Craig. *Pepperdine Private Capital Index Survey Responses: Second Quarter 2014.* Quarterly Report, Malibu: Pepperdine University.

Chart: Prevalence of Funding Type by Revenue Size



	$0 - $100K	$100K - $500K	$500K - $1M	$1M - $5M	$5M - $10M	$10M - $25M	$25M - $50M	$50M - $100M
Pers. Inv.	64.2%	55.6%	48.1%	42.7%	35.8%	31.9%	35.9%	24.7%
Debt	21.9%	32.2%	43.8%	52.6%	59.4%	63.6%	60.9%	70.6%
Friends Family	26.1%	23.4%	24.3%	20.2%	19.5%	16.5%	11.7%	10.6%
Credit Card	25.4%	30.2%	29.9%	21.9%	11.6%	9.7%	7.8%	4.7%
Priv Equity	4.7%	5.7%	6.9%	5.8%	7.0%	9.0%	10.2%	15.7%
PubEq-NYSE/NAS	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	0.7%	1.4%
PubEq-OTC	0.1%	0.0%	0.0%	0.0%	0.1%	0.3%	0.4%	0.4%
Cum % Biz	21.6%	61.2%	76.2%	93.9%	96.7%	98.6%	99.3%	99.7%

Source: Pepperdine Private Capital Markets Project, Summer 2011