Written testimony of
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for the
U.S. House Small Business Committee
hearing entitled

"Exploring SBA Programs: Reviewing the SBIC and SBIR Programs' Impact on Small Businesses"

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SBIA
SMALL BUSINESS INVESTOR ALLIANCE

The Small Business Investor Alliance

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. We also represent the institutional investors (e.g. community banks, university endowments, pension funds) who invest into these small private funds. Our association's purpose is to represent the entire lower middle market investing ecosystem, both General Partner and Limited Partner. As such, our public policy goals are balanced and focused on maintaining a robust, healthy, and competitive market for investing in American businesses.

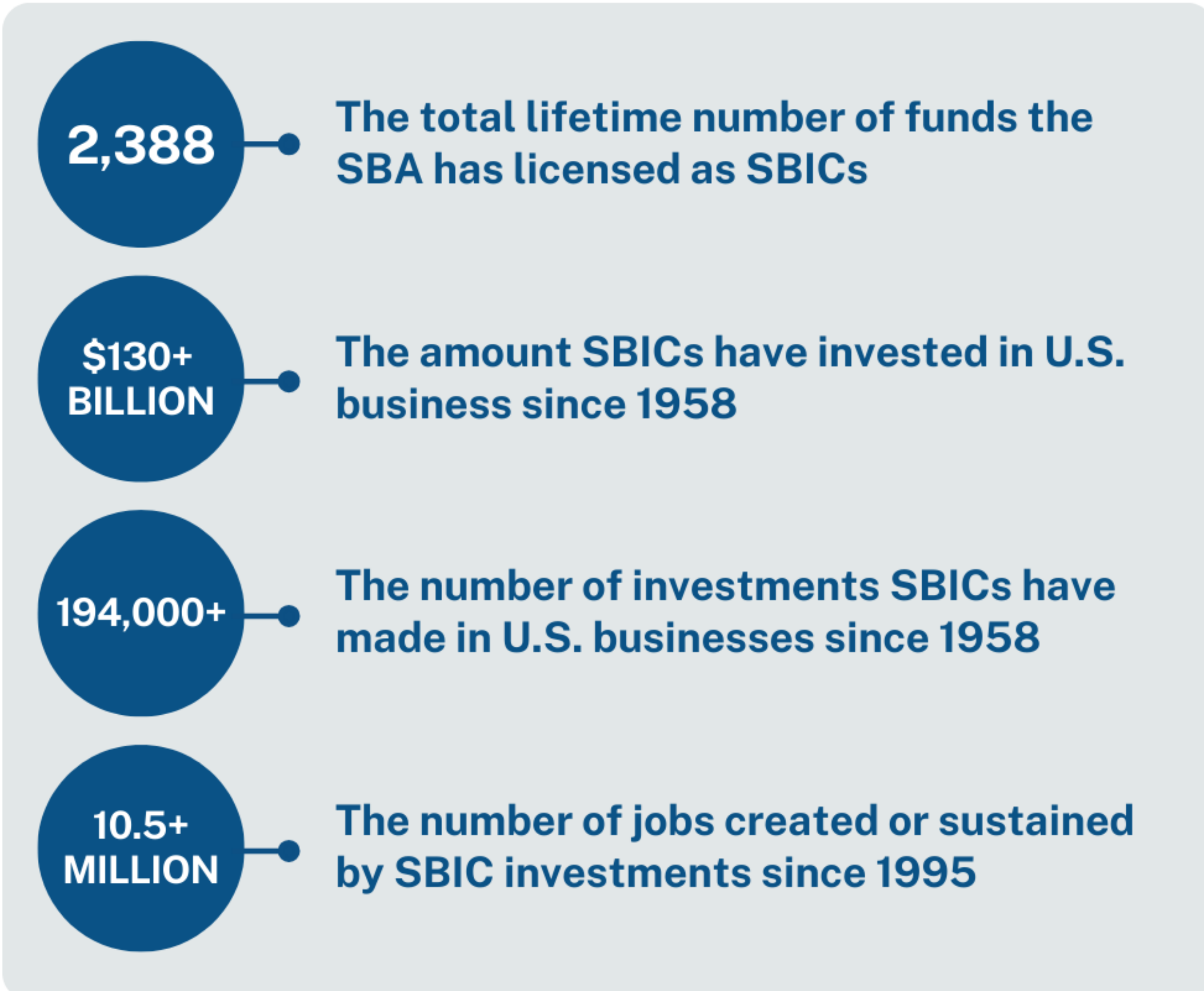
Overview of the Small Business Investment Company Program

SBICs are an American success story and example of a successful federal public policy that aligns the power of private markets with the public interest of job creation and economic growth. Congress declared in its original authorizing legislation that the SBIC program should "stimulate and supplement the flow of private equity capital and long-term loan funds which small business concerns need for the sound financing of their business operations" while also stimulating the national economy and job growth.[1]

SBICs invest exclusively in domestic small businesses, creating jobs and empowering U.S. small businesses to compete in a global economy. Companies that in their early stages received SBIC investments and have subsequently grown into icons of American industry include Federal Express, Apple, Intel, and Callaway Golf. While these are recognized companies globally, many more small businesses backed by SBICs have grown from smaller businesses into robust, sustainable mid-sized businesses. Since inception, 2,388 SBICs have made over 194,000 investments in U.S. small businesses totaling $130 billion. These investments are in real companies with real staying power and real growth potential.

[1] Small Business Investment Act of 1958, Pub. L. 85-699 (Aug. 21, 1958). 15 U.S.C. 661.

SBIC History by the Numbers



[2]

<u>Types of SBICs</u>

Most SBICs are levered (debenture) funds, which means those funds are authorized to borrow money from a federally-guaranteed credit facility using the Federal Home Loan Bank system. Federal leverage permits individual SBICs to multiply paid-in private capital up to two times capital or $175 million, whichever is less. Almost all SBIC Funds have a finite term, with an investing period of 5 years and then a harvesting period of another 5 years. As such, SBICs commonly have several SBIC funds that are in different parts of their investing/harvesting life cycles (investing, harvesting, and then forming their next fund). The maximum leverage for an SBIC family of funds (a group that holds multiple SBIC licenses) is currently $350 million. Leverage is provided at a **<u>zero-subsidy rate</u>**, with no annual appropriations

[2] Jobs are a sum of findings from Library of Congress report entitled "Measuring the Role of the SBIC Program in Small Business Job Creation" from 1995-2014 and data from SBA SBIC annual reports 2014-2023.

necessary to fund up to $6 billion a year (FY2024 enacted), which is eventually paid back in full to the SBA with interest and fees. (*See Appendix for the typical lifecycle of a traditional SBIC*).

In August 2023, SBA introduced several new tools to allow different types of capital to fill more types of capital access gaps: Accrual and Reinvestor SBICs. Accrual SBICs are also leveraged funds but interest accrues and is paid back by the SBIC at the end of the 10-year debenture period to better align with the cash flows of long-term, equity-oriented funds. Reinvestor SBICs are a subset of Accrual SBICs for the express purpose of reinvesting in a portfolio of smaller investment funds to increase the geographic reach of the SBIC program. Reinvestor funds are market-driven developmental league to provide more capital to a next generation of emerging small business investors.

Also in 2023, SBA announced the SBIC Critical Technologies Initiative (using the accrual debenture license) in partnership with the Department of Defense (DOD) to increase early-stage investment in startups and small businesses in critical national security industries and supply chains, that are not supported through procurement. SBA and DOD have identified gaps in the credit markets for high-tech startups and small businesses that could produce the technology needed for future national security efforts.

SBIC License Types

License Type	Investment Strategy	Details
Standard SBIC	Private Credit, Structure Equity or Mezzanine	• Uses Standard Debenture • Eligible for up to 2 tiers of leverage • $175M for one fund or $350M for family of funds
Accrual SBIC	Venture, Growth or Buyout	• Uses Accrual Debenture • Eligible for up to 1.25 tiers of leverage • $175M cap for one fund, $350M for family of funds
Non-Leveraged SBIC	Benefits of an SBIC license, without SBA leverage	• No funding from SBA • Typically established and owned by a bank • Provides financial institutions with opportunities to receive Community Reinvestment Act credit and a limited exemption from the Volker Act
Reinvestor SBIC	Fund-of-Funds	• Uses Accrual Debentures • Must invest ≥ 50% of capital in private funds • Eligible for up to 2x tiers of leverage • $175M cap for one fund, $350M for family of funds

<u>Current Impact of SBICs on small business economy</u>

At the end of FY2023, the capital committed to U.S. small businesses from licensed SBIC funds was at a record level nearly 40 percent higher than five years earlier (2019). Nearly one in four investments, moreover, were made in small businesses that were either women-, minority- or veteran-owned, or located in LMIs areas.[3] During 2023, the SBIC program had more than 300 active funds[4]. SBICs are a critical part of the small business capital markets. SBICs investments are overwhelmingly the first institutional capital to ever be deployed into the small business they are backing. Further, once SBIC capital is invested into a small business then the small business is often able to access more conventional bank capital. SBICs are only able to make a profit by successfully growing small businesses.

SBIC Impact Today

SBICs have combined SBA commitments and private equity capital exceeding **$42.5 billion**

SBICs invested over **$8 billion** in **1,200 small businesses** in FY23

As of 2023, the SBIC program has grown to nearly **320** licensed funds

SBIC investments created or sustained **130,281** jobs in FY23

State of Small Business Access to Capital

For all companies, small and medium-sized businesses in particular, access to capital is a distinguishing feature that often determines success or failure. It is much more difficult for smaller businesses to access long term patient capital than it is for medium-sized or larger businesses.

Traditionally, community and regional banks generally help finance small businesses that have assets to borrow against. Unfortunately, the smaller and more rural the businesses the more difficult it is to access traditional sources of capital. Also, many small businesses do not have adequate assets to access the amount of bank loans that they need. Smaller businesses are seen as too risky for most banks and larger financial institutions.

[3] Id.
[4] Id.

The rapid rise in interest rates in 2022 and the imbalance of assets and liabilities on bank balance sheets has had a material negative impact on lending to small businesses. The private capital markets are tight, particularly for small private businesses with values below $50 million. Access to senior credit is more difficult now than it was a year ago, it is more expensive, and lenders have regulatory concerns for not extending new loans or not renewing existing facilities (like lines of credit). Conventional private investment funds have also pulled back on making investments in small businesses because economic and market conditions forced them to reevaluate and adjust investment strategies. SBICs are available filling the gap, but capital demand has outstripped supply.

Additionally, smaller businesses need hands-on help to manage growth while some need help to navigate changes in the competitive landscape. Some family-owned small businesses need help to transfer ownership when the original founders are ready to retire but want to maintain the business as a going concern. This is the kind of help that SBIC funds can provide.

SBIA Policy Recommendations

While the SBIC program has shown record growth over the past 5 years, there are policies this committee can consider to expand access to capital in unserved geographies, ensure the SBICs remain on par with rising inflation, and provide the Office of Investment and Innovation with the resources necessary to administer the program.

SBIA thanks Members of the Committee for supporting H.R. 400, the Investing in Main Street Act

During the first weeks of the 118th Congress, the House passed H.R. 400, the Investing in Main Street Act with a near-unanimous bipartisan vote.[5]

The bill, introduced by Rep. Judy Chu (CA-28) and Rep. Andrew Garbarino (NY-2), would rectify a historical disconnect between banking law and small business investment law and allow a bank or federal savings association to invest up to 15% of their capital and surplus in SBICs, while still subject to the approval of the bank regulator if above 5%. This would dramatically increase the amount of private capital in the SBIC program, which will then be deployed to domestic small businesses, at no cost to taxpayers.

The bill has passed the House of Representatives the last four Congresses. The Senate version was introduced in February 2024, by Senators Todd Young, Tammy Duckworth, and Jim Risch and is awaiting Senate vote.

SBIA strongly supports passage of H.R. 5333

SBIA strongly urges Congress to consider and pass H.R. 5333, the Investing in All of America Act, to increase access to capital through the SBIC program. This bipartisan legislation, introduced by Reps. Meuser and Scholten, will encourage private capital investments in the parts of America that are often overlooked. SBIA wants to thank Reps. Meuser and Scholten for their leadership.

[5] House Roll Call No. 35. 411-13.

The Investing in All of America Act reforms the Small Business Investment Company program at SBA to encourage private capital investment in underserved areas and industries with the following benefits:

- No new spending.
- No new mandates.
- No subsidies.
- 100% of investment is in American small businesses.
- Encourages investment in Low-income and Rural Areas.
- Encourages investment in industries that are vital to national defense.
- Inflation adjustment allows the program to remain competitive as prices rise.
- Market-led and market-driven.

The Investing in All of America Act provides SBICs with bonus leverage to invest solely in rural, low-come, and national security-focused businesses. Investments eligible for bonus leverage under the legislation include smaller enterprises in low income or rural areas. These are businesses that are smaller than small businesses by definition and are in areas that are traditionally underserved. Bonus leverage is also available for investments in small businesses that are in industries critical to national security. It should be noted that bonus leverage for investing in rural and low income areas does not change the cost or risks of the program because it maintains the private capital ratio to SBA leverage determined during the licensing process.

H.R. 5333 would streamline the current bonus leverage provisions to make them simple and straightforward, with no need for new appropriation for implementation as drafted. SBA already captures zip codes and NAICS codes of the small businesses financed. Simply adding check boxes and drop-down menus on the Form 1031 (Form 1031 must be completed by SBICs and submitted to SBA for every financing made to a small business. It includes details of the financing and information on the small business) for "rural", "low-income", and "critical technology" captures the remaining data needed to exclude the cost basis of the investment when calculating an SBIC's outstanding leverage.

The legislation would also adjust the leverage commitment levels by a factor of inflation from the last time they were adjusted in statute and make annual adjustments thereafter. This ensures successful SBICs do not grow out of the program and can continue assisting job-creating small businesses across the country for years to come.

The SBIC program had an inflation adjuster for many years prior to raising the caps in emergency legislation (ARRA) during the Great Recession. However, the leverage caps have not been adjusted since 2015 for single licensees and 2018 for a family of funds. In that time, inflation has risen nearly 30%. In the face of current and future inflationary pressure, reinstating the inflation adjuster is necessary to ensure the program's investment power remains consistent with the broader markets and small businesses can continue to receive the capital they need.

<u>SBIA urges Congress to ensure all fees charged to, and collected from, SBICs are used by OII exclusively to administer the SBIC program.</u>

The SBIC program has experienced significant growth recently. As mentioned previously, today there are nearly 320 licensed funds with combined SBA commitments and private capital exceeding $42.5 billion. There has also been record-setting interest from prospective and returning licensees. There are currently

94 SBIC license applications that have been submitted to SBA for approval. To put that in context, SBA normally licenses 25-28 funds a year. The market has recognized the need for SBIC capital, but we need to get these applicants processed. That is at least $15 billion dollars in capital that is waiting for permission to be deployed into American small businesses.

Ensuring the fee revenues collected from SBICs by the Office of Investment and Innovation are used to provide the personnel and resources to process and manage the influx of new and existing licensees is critical.

<u>SBIA recommends the SBA publish timelier and more detailed SBIC program data.</u>

There is a long precedent of providing Congress and the public with detailed program data on SBA's other access to capital programs. SBA publishes a weekly lending report on the 7(a), 504, and Community Advantage loan programs which include demographic data on borrowers, loan size breakouts, urban and rural delineations, and cumulative loan volume, among others.

The Office of Investment and Innovation (OII) collects similar data on each small business investment made by SBICs via form 1031. OII also collects fund-level performance data from each SBIC on a quarterly and annual basis using form 468. SBIA understands that sensitive information about small businesses and SBICs is also captured on these forms, but this should not prevent SBA from providing aggregated anonymized data about the program to Congress and the public.

SBA should also make data releases timelier – SBA has not provided new data since it released the year-end FY2023 report nearly 5 months ago.

SBIA thanks the Committee for holding this important hearing and looks forward to working with Members on bipartisan legislation that will increase capital access for all of America's small businesses.

APPENDIX

Phases of a Debenture SBIC License Lifecycle

Pre-Screening

- Submit Pre-Screen Application (optional).
- Call with SBA.
- Decide to Apply for an SBIC license.

Application Submision

- Submit application, exhibits, and pay application fee.
- SBA conducts due diligence.
- Investment Committe votes to conduct in-person interview with applicant.

Turnaround 4 - 6 weeks

Green Light Letter

- Applicants interview with SBA at Washington DC Headquarters.
- Investment Committee, Licensing Committee, and Administrator vote to issue Green Light Letter.
- Green Light Letter issued - a certification that the management team will be issued an SBIC license and the intended leverage commitment from SBA at fund closing, provide terms and conditions are met.

Initial fundraising period of 12 months after issuance of Green Light Letter

SBIC Licensing

- Managment team raises required private capital for inital fund closing.
- Apply for license and submit fee.
- Administrator approves license and issues it to SBIC.
- Conduct Initial Fund Closing and start operating.

Post-licensing - Fund in Operation

- SBICs have 12 additonal months post-licensing to raise additional capital (multiple closings allowed).
- SBIC operational life:
  - ~ 5 years for investment period.
  - ~ 5 years for harvest period.

Wind Down

- Repay SBA in full.
- Surrender license.