RELEASED

5525

RELEASED

# REPORT OF THE COMPTROLLER GENERAL OF THE UNITED STATES

LM105042

# The Small Business Investment Company Program: Who Does It Benefit? Is Continued Federal Participation Warranted?


Continued Federal participation in the Small Business Investment Company Program, in its present form, is questionable. Under the program, equity financing is provided to small businesses even though they have access to other sources of such financing. The companies are providing clients with loans similar to those of the Small Business Administration's major business loan program, which is much larger and provides loans on better terms.



CED-78-45

MARCH 3, 1978

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-149685

The Honorable Richard Bolling
Chairman, Joint Economic Committee
Congress of the United States

Dear Mr. Chairman:

This report describes the Small Business Investment Company program administered by the Small Business Administration and questions whether it continues to be an effective means of providing equity financing to small businesses. Our review was made pursuant to your Committee's request of April 13, 1976.

In the report we recommend to the Congress that continued Federal funding of the program be contingent on the Small Business Administration fully justifying the program's role in financing the equity needs of small businesses.

As arranged with your Office, this report will be released 30 days after the issuance date unless you publicly release its contents prior to this time.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

DOCUMENT RESUME

05042 - [B0625525] (Restricted)

The Small Business Investment Company Program: Who Does It Benefit? Is Continued Federal Participation Warranted? CED-78-45; B-149685. March 3, 1978. 28 pp. + 5 appendices (24 pp.).

Report to Rep. Richard Bolling, Chairman, Joint Economic Committee; by Elmer B. Staats, Comptroller General.

Issue Area: Domestic Housing and Community Development Programs: Focus and Grants to Business (2110).
Contact: Community and Economic Development Div.
Budget Function: Commerce and Transportation: Other Advancement and Regulation of Commerce (403).
Organization Concerned: Small Business Administration.
Congressional Relevance: Joint Economic Committee. Rep. Richard Bolling.
Authority: Small Business Investment Act of 1958 (15 U.S.C. 661). Federal Financing Bank Act of 1973.

The Small Business Investment Company (SBIC) program was intended to stimulate and supplement the flow of private-equity capital and long-term loans to small businesses (independently operated, generally with assets not exceeding $9 million) for growth, expansion, and modernization. The Government makes long-term loans to SBICs which are regulated and licensed by the Small Business Administration (SBA), charging interest at approximately its cost of borrowing, about 7% or 8%. Findings/Conclusions: In spite of the Government's large financial commitment to the program, only a select group of small businesses is being serviced. As of March 31, 1976, 277 SBICs had outstanding investments of about $569 million and about $467 million in Federal loans outstanding. Equity-oriented SBICs consider investments according to risk and growth potential and set rigid investment criteria, while loan-oriented SBICs are primarily concerned with the borrower's ability to repay loans. The following factors restrict the usefulness of the program: it is smaller than it was in its formative years in number of investment companies and annual financings; few businesses get equity-type financing because of the preference of SBICs for larger small businesses with growth potential; such businesses can receive financing from private industry; private companies sometimes financed the same businesses as SBICs, usually with larger investments; much of the equity capital provided has come from bank-dominated SBICs--many of the companies have not used the loan funds; and SBICs often serve the same clientele as those of the SBA's 7(a) business loan program which has better terms for loans. Recommendations: The Congress should require the Administrator of SBA to fully justify the role, if any, that the SBIC program should play in meeting the financing needs of small businesses, including a determination of: size and type of small businesses that are

financed by the private venture capital industry and its ability to meet equity-financing needs, whether the SBIC program is the proper vehicle to meet the needs of small businesses, and whether continued funding of loan-oriented SBICs is warranted. (RTH)

COMPTROLLER GENERAL'S REPORT TO THE JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

# THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM: WHO DOES IT BENEFIT? IS CONTINUED FEDERAL PARTICIPATION WARRANTED?

## D I G E S T

The Congress should require the Small Business Administration to fully justify the role the Small Business Investment Company program should play, if any, in financing the equity needs of small businesses. Issues that should be addressed in such an effort by the Small Business Administration are provided in this report. (See pp. 27 and 28.)

Despite the Federal Government's large financial commitment to the program and the benefit to some small firms, only a select group of small businesses are being serviced.

As of the most recent date that information was available--March 31, 1976--277 small business investment companies had outstanding investments of about $569 million. These companies had about $467 million in Federal loans outstanding.

As with private venture capital companies, equity-oriented small business investment companies are profit-motivated firms operating in a competitive market. Accordingly, each small business investment company's equity investment in a small business is considered in light of risk and growth potential, and only those small businesses that meet rigid investment criteria receive financing. (See pp. 8 to 10.)

On the other hand, loan-oriented small business investment companies operate differently. These companies are concerned with the borrower's ability to make loan payments and provide sufficient collateral as security; the borrowing firm's growth or profitability is a lesser concern. (See pp. 6 and 14 to 16.)

Several characteristics of the program and of the market in which it functions cast doubt on whether the program can continue to be the most effective means to provide equity and long-term financing to small businesses. The following factors are not intended as criticisms of the small business investment companies as profitmaking enterprises. They do, however, restrict the usefulness of the program.

--In terms of the number of investment companies participating and the annual financings made, the program is smaller than it was in its formative years. (See p. 4.)

--Few businesses get equity-type financing since the small business investment companies, which are extremely selective, prefer larger small businesses that have significant growth and profit potential. Officials of most of the 14 equity-oriented small business investment companies reviewed said that they honor only about 1 to 5 of the 200 to 600 financing applications received annually. (See pp. 8 to 10.)

--A large private venture capital industry, not receiving Federal loans and having greater resources than the small business investment company industry, also provides equity financing to the same type of small businesses. (See p. 11.)

--In some cases, private venture capital companies and small business investment companies financed the same small businesses, and in most cases the private venture capital investments greatly exceeded those of the small business investment company. (See p. 12.)

--Much of the equity capital the program provided to small businesses has come from bank-dominated small business investment companies established to permit the banks to make equity investments which they are otherwise prohibited by law from making. Many of these companies have not used Federal loan funds, and others have sought only minor amounts compared to what they could obtain. (See pp. 12 and 13.)

--The small business investment companies that generally make loans serve the same clientele (charging higher interest rates and requiring greater collateral) as those of the Small Business Administration's 7(a) business loan program. (See pp. 14 to 16.)

The Congress anticipated that Federal funds to supplement a small business investment company's private capital would be relatively temporary, would act primarily as a catalyst in starting the program, and would be replaced by private financing once the Government had taken the first step. Instead, Federal investment in the small business investment companies has grown in relation to private money invested in these companies. Despite increasing Federal financial support, the number of companies and the annual number and amount of financings made to small businesses have declined over the last 10 years. (See pp. 2 to 4.)

Comprehensive program evaluations are not being performed because the Small Business Administration did not compile the necessary information. The Small Business Administration said that it lacks sufficient resources to perform this function. (See pp. 19 and 20.)

The Administrator, Small Business Administration, disagreed in many respects with GAO's analysis of the program. His comments did not respond to the issues raised by this report. (See pp. 23 to 27.)

BLANK

## Contents

| APPENDIX | | Page |
|---|---|---|



## ABBREVIATIONS

| | |
|---|---|
| FFB | Federal Financing Bank |
| GAO | General Accounting Office |
| NASBIC | National Association of Small Business Investment Companies |
| NVCA | Nat' nal Venture Capital Association |
| SBA | Business Administration |
| SBIC | all business investment company |

## GLOSSARY

| | |
|---|---|
| Bank-dominated SBIC | SBIC in which banks hold 50 percent or more of any class of equity security having actual or potential voting rights. |
| Equity-oriented SBIC | SBIC specializing in equity-type investments or various combinations of loan and equity-type investments. (For example, stock and loan, convertible debentures and loan, stock and convertible debentures.) |
| Equity-type investment | Funds supplied by an SBIC in consideration for stock or the right to purchase stock. |
| Federal Financing Bank | Created under the Federal Financing Bank Act of 1973 to consolidate the market financings of other Federal agencies. The Bank is authorized to purchase obligations issued, sold, or guaranteed by any Federal agency and to finance such purchases by issuing its own obligations in the market or to the Secretary of the Treasury. |
| Loan-oriented SBIC | SBIC specializing in loan-type investments. For the purpose of our review, an SBIC was considered loan-oriented if 90 percent or more of the dollar value of its outstanding portfolio was in the form of loans. |
| Long-term SBIC loans | Loans negotiated for 5 years or more. |
| Venture capital | Includes stock, rights to purchase stock (convertible debentures, warrants), and certain loans subordinated as to collateral. |
| Venture capital qualified | An SBIC's right to borrow $4 of Federal funds for every $1 of its |

combined, private paid-in capital and surplus, up to a maximum of $35 million. To qualify, an SBIC must have at least 65 percent of its funds in venture capital and a combined, private paid-in capital and surplus of $500,000 or more.

## CHAPTER 1

## INTRODUCTION

The Small Business Investment Company (SBIC) program was authorized by the Small Business Investment Act of 1958 (15 U.S.C. 661 et seq., to stimulate and supplement the flow of private-equity capital and long-term loans to small businesses for growth, expansion, and modernization. The act defines small business concerns as those that are independently owned and operated and that do not dominate their field. Generally, a business is considered small if its (1) assets do not exceed $9 million, (2) net worth is not greater than $4 million, and (3) average annual net income for each of the preceding 2 years is not more than $400,000.

The Government makes long-term loans to SBICs in the ratio of Government-to-private funds of $4 to $1 for venture-capital-qualifying companies and $3 to $1 for other SBICs. The interest charged approximately represents the Government's cost of borrowing the money and reflects a rate of about 7 or 8 percent. The maximum amount of Government funds that can be borrowed by a single SBIC is $35 million. As of March 31, 1976, SBICs had outstanding Government loans of about $467 million and investments of about $569 million at cost.

### LEGISLATIVE HISTORY

At the time the Small Business Investment Act of 1958 was enacted, the Congress believed there was an "institutional gap" in the financial structure that made it impossible for small businesses to meet their needs for equity capital and long-term credit. The Congress declared that the purpose of the act was to:

> "* * * improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to 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 and for their growth, expansion, and modernization, and which are not available in adequate supply * * *."

The act authorized creation of SBICs, regulated and licensed by the Small Business Administration (SBA), to achieve the above. Federal loans were provided to SBICs to encourage them to form and grow. The Congress anticipated that the loans would be relatively temporary, would act primarily as a catalyst in starting the program, and would be replaced by private financing once the Government had taken the first steps.

SBICs are privately operated investment companies and may be owned by (1) individuals, (2) holders of publicly traded company shares, or (3) corporations, such as banks. Bank ownership is limited to the extent that the investment cannot exceed 5 percent of the bank's total capital and surplus.

SBICs are authorized to make equity investments in small businesses; however, an SBIC may not ordinarily assume control of a business--generally, ownership of 50 percent or more of its outstanding voting securities. SBICs may also make long-term loans for periods up to 20 years at interest rates not to exceed 15 percent or the maximum rates permitted by the laws of the States in which they operate, whichever is lower.

PROGRAM FUNDING AND GROWTH

SBA provides financing to SBICs by selling guaranteed debentures to the Federal Financing Bank (FFB). SBA acts as an agent for such sales. FFB was created pursuant to the Federal Financing Bank Act of 1973 to consolidate the market financings of all Federal agencies. It purchases obligations issued, sold, or guaranteed by Government agencies and finances these purchases by issuing its own obligations in the public market or to the Treasury Secretary. The interest rate charged on debentures sold to the FFB is based on the FFB cost of funds at that time. The interest rate on SBIC debentures has ranged from about 7 to 8 percent during the period 1972-76.

As noted, when the SBIC program was created, the need for Federal financial support of the investment companies was expected to diminish over time. This has not happened. The following chart shows that over the last 10 years Government loans have increased in absolute terms and in relation to the total capital invested in SBICs by private sources.

| Balance dates March 31 | Outstanding balance of Federal loans | Total private capital |
|---|---|---|
| | (millions) | |
| 1976 | $466.9 | a/$422.8 |
| 1975 | 367.9 | a/ 341.5 |
| 1974 | 448.0 | 322.4 |
| 1973 | 280.6 | 315.7 |
| 1972 | 292.6 | 331.3 |
| 1971 | 246.1 | 320.5 |
| 1970 | 231.0 | 349.9 |
| 1969 | 223.8 | 350.1 |
| 1968 | 229.7 | 346.6 |
| 1967 | 246.8 | 370.8 |

a/In 1975 SBA revised its accounting regulations for SBICs to permit the inclusion of unrealized gain on portfolio securities and other amounts in total capital. Figures shown for 1975 and 1976 are higher than they would have been if computed on a basis comparable to the earlier years.

The following schedule shows SBIC borrowing and interest rates charged for the past several years.

| Calendar year | Number of SBICs borrowing Federal funds | Amount | Average interest rate |
|---|---|---|---|
| | | (millions) | (percent) |
| 1976 | 67 | $ 53.1 | 7.55 |
| 1975 | 59 | 48.4 | 8.07 |
| 1974 | 44 | 42.3 | 8.12 |
| 1973 | 85 | 116.8 | 7.32 |
| 1972 | 49 | 38.6 | 7.00 |
| 1971 | 93 | 53.0 | 7.38 |
| 1970 | 139 | 59.6 | 7.29 |

The maximum amount of Federal funds an SBIC may borrow is limited to $35 million. Further limitations are that (1) if an SBIC has at least 65 percent of its funds invested in venture capital and has private capital and paid-in surplus of $500,000 or more, it may borrow up to four times its capital and (2) if an SBIC does not satisfy the venture capital investment requirements, it may borrow up to three times its capital.

In certain respects the SBIC program is smaller than it was in its formative years. The number of SBICs and the annual number and value of financings made to small businesses have declined over the last 10 years. The number of financings decreased by 54 percent and the value of financings by 21 percent over the period. As of March 31, 1967, SBICs had invested about $536 million in small businesses--including firms classified as small at the time of investment but which have outgrown the "small business" definition. As of March 31, 1976, SBICs' total portfolio had increased to about $569 million, a total increase of about $33 million over a 10-year period. The following table shows data reported by SBICs on their investment activity over the last 10 years:

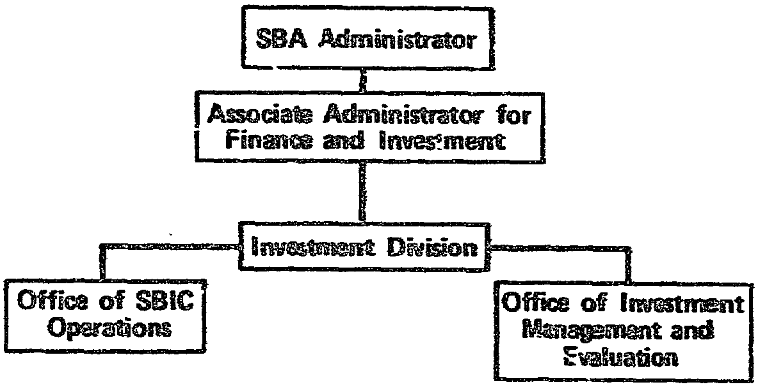
| Year (note a) | Number of reporting SBICs | Number of financing disbursements | Value of financing disbursements |
|---|---|---|---|
| | | | (millions) |
| 1976 | 215 | 1,720 | $129 |
| 1975 | 205 | 1,655 | 123 |
| 1974 | 252 | 2,000 | 198 |
| 1973 | 235 | 2,405 | 175 |
| 1972 | 274 | 2,544 | 169 |
| 1971 | 288 | 2,536 | 156 |
| 1970 | 331 | 2,920 | 187 |
| 1969 | 373 | 3,090 | 182 |
| 1968 | 441 | 2,816 | 143 |
| 1967 | 548 | 3,728 | 164 |

a/Figures for 1967-74 are for the years ended March 31, 1967-74. Figures for 1975 and 1976 are for the calendar years.

Limited program growth is also evidenced by SBICs' lack of demand for Federal funds. As of March 1976, SBICs' outstanding borrowings totaled about $467 million. As of that date, SBA was authorized to provide financing of $725 million for investment companies.

## SBA's ROLE IN PROGRAM IMPLEMENTATION

SBA administers the program from the central office in Washington, D.C. Regional and district offices are not involved in SBIC operations. The following chart shows the organizational structure for SBIC program administration.




SBA's primary functions include

--prescribing regulations governing SBICs' operation according to the provisions of the Small Business Investment Act,

--approving SBIC articles of incorporation and issuing licenses to operate,

--providing SBICs with guaranteed financing, and

--examining and investigating SBICs to determine their compliance with legal and regulatory requirements.

SBA's Investment Division plans, coordinates, and administers the program to assure uniform application of SBA rules and regulations developed by the Office of the Associate Administrator for Finance and Investment. The Investment Division performs two basic functions: (1) regulation of SBIC licensing, funding, and operation, which are responsibilities of the Office of Operations, and (2) program evaluation, for which the Office of Investment Management and Evaluation is responsible.

Examination of SBICs to assure compliance with legal and regulatory requirements is performed by the Examinations Division in SBA's Office of Audits and Investigations.

## CONGRESSIONAL INTEREST

After we began our review, the Chairman of the Joint Economic Committee requested in April 1976 that we provide an overall assessment of the SBIC program as a result of doubt that the program was satisfying the long-term loan and equity capital needs of small business. We were requested to furnish answers to several questions about both the loan and the equity-financing aspects of the program. The Chairman's questions and our responses are presented in appendix II. The responses are focused on specific sections of this report to provide more comprehensive insight into the matters discussed.

## DISTINCTION BETWEEN LOAN- AND EQUITY-ORIENTED SBICs

During the initial phases of our review, we noted that SBICs finance individual small businesses in a variety of ways: by loan, by equity investment, or by a combination of both.

When an SBIC loans money, it is interested in obtaining interest income and is less concerned with the profitability or growth of the borrowing firm. This is in contrast to both an equity investment or a combined equity and loan arrangement. In these cases, an SBIC provides financing because it hopes to participate in profits expected to flow from a successful venture. Because of this marked difference, we categorized SBICs as loan or equity oriented. For our review, an SBIC was considered loan oriented if 90 percent or more of the value of its outstanding portfolio was in the form of loans. The remaining SBICs were considered equity oriented.

Although there are two major types of SBICs (those specializing in equity investments and those providing loans) in order to make certain evaluations we further distinguished the equity group by whether it was bank dominated. These SBICs made little use of Federal funds, yet had invested a relatively large amount in small business equity. The following table shows the number of SBICs by type along with investment activity as of March 31, 1975.

| Type SBIC | Number of SBICs | Percent of total number | Investments outstanding | Percent of total dollars |
|---|---|---|---|---|
| | | | (millions) | |
| Equity oriented, nonbank dominated | 187 | 73 | $320 | 56 |
| Equity oriented, bank dominated | 30 | 12 | 181 | 31 |
| Loan oriented | 39 | 15 | 73 | 13 |
| Total | 256 | 100 | $574 | 100 |

SCOPE OF REVIEW

We examined applicable legislation and SBA regulations, policies, and procedures. We reviewed SBA-published reports and portfolio data on the entire SBIC industry as well as the activities of 19 SBICs representing about $200 million of investments in small businesses (about 35 percent of total SBIC investments) outstanding as of March 31, 1975. We also developed information on SBA's major loan program--commonly referred to as the 7(a) program.1/

We visited 18 SBICs, 11 private venture firms, and 5 investment bankers in the Boston, New York City, Dallas, Chicago, and San Francisco areas. We also contacted officials from 126 small businesses that had either received or been denied SBIC financing.

We met with the executive vice president of the National Association of Small Business Investment Companies (NASBIC) and the administrator of the National Venture Capital Association (NVCA) to solicit their views on the SBIC program. We also discussed the program with SBA officials.

---

1/SBA's primary loan program, as authorized by section 7(a) of the Small Business Act, is commonly known as the 7(a) program. Under this program SBA generally makes direct or guaranteed loans to small businesses to finance plant construction, conversion, or expansion; to purchase equipment, facilities, machinery, supplies, and materials; and to supply working capital. The vast majority of loans are guaranteed. A guaranteed loan is made by a lending institution under an agreement with SBA. This agreement obligates SBA to purchase the guaranteed portion of the loan (not more than 90 percent of the balance outstanding) from the lending institution upon default.

## CHAPTER 2

## SBICs PROVIDE EQUITY FINANCING TO SELECTED BUSINESSES THAT HAVE ACCESS TO OTHER SOURCES

Those SBICs that primarily provide equity financing to small businesses are extremely selective, investing in larger firms that have significant growth and profit potential. Private venture capital companies--not receiving Federal loans and having greater resources than SBICs--provide equity financing to the same small business segment. The goal of both SBICs and the private venture capital companies is to maximize profits by making the best investments possible, considering risk and potential for growth. Accordingly, equity-oriented SBICs are serving a segment of small business that has access to other financing sources.

### SBICs HIGHLY SELECTIVE IN MAKING INVESTMENTS

Using the criteria cited in chapter 1 (see p. 6), 217 of the 256 SBICs in operation as of March 31, 1975, could be categorized as equity oriented. These SBICs had investments of $501 million--87 percent of the total outstanding at that time. Twenty-three of the largest companies--each with assets over $10 million--accounted for investments of about $277 million.

We reviewed the operations of 14 equity-oriented SBICs whose investments totaled $171 million. Nine of the 14 were relatively large, with investments of about $153 million--27 percent of total SBIC investments outstanding as of March 31, 1975. As shown in the following table, the average amount invested by these nine SBICs in an individual small business was about $460,000.

Average Individual Investment by the

Nine Largest SBICs Visited (note a)

| SBIC | Total portfolio | Number of businesses financed | Average investment per business |
|---|---|---|---|
| 1 | $ 6,524,993 | 29 | $ 225,000 |
| 2 | 16,323,459 | 51 | 320,068 |
| 3 | 13,841,213 | 32 | 432,538 |
| 4 | 13,737,012 | 35 | 392,486 |
| 5 | 9,237,538 | 54 | 171,065 |
| 6 | 28,206,784 | 40 | 705,169 |
| 7 | 31,006,354 | 44 | 704,690 |
| 8 | 26,646,059 | 22 | 1,211,185 |
| 9 | 7,704,094 | 27 | 285,337 |
| Total | $153,227,506 | 334 | $ 458,765 |

a/With assets exceeding $10 million.

We tried to determine the size of small businesses at the time SBICs initially made their investments; however, we were unable to do so. Many of the investments had been made more than 10 years ago, and the structure of some firms receiving the financing had also changed. (For example, some firms had been absorbed by larger corporations.)

Despite our inability to determine the size of the small businesses at the time of initial SBIC investment, the fact that the SBIC's average investment in an individual firm approximated $460,000 would indicate that the firms were relatively large. Seven of the nine larger SBICs had established at least $250,000 as a minimum investment amount.

Officials of most of the 14 equity-oriented SBICs reviewed stated that their companies receive 200 to 600 applications for financing each year. However, only about one to five of these requests are honored. SBICs are extremely selective and, in making investments, attempt to minimize risk and maximize the opportunity for profit. Accordingly, they seek to invest in the best businesses--those they believe to have the best potential for growth and increased profitability. Following are examples of the written investment criteria of the larger SBICs:

--"In general, we look for companies which are profitable, have proven management, strong proprietary products or services and the potential to grow quickly and profitably to several times their present size."

--"We prefer to invest in companies which have broad markets for their products or services and can grow rapidly to a size where public ownership of their securities is both desirable and feasible."

--"The basic investment philosophy of (name of company) is to seek capital gains with established companies that have evidenced a growth potential. By providing long-term equity funds, it is able to assist a company in growth to a point where its principals can achieve their goals through a public offering, sale of the company, or repurchase of the (SBIC) equity ownership."

A further indication of SBIC selectivity in providing equity financing was given by the SBA Administrator in July 1976 hearings before the Subcommittee on SBA Oversight and Minority Enterprise, House Committee on Small Business:

> "Our conclusion must be that the SBIC program has been a minimal effort by the Federal Government to solve the equity financing problems of small business. And the SBICs themselves, at best, have provided only a trickle in the total flow of equity capital in the country * * *."

SBIC selectivity in making investments cannot be attributed to lack of funds. As of March 1976, the ceiling on Federal funding available for the program was $725 million, yet SBICs borrowed only about $467 million. SBIC officials stated that each investment must be evaluated in terms of growth potential and risk, considering such factors as management capability, general economic conditions, industry growth, short- and long-term product demand, and the percent of equity that a business is willing to sell for a specific negotiated price.

PRIVATE VENTURE CAPITAL COMPANIES PROVIDING EQUITY FINANCING TO SMALL BUSINESSES

There are privately owned venture capital firms (not receiving Federal loans) that provide equity financing to small businesses. These private firms have investment objectives similar to SBICs and serve the same segment of small business--the larger companies having the best growth and profit potential.

A venture capital source publication 1/ lists about 560 such firms and briefly describes the investment criteria of each. Of the firms listed, 380 were private venture capital companies and 137 were SBICs. The larger SBICs and the private venture capital firms have similar investment goals--both are interested in businesses that have the potential to grow much faster than the economy and to become significantly larger.

We discussed small business equity financing with five investment bankers and officials from 11 private venture capital firms. Although private venture capital firms are not restricted to making investments in small businesses, we were told that such firms invest substantial amounts in companies that are "small" as defined by SBA. We were unable to obtain specific data that would indicate the extent of such investment by private venture capital firms; however, the officials interviewed generally agreed that:

--Private venture capital firms have substantially greater amounts invested in small business as compared to SBICs.

--Private firms seek to invest in the same type of small business as SBICs--firms having substantial growth potential.

--Many small businesses seek equity financing, but only a select few are considered worthy in light of their risk and growth potentials.

---

1/Stanley M. Rubel, "Guide to Venture Capital Sources," 3d ed., Capital Publishing Corporation, 1974.

SBICs and private venture capital firms coinvesting in small businesses

As further indication that SBICs and private venture capital firms seek the same type of companies for investment, we noted a number of instances in which individual small businesses received funding from both sources. For example, one SBIC had coinvestments with private sources in 20 companies, and in most cases the private financing was substantially greater than that provided by the SBIC. In one case, SBIC financing amounted to only about 3 percent of the total received by the firm. We also found eight SBICs that had invested in one firm which had received far greater amounts from private sources.

We questioned SBA about whether data had been collected on small businesses jointly financed by SBICs and private sources and were told that a lack of personnel prevented collection of comprehensive data. As discussed in chapter 4, this data is needed to evaluate the program's effectiveness in assisting small businesses.

Bank-dominated SBICs

Bank-dominated SBICs--that is, SBICs 50 percent or more of whose voting stock is owned by banks--are major suppliers of the equity capital provided by the program. 1/ They participate in the program primarily because it gives them authority to make equity investments rather than because federally guaranteed loans are available.

As of March 31, 1975, there were 30 equity-oriented SBICs dominated by banking institutions. Many of these bank-dominated SBICs have not used SBA-guaranteed funds while others have sought only minor amounts compared to what they could obtain. Although the current allowable ratio of SBA funds to private capital for equity-oriented SBICs is 4 to 1--revised upward from 3 to 1 by Public Law 94-305 (90 Stat. 663) on June 4, 1976--in the case of bank-dominated SBICs the actual ratio is 0.7 to 1. For the SBIC program as a whole the ratio is 1.2 to 1.

-------------

1/As of Mar. 31, 1976, outstanding equity investments made by the bank-dominated SBICs totaled $75.3 million, or 42 percent of the $177.7 million outstanding equity investments made under the program.

We discussed the overall lack of demand for SBA funds with officials of bank-dominated SBICs and received indications that the primary reason that banks became involved in the program was to enable them to make equity investments--an activity otherwise prohibited by law. There were also indications that these bank-dominated SBICs, as well as others, would continue to invest in the equity of small businesses if they were legally permitted to do so without the necessity of being incorporated as SBICs.

We contacted SBA officials to determine the validity of these observations and were told that revision of the banking laws undoubtedly would create an additional source of funds for small business equity investments.

## CHAPTER 3

## SBICs PROVIDE LOANS TO SMALL BUSINESSES THAT ARE SIMILAR TO SBA 7(a) BUSINESS LOANS

Loan-oriented SBICs provide small businesses with the same type of financing as SBA's 7(a) business loan program provides. Both sources provide long-term loans either to start new businesses or for the growth, expansion, and modernization of existing small firms, but the 7(a) program is much larger.

Many small businessmen stated that at the time they applied for SBIC financing, they were unfamiliar with the 7(a) program or had heard that it took an inordinately long time for SBA to process such loans.

### TERM OF LOANS

Although the maximum term of an SBIC loan is 20 years, compared to generally 10 years under the 7(a) program, actually both types of loans are approved for an average term of about 7 years.

As of March 31, 1975, 39 loan-oriented SBICs had $73 million outstanding to small businesses, $71 million of which was in loans. A review of 712 outstanding loans valued at $27.5 million made by 36 of the 39 SBICs 1/ between January 1, 1974, and March 31, 1976, showed that loans were negotiated for an average term of 7.4 years. Of the 712 outstanding loans, 591 (83 percent) were approved for periods ranging from 5 to 10 years.

In comparison, from July 1, 1974, through June 30, 1976, 34,279 SBA 7(a) guaranteed loans worth $3.1 billion were approved. The average term of these loans was 7.1 years. As in the case of SBIC loans, most of the 7(a) loans (30,125 or 87.9 percent) were negotiated for 5- to 10-year periods.

---

1/Three SBICs made no loans during the period.

## INTEREST RATES

Loan interest rates under the SBA 7(a) guaranteed loan program generally are more favorable than those offered by loan-oriented SBICs. Although SBICs may charge a maximum interest rate of 15 percent, the 7(a) guaranteed loan maximum interest rate as of October 7, 1976, was restricted to 10 percent. Since April 1971 the maximum loan rates for 7(a) loans have ranged from 7.75 to 11.5 percent.

A review of 712 outstanding loans made by 36 loan-oriented SBICs between January 1, 1974, and March 31, 1976, showed that the average interest rate charged was 12.1 percent. Ten of the 36 SBICs generally charged from 13 to 15 percent in interest.

On the other hand, a review of 34,279 SBA 7(a) guaranteed loans approved during the 2-year period ended June 30, 1976, showed that the average loan interest rate was 10.1 percent. During this period, 7(a) guaranteed loan interest rates generally ranged from 8 to 11 percent.

## COLLATERAL REQUIREMENTS

Under both loan programs, collateral is a major consideration in granting a loan. The collateral requirements established by SBICs, however, are more demanding.

SBICs provide loans to small businesses primarily on the basis of their ability to repay the loan and on the amount and type of collateral pledged as security. Four of the five loan-oriented SBICs visited almost always sought collateral above the loan amounts. For example, all of one SBIC's loans were fully secured by collateral, as shown by the following examples:

| Loan amount | Collateral value as appraised by the SBIC |
|---|---|
| $70,000 | $91,000 |
| 10,000 | 16,000 |
| 45,000 | 55,000 |
| 65,000 | 90,000 |

At another SBIC, an official commented that its policy was to loan funds up to 70 percent of the collateral's value. Loans we reviewed were even more fully collateralized. For example:

| Loan amount | Collateral value as appraised by the SBIC |
|---|---|
| $45,000 | $ 90,000 |
| 75,000 | 200,000 |
| 70,000 | 135,000 |

At the fifth SBIC visited, officials stated that loans were generally secured by collateral valued at 80 to 100 percent of loans. We noted, however, that one small business had received a 5-year, $35,000 loan from the SBIC and was required to secure it with collateral worth $100,000 as appraised by the SBIC.

In contrast to these findings, an SBA official stated that although collateral is a major factor in approving 7(a) loans, loans are not required to be fully secured providing the business has shown a good profit picture.

We contacted officials from 10 small businesses that had been denied SBIC loans. Four firms had been successful in obtaining financing elsewhere; five had not yet obtained financing; and one no longer needed it. We noted that several businesses that had been denied financing due to a lack of collateral later sought SBA assistance. For example, one firm sought a $15,000 loan from an SBIC which was denied because of inadequate collateral. The small business subsequently obtained an SBA 7(a) loan.

Another small business sought a $30,000 loan from an SBIC for working capital. This loan also was denied because the firm lacked sufficient collateral. The president of the business stated that over the past 10 to 12 years the business had received three SBA-guaranteed loans and was currently applying for another.

In a third instance, a small business was denied a $30,000 SBIC loan for equipment because it lacked collateral. The firm then sought an SBA-guaranteed loan and was told it had a good chance of getting it approved; however, it would take 2 to 3 months to process the application. The business could not wait for financing and had to admit a partner to provide the needed capital.

## WHY SMALL BUSINESSES ACCEPT SBIC FINANCING OVER LESS COSTLY 7(a) LOANS

Small businesses generally accept SBIC loan financing either because they are unfamiliar with SBA's 7(a) loan program or have heard that 7(a) loan-processing time is excessive. SBIC officials felt that the major difference between the two sources is that SBICs can provide quick financing.

We contacted officials from 22 small businesses that had received SBIC loans; 17 stated that they were unfamiliar with the SBA 7(a) guaranteed loan program when they sought SBIC financing. Several officials also indicated that they decided not to seek SBA financing because they had heard it took months for a loan to be approved.

The following case studies explain why some small businesses turn to SBICs for assistance.

Company A

The firm received a 5-year, $70,000 SBIC working capital loan at 14.75 percent interest. The loan was secured by about $135,000 of collateral. At the time of financing, the owner was unfamiliar with SBA's guaranteed-loan program. Recently he learned of the program and is currently negotiating for a guaranteed loan through a local bank. Part of the money that is being sought will be used to pay off the SBIC loan.

Company B

The firm received a 6-year, $75,000 SBIC loan at 14.5 percent interest to buy out a partner. The loan was secured with collateral--land, buildings, life insurance policies--valued at about $200,000. The small business accepted the SBIC terms since it was hard pressed for cash--it had been denied bank financing, since banks were reluctant to loan at the time. The small businessman was unfamiliar with SBA's guaranteed program. However, after we discussed it with him, he contacted SBA and was attempting to refinance the SBIC loan with an SBA-guaranteed loan.

Company C

The firm received a 5-year, $25,000 loan at 15 percent interest to purchase a second business. The loan was secured by collateral valued at $35,000. The owner said that he accepted SBIC financing since he thought he was receiving an SBA loan. He later learned (through his attorney) that he had not, since the SBA-guaranteed loan interest rate was much lower.

At the time of the financing, the owner's first business had completed a successful year of operation: gross income, $277,402; net income, $35,182. It had $62,182 in assets and no liabilities. It appears the owner could have easily qualified for an SBA-guaranteed loan had he approached SBA for assistance.

Company D

The business received a 5-year, $75,000 SBIC loan at 15 percent interest. The owner had not sought financing elsewhere, since at the time he needed the money quickly. The owner said that "the interest rate is killing me." He is currently negotiating to get an SBA-guaranteed loan at 10-percent interest.

SBIC officials were hard pressed to distinguish their lending activities from those associated with the 7(a) program. One official stated that the 7(a) program is basically the same as a loan-oriented SBIC since both provide long-term loans that are generally secured by collateral. He noted, however, that the disadvantage of the 7(a) program is the tremendous amount of paperwork and time involved in loan processing. He stated his SBIC can process a loan in 1 to 2 weeks.

Another SBIC official also noted that 7(a) and SBIC loans are basically the same. However, SBICs can offer a borrower less "red tape." The official stated that her SBIC competes with SBA in providing long-term loans to small businesses.

A third official also said that loan-oriented SBICs and the 7(a) loan program are basically alike, although SBICs can usually provide faster service.

## CHAPTER 4

## DATA NECESSARY FOR MEANINGFUL PROGRAM EVALUATION

## NOT DEVELOPED

SBA has not developed data on a number of aspects of the SBIC program, including

--activities of loan-oriented and bank-dominated SBICs,

--extent of small business equity financing by both SBICs and private sources, and

--circumstances surrounding instances where small firms financed by SBICs are subsequently absorbed by larger corporations.

Accordingly, the agency has not been able to comprehensively evaluate the SBIC program or to fully apprise the Congress of its effectiveness. SBA officials basically agreed that the foregoing information would provide additional insight into the program but stated that insufficient personnel prevented data development.

As noted in chapters 2 and 3, to adequately assess the SBIC program it is important to distinguish the predominantly loan-oriented SBICs from those dealing in equity that also make loans but only as a supplemental form of financing. The major distinctions between the two types are the criteria used to select firms to be granted financing and the effect of the financing on the businesses. A firm must demonstrate growth potential before an SBIC will agree to make an equity investment, whereas collateral and ability to make repayments are the primary concerns in making loans. Also, an SBIC's investment in small business stock places no repayment burden on the business.

Bank-dominated SBICs constitute a significant segment of the SBIC program and, as previously mentioned in this report, are rather unique compared to other SBICs. Bank-dominated companies have invested substantially in small businesses yet have used relatively minor amounts of Federal funds. Officials from bank-dominated SBICs indicated that the primary reason banks became involved in the SBIC program was to enable them to make equity investments--an activity otherwise prohibited by law. SBA officials stated that revision of the banking laws "* * * would undoubtedly create an additional source of funds for small business equity investments * * *."

Many SBICs had been involved with private venture capital companies in joint financings of small businesses. (See p. 12.) This indicates that SBICs and private venture capital firms are mutually interested in specific business types. Data on this activity has not been collected or reported by SBA.

Several SBICs invested in small businesses that were later absorbed by large corporations. Although information on the frequency of such occurrences would clarify the extent that SBIC financing is ultimately benefitting large corporations, SBA has not developed such data.

RECENT SBA PROGRAM EVALUATION

In January 1977 SBA's Planning and Program Evaluation Division issued "Evaluation of the SBA Small Business Investment Company Program." The evaluation covered the time from the program's inception in 1958 through March 1975. Concerning the extent SBICs have aided small business, the report stated:

> "Flow of private equity capital and long-term loans to small business concerns is limited and insufficient.
>
> "During some 16 years of program operation through 1975, only about 21,000 small business concerns received financial assistance from SBICs. This represents about two-tenths of one percent of the present small business universe in the U.S., and much less of the total that existed over the 16-year life of the program."

The report also noted that the SBIC program has largely overlapped and possibly competed with SBA's regular business-loan programs. The report concluded that "Generally, the SBIC program on the whole, has done little to alleviate the enormous economic problems of small business."

The report set forth three possible alternative courses of action: (1) change nothing and maintain the status quo, (2) maintain the program basically in its present form but with modifications that would seek creation of an environment more conducive to SBIC viability, and (3) substitute a new system, possibly with no Government involvement at all (other than incentives). The report recommended an approach that combined the modification and substitution alternatives. Modification would be short term--3 to 5 years--and would be designed to correct program weaknesses. Specifically, the report recommended during this phase that

--steps be taken to induce the establishment and retention of substantially larger SBICs;

--regulations, guidelines, and/or incentives for SBICs to increase the amount of appropriate assistance to their portfolio small businesses be established; and

--possible methods for improving program administration and operation be investigated.

The report goes on to state that in approximately 3 to 5 years SBA should begin a study of the progress made during the short-term phase. If substantial improvement is not made, then a legislative program review should be initiated, probably preceded by an indepth position paper by a study group within SBA.

SBIC program officials disagreed with the findings of the SBA study and did not respond to its recommendations.

We agree with the SBA study that the SBIC program has provided financial assistance to only a limited number of small businesses and that some overlap with the Agency's regular business loan program exists. Our review, however, showed that in addition SBICs are extremely selective in providing equity financing, mainly servicing the larger small businesses that have substantial growth potential. A large private venture capital industry also services the same type of small business. We cannot agree, therefore, that providing added incentives to increase the size of SBICs and/or their investment portfolios will improve the program. SBICs are profit-motivated companies operating in a competitive environment and as such will of necessity continue to provide financing to selected firms--those they consider to have the greatest growth potential--which are the same companies serviced by the private venture capital companies.

# CHAPTER 5

## CONCLUSIONS, AGENCY COMMENTS AND OUR EVALUATION, AND RECOMMENDATION TO THE CONGRESS

### CONCLUSIONS

The Federal Government's role in meeting its large financial commitment to the equity needs of small business through the SBIC program is one whereby the needs of only a select group of small businesses are being served. These businesses are generally well-established firms that have the greatest growth potential. In some cases the program was useful in aiding small businesses in their attempts to become viable, successful business entities.

However, several characteristics of the program and the market in which it functions, as identified below, raise some doubt about whether the SBIC program will continue to be the most effective means of providing equity and long-term financing to small businesses. In certain respects, the SBIC program is smaller than it was in its formative years. Few small businesses get equity financing.

--The program operates in the same market with what we believe is a large private venture capital industry.

--In some cases SBIC and private venture capital investment companies financed the same small businesses, and in most cases the private venture capital firms' investments greatly exceeded SBICs'.

--Several bank-dominated SBICs were established only to permit the banks to make equity investments--an activity otherwise precluded by law. Many of these SBICs have not used SBA-guaranteed funds while others have sought only minor amounts in relation to what they could obtain.

--SBICs that generally make loans serve the same clientele--charging higher interest rates and requiring greater collateral--as those of SBA's 7(a) business loan program.

--SBA does not know the equity needs of small businesses.

Comprehensive program evaluations are not being performed because SBA does not collect enough data on the activities of SBICs and private venture companies.

AGENCY COMMENTS AND OUR EVALUATION

SBA's comments on our report (see app. I) generally did not respond to our findings and recommendations. These comments mainly explained the investment practices of SBICs as "for profit" enterprises and generally avoided the issue of how effectively the program has served small business. SBA did acknowledge that the SBIC program was not satisfying the long-term loan and equity needs of small businesses and that the fundamental economic/financial structure of the SBICs makes their use suitable only for certain segments of small business financing. SBA made no suggestions for improving the situation. It said only that satisfying all the equity capital needs of all small businesses would take a grant program ten times the size of the SBIC program, at least, plus the SBIC program for certain tiers of the market.

SBA said it viewed the report as an extraordinary document that did not show a good understanding of how the U.S. capital market system functions, the distinctions between the various types of financial intermediaries in the process, the lending and investment objectives of these institutions, and the relative role SBICs play in this process.

As previously mentioned in the scope section of this report, we extensively covered all facets of the SBIC industry and the private sector by personally visiting 18 SBICs, 11 private venture capital firms, and 5 investment bankers in the Boston, New York City, Dallas, Chicago, and San Francisco areas and representatives of associations of venture capitalists. In addition, officials of 126 small businesses who had either received or been denied SBIC financing provided us with a good understanding in these areas.

Moreover, we believe that SBA lacks enough information to determine the role of the SBIC program in the U.S. capital market and its effects on the small business community. SBA's response to written questions we asked during our review (see apps. III and IV) and chapter 4 of this report dealing with program evaluation indicate that SBA does not know the extent to which the needs of small business for long-term loans and equity capital are being met. Nor does it know the extent to which or in what proportion SBICs share investments with private venture capitalists or the number of small business concerns that are being absorbed by big businesses as a result of SBICs' selling their stock. It seems to us that these matters must be known to understand the role of SBICs and to evaluate program results.

We do not intend our findings as criticisms of the internal management of the SBICs; however, they do raise questions about the program's effectiveness in serving small businesses.

SBA's comments dealt with the following issues.

Slow program growth

Our report indicates that in several key respects the SBIC program has declined from a peak reached in the 1960s. SBA acknowledged the decline in the number of SBICs and in the number and value of their investments in small businesses. SBA explained that part of the reduction in number was a result of its delicensing many firms. SBA also cited Securities and Exchange Commission statistics showing the decline in common stock offerings over the last 10 years.

SBA challenged the significance, but not the accuracy, of statistics we presented for a 10-year period on the slow growth of the SBICs' combined portfolio and the 54-percent reduction in the number and 21-percent (much greater if real dollars were used) reduction in the amount of financings SBICs made to small businesses. SBA refers to the data presented on the small increase in the SBICs' combined portfolios as "meaningless." We find it hard to understand why this information is meaningless to SBA. The purpose of the SBIC program is to provide financing to small businesses. The statistics most useful in showing program growth would, therefore, be the annual number and amount of financings provided and the aggregate portfolio of SBICs.

SBA indicated that 81 SBICs and section 301(d) small business investment companies were licensed between January 1975 and September 1977, but it did not disclose that during the same period 68 SBICs surrendered their licenses.

We realize that many factors, including some beyond the control of SBICs and SBA, have contributed to the lack of program growth. If only equity (common stock, investments are considered, as SBA does in its comments on stock market investments in small business, this lack of growth is particularly striking. For calendar year 1976, SBICs made only 129 pure equity investments amounting to $14.3 million as opposed to 1,005 such investments amounting to $51.8 million for the year ending March 31, 1969.

Our point remains that the lack of program growth is one of a number of factors which suggest that the continued existence of this program in its present form should be justified.

SBIC investment policies

Our report states that (1) SBICs have followed very conservative investment policies which closely parallel the policies of private venture capital companies and (2) in a number of instances we reviewed, the SBICs and private companies had financed the same businesses with the SBICs contributing only a small portion of the total financing package.

SBA responded that because SBICs were profitmaking enterprises they had to be selective in investing and although SBA does not collect information on this point, that "risk-sharing" between SBIC and private companies was "healthy and quite common." SBA said that we (1) assumed that "an SBIC should invest in every concern that walks through the door," (2) were not aware of studies on the lack of venture and equity capital for small business, and (3) assumed, falsely, that there is an oversupply of capital for small business.

We are aware of the widely held opinion that there is a lack of venture and equity capital for small businesses. We do not assume that an SBIC should invest in every small business that applies for financing. We do believe that in view of the large amounts of money the Government has loaned to the SBIC program, there should be some difference between SBICs' role in financing small business and the role of private companies that do not receive Federal funds.

We have concluded that since the average investment per small business of equity-oriented SBICs we reviewed approximated $460,000, the businesses that received this financing were relatively large. SBA said that this conclusion was speculative "since a $460,000 risk investment can easily be made in a company with no sales and a net worth of $460,000, after the investment." We believe it is clear from SBIC investment criteria, some of which are quoted on page 10 of this report, that the equity-oriented SBICs are generally interested in well-established firms, not new businesses. In addition, an equity investment of

$460,000 could not be made in a firm with no net worth, since under SBA regulations an SBIC may not obtain a controlling interest in a small business.

SBA also points out that section 102 of the Small Business Investment Act calls for maximum participation of private financing sources in carrying out the policy. If SBA is using this section of the act to support the validity of joint financing of small businesses by SBICs and private investment companies, it should be aware that this section of the act refers to private financing of the SBICs themselves.

Bank-dominated SBICs

Our report notes that bank-dominated SBICs, which are major suppliers of the equity (as opposed to loan) capital provided by the program, have not used the SBA-guaranteed funds for which they are eligible. SBA assumed in its comments that we were criticizing these SBICs for not borrowing the guaranteed funds.

Our point is that much of the equity capital the program supplied to small businesses has not been stimulated by Government-guaranteed funds but has resulted from the use of the program by banks, which otherwise are forbidden by law from making equity investments. This raises the question of whether the present SBIC program, heavily financed by the Federal Government, is needed to insure this flow of funds to small business.

Loan-oriented SBICs

Our review found that 39 SBICs had portfolios consisting of at least 90 percent in loans. Loans were made on terms less advantageous than 7(a) loans. These 39 SBICs had $59.7 million in SBA-guaranteed loans outstanding.

SBA responded that a small business is not eligible for a 7(a) loan unless it cannot obtain credit elsewhere, including from SBICs; that "SBICs frequently provide financing to start businesses, whereas the majority of the 7(a) assistance is provided to established businesses;" and that SBICs make higher risk loans.

SBA did not address the issue of why SBA should continue to provide financing to SBICs to relend when similar assistance is provided by lenders participating in the 7(a) loan program who receive only an SBA guarantee.

Statistics are not available from SBA on the number of businesses started with the assistance of loans from the 39 loan-oriented SBICs we reviewed. The total loan portfolio of these SBICs was about $71 million. In contrast, in fiscal year 1976 alone, 5,206 7(a) guaranteed loans valued at $365.6 million were made to start businesses.

SBA's assertion that SBICs make higher risk loans than does the 7(a) program was not made to us by officials of loan-oriented SBICs. As we discussed on pages 16 to 18, these officials distinguished their loan financing and the 7(a) program as being simpler and faster to process.

Program evaluation

We found that SBA has not collected enough information to evaluate the SBIC program. SBA responded that it does collect valuable information on SBIC activities. We agree that valuable information is being obtained but believe, as discussed in chapter 4, that additional data is needed for program evaluation.

RECOMMENDATION TO THE CONGRESS

In this review we tried only to touch on the issues raised by the Joint Economic Committee. However, on the basis of evidence presented in this report, we believe that before the Congress provides further funding the program should be thoroughly reviewed and justified by the Small Business Administration.

Therefore, we recommend that the Congress require the Administrator of the Small Business Administration to fully justify the role, if any, that the SBIC program should play in meeting the financing needs of small businesses. In examining the program's role, the Administrator should determine:

--What size and type of small businesses are financed by the private venture capital industry and what is the degree that small businesses' legitimate equity-financing needs are not being met by the industry? This determination would require collecting the type of data discussed in chapter 4.

--Whether the SBIC program is the proper vehicle to meet the needs of small businesses, if it is found that legitimate financing needs are not being met.

--Whether continued funding of loan-oriented SBICs is warranted.

U.S. GOVERNMENT
SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

NOV 9 1977

Mr. Henry Eschwege
Director, Community and Economic
Development Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

This is in response to your letter of September 20, 1977, requesting this Agency's comments to your draft report entitled, "The Small Business Investment Company Program--Who Does It Benefit and Is Continued Federal Participation Warranted?"

Enclosed herewith are our comments and we appreciated the opportunity to review the report before it has been put into final form.

Sincerely,

A. Vernon Weaver
Administrator

Enclosure

SMALL BUSINESS ADMINISTRATION'S COMMENTS ON THE GENERAL ACCOUNTING OFFICE DRAFT REPORT ENTITLED, "THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM--WHO DOES IT BENEFIT AND IS CONTINUED FEDERAL PARTICIPATION WARRANTED?"

GENERAL

The report is an extraordinary document. However, we do not believe that the report shows a good understanding of how the U. S. capital market system functions, the distinctions between the various types of financial intermediaries in the process, the lending and investment objectives of these institutions and the relative role SBICs play in this process. We would commend to the attention of the GAO to the recently issued SBA Task Force Report on Venture and Equity Capital as a basic starting point to gain an understanding of this process. Also, because of this misunderstanding, the report has produced several incorrect and potentially harmful conclusions.

Below are our comments organized in the same format as the report.

DIGEST

GAO recommends that Congress require SBA to justify the role that the SBIC Program should play in financing the equity needs of small business. The figures included in this report show that as of March 31, 1976, the outstanding financings to small concerns by SBICs total about $569 million. This figure alone is evidence that Congressional intent is at least being attempted.

On page ii, there are several key issues on which SBA would like to comment.

1. The only thing smaller about the program now than in its formative years is the number of operating SBICs. Although the outstanding number of companies is smaller, for the first time total assets of the industry have surpassed $1 billion. In the early years of the program, a large number of SBICs were licensed, some of which were either not equipped to serve the purposes of the Small Business Investment Act (Act), or which entered the program with the intention of accruing personal gain with no regard for legislative intent. SBA forced the delicensing of many of these companies with the goal of improving the quality of the program.

Further, the GAO comparison begins in 1967, the beginning of a three-year bull market period. The markets were liquid; equity (risk) investments could be turned over. All kinds of people and institutions, including SBICs, were investing in small companies, because they thought they could, at some time, liquidate their investments, instead of being frozen into them, with no income from capital for the duration.

GAO should note that the SEC reports the following activity in common stock offerings over a comparable period:

Offerings of Common Stock for Cash

| | Total Issues | Issues by Companies with less than $5M Assets |
|---|---|---|
| 1968 ... | 1,009 | 358 |
| 1969 ... | 1,703 | 698 |
| 1970 ... | 976 | 198 |
| 1971 ... | 1,112 | 248 |
| 1972 ... | 1,020 | 409 |
| 1973 ... | 324 | 101 |
| 1974 ... | 150 | 9 |
| 1975 ... | 211 | 3 |
| 1976 ... | 251 | 29 |
| 1977 ... | -- | -- |

This has been the private market. In that environment, SBICs experienced a more modest aggregate decline in disbursements, from 3,728 to 1,720, with a smaller decline in dollars out, from $164 million to $129 million. They were taking risks then, that the private market by itself was not.

The point is that much of the "venture capital industry" was eliminated in the past few years, since private investors left equities and went into fixed income securities. It was a classical "shake out" in the industry, as its economics became more marginal due to changes in rate structures.

The SBICs had to weather a serious storm, and the GAO report indicates that they survived.

2. It appears that GAO is actually criticizing the professional managers of SBICs for being selective in their investment decisions. The managers of SBICs are approved by SBA, in part, because of the probability of their operating the SBICs profitably. Legislative history shows a Congressional intent that SBICs be profit making.

   It should be understood that equity is <u>permanent</u> capital, entailing no fixed obligation to repay. Institutional investors have to place it where there is reasonable chance to become liquid by replacing it with other capital. This can only be done where enhanced growth of profits is possible, and even then, it is difficult.

3. It appears that GAO is concerned with duplication of efforts by SBICs and private venture capital firms. The implication here is that there is an over-supply of capital for small business, which is not a true assumption.

   The figures given in our comments on one above shows the performance was inadequate.

   Second, the bulk of the private (non-public market) venture capital market consists of wealthy families with surplus capital to put at risk.

   > SBICs provide a means of capital formation among not poor, but certainly less-well-off individuals, on a pooled basis.

   It is true that certain of the private sources make the SBICs small in comparison. But the importance of multiple intermediaries to make decisions on risk investments and to have an opportunity to make a capital gain -- is critical.

   The GAO report implicitly endorces financial concentration in wealthy institutions and individuals; SBA does not.

   Further, Section 102 of the Act calls for maximum participation of private financing sources in carrying out the policy.

4. It is advantageous for small businesses that SBICs participate with other SBICs and with larger private venture capital firms. This practice, known as "risk-sharing", is healthy and quite common.

   It should be noted that virtually every private venture capital transaction -- SBIC-financed or not -- has a "lead investor" who takes a disproportionately larger share of the investment. The idea is that the party having the most at stake will take vigorous steps to prevent business failure, and they normally do.

   The end result is that more funds are being made available to small business concerns.

5. The report criticizes many bank-owned SBICs for not becoming leveraged by SBA, yet GAO also criticizes the increased level of Federal funds in the SBIC Program (page iv). These statements are clearly inconsistent. The Congress made the leverage available as an incentive, however, as our research shows, too much of the wrong kind of leverage can severely damage an SBIC's chance of success. Thus, the judicious use of leverage should be encouraged and complimented.

6. The assumption that loan-making SBICs are serving the same clientele as those served by the SBA 7(a) business loan program is questionable. If true, the 7(a) program is serving small business concerns it should not serve. Statute requires the 7(a) program to assist concerns to whom credit is not otherwise available on reasonable terms. Any concern which can be financed by an SBIC should not be eligible for 7(a) assistance. Because SBICs are profit motivated privately owned firms, it is true that they charge higher interest rates than SBA. Section 302(a)(2) of the Act is clear evidence of Congressional intent that SBICs be operated soundly and profitably.

   Consideration should also be given to the fact that most 7(a) loans are guaranteed up to 90%. The effect of a guaranty on a debt is to reduce both the rate and the collateral requirements.

   There is a criticism of the increased Federal investment in SBICs over the years instead of a withdrawal of Federal funds. The increased Federal participation has occurred because of legislation by Congress in response to legitimate increased needs for such funds as the program has grown and matured.

The statement regarding the decline in the number of SBICs and the annual number and amount of financings made to small concerns on page iv needs to be expanded. Stating that the number of SBICs has declined is incomplete without adding that the total asset size of the industry has continued to grow. The industry now has total assets of $971.5 million. If Section 301(d) licensees are included, the total asset size is in excess of $1 billion. In addition, the statement fails to recognize that a large number of SBICs were dropped from the program as a result of a joint Congressional/SBA initiative during the mid-1960s.

GAO's statement on the decline in financings during the last several years can be directly related to the economic slowdown and general health of the economy, and should recognize that economic context.

GAO states that critical program evaluations are not being performed by SBA. Through the report on financings made (SBA Form 1031) and annual Financial Reports (SBA Form 468), SBA is obtaining valuable information on the small businesses being financed, by which program evaluations are being made.

CHAPTER 1

[See GAO note 1, p. 39.]

The GAO has compared an investment portfolio of $536 million made by a group of 548 SBICs to an investment portfolio of $569 million made by a group of 215 SBICs as a total increase of $33 million, without regard to the change in the number of SBICs or size of investments. The comparison on page 4 of the total increase in investments by SBICs in small concerns over a ten year period is meaningless.

The statement on page 4 concerning limited program growth being evidenced by the SBICs' lack of demand for Federal funds is a contradiction of GAO's earlier criticism (page iv) of the increased Federal investment. This presumption is not necessarily true in light of increased program growth through more private funds being injected into existing and newly formed SBICs. Whereas only 152 SBICs were licensed from 1967 through 1974 (eight years), 81 SBICs have been licensed from the beginning of 1975 through September 1977. These figures include Section 301(d) licensees.

With regard to the question raised on page 6, ". . . whether the program was satisfying the long-term loan and equity needs of small business . . .", the answer has to be no, without any examination. The fundamental economic/financial structure of the SBICs makes their use suitable only for certain segments of small business financing.

Satisfying all the equity capital needs of all small business would take a grant program ten times the size of the SBIC program, at least, plus the SBIC program, for certain tiers of the market.

## CHAPTER 2

GAO is obviously not aware of the studies and reports which have been produced on the lack of venture and equity capital for small business. The most recent SBA study published in January 1977, is the Report of the SBA Task Force on Venture and Equity Capital for Small Business. It is replete with supporting data on the scarcity of capital for small business. Other studies include the following:

Analysis of Capital Market Imperfections, Charles River Associates, Inc., November 1975.

"Capital Crisis-The $4.5 Trillion America Needs to Grow," Business Week, September 22, 1975.

"Capital Formation Equals Jobs, Output and Expansion," U.S. Treasury, January 1976.

Capital Needs in the Seventies, Bosworth, Duesenberry, Carron, April 1975.

The Capital Shortage: Near Term Outlook and Long-Term Prospects, Sinai and Brinner, Summer 1975.

"The Capital Shortage as it Affects Small Business," U. S. Treasury, December 1975.

Is There a Capital Shortage?, Wallich, October 1975.

"The Role of New Technical Enterprises in the U. S. Economy," U. S. Department of Commerce, January 1976.

"A Study of Fixed Capital Requirements of the U. S. Business Economy 1971-1980," U. S. Department of Commerce, December 1975.

On page 9, the statement that ". . . equity-oriented SBIC's are serving a segment of small business which has access to other sources of financing. . ." is not true. If the SBICs do 5 out of 200 to 600 investments, what happens to the other 195 or 595? If risk capital were as plentiful as suggested, these ratios would not be so large.

Second, even 560 venture firms (including SBICs) in the U. S., given that most are three-to-six person shops, is small. There is no such thing as a redundant function in that environment.

On page 10, the report concludes that SBICs average investment of $460,000 per firm would indicate the firms were relatively large. We believe that such a conclusion is speculative, since a $460,000 risk invesmtnet can easily be made in a company with no sales and a net worth of $460,000, after the investment.

Page 10 reiterates an earlier criticism of the selectivity of equity-oriented SBIC management in its investment decisions. We would have to state that management seeking to invest in those concerns which have the best potential for growth and increased profitability are indeed carrying out the intent and spirit of the SBIC legislation. GAO's comment on page 11 that SBIC management advised GAO that each investment must be evaluated in terms of growth potential and risk, considering such factors as management capability, general economic conditions, industry growth, short and long-term product demand and the percentage of equity the small concern is willing to give up, is an excellent commentary on the SBIC industry.

With respect to the statement on page 11 that ". . . selectivity . . . cannot be attributed to a lack of funds," one must also consider that SBIC funds are hard to place if there is no reasonable prospect of turning over capital. Between 1973 and 1976, there was little such prospect for equity holders.

The discussion on page 12 deals with the private venture capital industry. The three points emphasized about that industry are completely true, but the fact that they are does not reflect poorly on the SBIC industry.

1. Because the private venture capital industry is larger than the SBIC industry, it follows that private venture capitalists would have substantially larger amounts invested in small business. Also, private firms are not restricted to an investment limit of 20 percent of private capital in any concern or group of related concerns, as are SBICs.

2. Yes indeed, private firms as well as SBICs seek to invest in small concerns having substantial growth potential.

3. Here again, the GAO assumes that an SBIC should invest in every concern that walks through the door, without regard to the merit of the investment.

The fact that SBICs and private venture capitalists participate with each other has several positive aspects:

1. It is beneficial to the small concern.

2. If they are participating, they are not competing.

3. More funds are being put out into the small business economy.

4. The risk is spread.

Further, consideration should be given to the fact that SBICs are private companies, and they have the same economics as a private venture firm. Therefore, there has to be a commonality of pursuit, if they are to survive financially.

The main difference is that SBICs generally have a higher overall cost of capital, because of the SBA debentures. They, therefore, tend to use more debt instruments than do the private equity funds, because they are "less patient" money, having to pay the government interest and principal in accordance with the appropriate amortization schedule.

On page 13, the criticism reappears that bank-oriented SBICs are not borrowing Federal funds, whereas earlier (page iv), GAO criticizes the increased Federal investment in the program.

CHAPTER 3

This entire chapter is totally inappropriate and shows a complete misunderstanding on GAO's part of the purposes of SBIC financing and those of the SBA 7(a) business loan program. They are not comparable.

The basic principle of the 7(a) program is that application for assistance may be considered only when there is evidence that the desired credit is not otherwise available on reasonable terms. If a small business concern can obtain financial assistance from an SBIC, it is not eligible for 7(a) assistance. There are basic differences in the criteria used by the 7(a) program and the SBIC managers. Before 7(a) assistance is provided, the applicant must demonstrate the ability to repay the loan, the ability to operate the concern successfully, and must provide security which could assure repayment. An SBIC makes loans which are of a higher risk and often secured by some type of collateral which would not be acceptable to a conventional lender. SBICs frequently provide financing to new start businesses, whereas the majority of the 7(a) assistance is provided to established businesses. The 7(a) business loan program has very clearly outlined criteria and terms which must be met before assistance is provided. A small concern and an SBIC can negotiate within the regulations, the terms and security of the assistance.

CHAPTER 4

This chapter lists several deficiencies in the tools of evaluation of the SBIC Program, but on the other hand, it does not discuss the valuable information which is being gathered. Every financing made to a small concern by an SBIC is reported to SBA on the Portfolio Financing Report (SBA Form 1031). This form also contains information about the concern, i.e., the number of employees, the number of years of its existence, i , financial condition, and taxes paid. A randomly selected group of SBICs reports once a year on certain portfolio companies on the Program Evaluation Report, SBA Form 684. The information taken from these reports is compiled for analysis purposes. The annual submission by SBICs of an audited Financial Report, SBA Form 468, provides additional information on the portfolio companies. The SBA's National SBIC Advisory Council has been working with SBA for the past year on a research project that examines the structural characteristics of SBICs operating in a risk/return atmosphere which is intended by the program. The results of this research shows that the industry's structure as per the legislation is wrong for the intended purpose. That is, there is a mismatch between legislative intent, and legislated incentives.

Also in this chapter, there is the statement which states that SBICs are benefiting large corporations. Again, this has to be understood in the context of what SBICs do. They make equity investments, which equity has to be replaced in the capital structure of a business before the SBIC can turn over its investment.

In the recent recession, one of the only means of turning over capital, to re-invest in other small businesses, was to sell to a third party, often a large corporation.

This is a function of illiquid and malfunctioning capital markets. It is not a systematic effort to enhance big business.

## CHAPTER 5

We feel that the information contained in the summary of conclusions has already been addressed in our comments above.

GAO notes: 1. Deleted comments refer to material contained in our draft report which has been revised or which has not been included in the final report.

2. Page references throughout the agency's comments refer to our draft report and may not correspond to this final report.

GAO RESPONSES TO QUESTIONS OF THE

JOINT ECONOMIC COMMITTEE LETTER

DATED APRIL 13, 1976

1. Considering the broad universe of small business, is the SBIC program directed toward meeting the needs of any specific segment? Is there any correlation between the size of an SBIC and the size of the small business being assisted and the type of assistance being provided?

The SBIC program is not directed toward meeting the needs of any specific segment of small business such as type of business, size, or geographic location.

The larger SBICs--assets in excess of $10 million--control the majority of program funds and invest primarily in larger, well-established small business. These SBICs make mostly equity-type investments in selected firms having the greatest growth potential and ability to go public or be bought by a large corporation in a relatively short period of time--about 5 to 10 years. 1/

2. What are the long-term loan and equity financing needs of small business?

The long-term loan and equity (capital stock) financing needs of small business cannot be quantified. The determination of need is subjective and is based on SBIC's analysis of the applicants' justification for the requested financing. Such justifications vary widely.

Although various groups have attempted to quantify small business financing needs, their estimates have varied considerably and have been widely disputed. SBA has stated that due to the paucity of raw data, attempts to measure need have failed.

3. To what degree have SBICs met the long-term loan and equity financing needs of small business?

The degree to which SBICs have satisfied the long-term loan and equity financing needs of small business cannot

1/GAO note: See chapter 2 of this report.

be measured. As previously noted, no reliable estimates of need exist. Also, businesses receiving SBIC financing have access to other sources of financing. Loan-oriented SBICs and SBA's 7(a) loan program serve similar clients in that both provide long-term loan funds; the interest rates of the 7(a) program, however, are substantially lower. 1/ Further, hundreds of private venture capital firms are a source of equity-type financing for small businesses having the potential of going public or being absorbed by a large corporation. Larger SBICs, accounting for the majority of invested dollars, invest in similar-type businesses. 2/

4. How have SBIC loan terms and interest rates compared with those of other lenders over the last 5 years?

Loan-oriented SBICs and SBA's 7(a) guaranteed loan program both provide long-term loans to small business. Although banks may also be a source of long-term credit, a Federal Reserve System official stated that a lack of data on the size of businesses receiving loans makes it impossible to determine the terms of magnitude of credit going to the small business community.

The maximum term of an SBIC loan is 20 years as compared to generally 10 years under the 7(a) loan program. Both type loans are approved, however, for an average term of about 7 years. Also, although SBICs may charge a maximum interest rate of 15 percent, the maximum interest rate of a 7(a) guaranteed loan as of October 7, 1976, was restricted to 10 percent. Since April 1971, 7(a) maximum loan rates have ranged from 7.75 to 11.5 percent. For a recent 2-year period, SBIC loan interest rates averaged 12.1 percent as compared to 10.1 percent for 7(a) guaranteed loans. 3/

5. In relation to SBA-guaranteed funds, how much private capital has been generated by the program?

Although the Congress intended that the SBIC program stimulate and supplement the flow of private capital to small business concerns, minimal capital in relation to total SBA-guaranteed funds has been generated.

---

1/GAO note: See chapter 3 of this report.

2/GAO note: See chapter 2 of this report.

3/GAO note: See chapter 3 of this report.

As of March 31, 1975, 256 SBICs had private-capital and SBA-guaranteed funds totaling $854.8 million, of which $573.2 million was invested in small business. Private capital totaled $386.9 million, or about 45 percent of funds for investment. We noted that bank-dominated SBICs, totaling 30 in number, accounted for $131.7 million or 34 percent of the private capital infused in the program. In relation to private capital, the bank-dominated SBICs borrowed relatively little Federal funds, $90.2 million or 19 percent of SBA guaranteed funds outstanding--a leverage ratio of SBA to private fund of .7 to 1. In comparison, the 226 non-bank-dominated SBICs were more dependent on Federal funds with a leverage ratio of 1.5 to 1.

Banks have established SBICs to make equity investments which otherwise they are legally precluded from doing. 1/ Most bank-dominated SBICs visited would continue to invest in the equity of small business, without being incorporated as SBICs, if they were legally permitted to do so.

6. To what extent does SBA administer the SBIC program?

SBA's administration of the program is conducted entirely out of its central office in Washington, D.C., and is primarily concerned with

--prescribing regulations governing the operation of SBICs and for carrying out the provisions of the act;

--approving SBIC articles of incorporation;

--issuing licenses to SBICs;

--examining SBICs to determine their compliance with legal and regulatory requirements;

--arranging SBIC financing through the Federal Financing Bank; and

--reporting on the overall status of the program.

SBA does not, however, get involved in the everyday operations of SBICs. Each SBIC independently develops its investment criteria and decides which small businesses should

---

1/GAO note: See chapter 2 of this report.

or should not receive financing. Also, SBA does not dictate or direct SBICs to serve a specific size or segment of small business.

Although SBA has attempted to report on the overall status of the SBIC program, the agency has not developed data on a number of areas which could have provided additional insight into the program. 1/

---

1/GAO note: See chapter 4 of this report.

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

12 Nov., 1976

Mr. Peter F. McNeish
Deputy Associate Administrator
for Investment
Small Business Administration

Dear Mr. McNeish:

As you know, we are presently conducting a review of the Small Business Investment Company Program at the request of the Joint Economic Committee. A member of the Committee staff responsible for coordinating the assignment has asked us to brief the full Committee staff on the preliminary results of our review in January 1977.

In order to present the SBA position most fully, we would appreciate your written response to the following questions.

1. Has SBA or any other organization measured the needs of the small business community for the types of assistance provided by the SBIC program: long term loans and equity capital? Have these studies expressed these needs quantitatively with any reliability? If quantitative expression is not possible, what factors have led SBA or other organizations to make conclusions about the needs of small business for this type of financing?

2. To what extent are the needs of small business for long term loans and equity capital being met by non-SBIC sources (e.g., the 7(a) program or private capital companies)? Are there differences between the investment policies and practices of private venture capital companies and SBICs? In particular, do they both serve the same small business market?

3. Many loan oriented SBICs supply loans to small business with maturities comparable to 7(a) loans but at a higher interest rates. In view of this, what justifies the existence of these investment companies in the SBIC program?

4. A relatively small number of SBICs (26) control the majority of SBA program funds. Indications are that these SBICs invest substantial sums in larger small businesses having the greatest potential to either trade stock publicly or be acquired by a larger public corporation within five years. Has data been developed concerning: (1) the extent to which portfolio companies of these SBICs are publicly trading stock or are being absorb by larger public corporations, and (2) the extent to which SBICs retain such investments? If so, we would appreciate receiving the data and any analysis of it.

5. Bank dominated SBICs invest in equity and avail themselves of considerably less SBA guaranteed funds than non bank dominated SBICs. If banking laws and regulation were revised to allow banks currently participating in the SBIC program to make equity investments in small businesses, without having to obtain an SBIC license, would these banks continu: to make such investments?

6. Some small businesses have received financing jointly from SBICs and private venture capitalists (e.g. [See GAO note.] ). Has data been collected on the number of small businesses which have been jointly financed and the relative amounts of financing provided by SBIC and non-SBIC sources? If data has been collected, we would appreciate your providing it to us.

7. The use of SBA guaranteed funds has been substantially less than anticipated in budget requests and appropriations--$725 million ceiling vs $500 million outstanding to SBICs. Although SBA may guarantee up to $150 million annually, SBICs, during the first eight months of 1976, have only drawn $25 million. Why haven't SBICs taken full advantage of SBA guaranteed funds?

GAO note: Material has been deleted to protect privacy of businesses.

8. The amount of SBIC funds invested in small business--currently about $575 million--is substantially less than the SBA ($468 million) and private capital ($387 million) held by SBICs. In view of this, do you feel that SBICs have made full use of their investment funds available for investment in small business?

9. The SBIC industry is composed of various types of investment companies which have distinct investment policies, methods of raising capital, and kinds of ownership. These SBIC types include: (1) loan oriented SBICs which are independently owned, (2) loan oriented SBICs which are subsidiaries of larger corporations and primarily service customers of their parents, (3) SBICs which finance small businesses through a mixture of loans and equity investments, and (4) bank-owned SBICs. SBA's regularly published reports on the SBIC program do not provide particular information on these segments of the SBIC industry. Reporting by type of SBIC could reveal useful information such as the facts that bank-owned SBICs supply a disproportionately large amount of funds to small business in relation to their Government leverage, and that interest rates charged by loan oriented SBICs vary with type of SBIC ownership. Do you agree that reports prepared on the SBIC program should provide data on the operations of the various types of SBICs into which the industry is segmented? In addition, if any analyses of these segments of the industry have been done, we would like to receive copies.

Your response to these questions within two weeks would be very much appreciated. If you need additional information, please contact me.

Sincerely yours,

James Donaghy

James F. Donaghy
Auditor-in-Charge
SBA Audit Site

cc: Mr. Raymond F. Randolph
Director, Office of Audits
and Investigations

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

NOV 22 1976

Mr. James F. Donoghy
Auditor-in-Charge
SBA Audit Site
General Accounting Office
Washington, D.C. 20548

Re: SBIC Program Audit

Dear Mr. Donoghy:

This is in response to the questions included in your November 12, 1976, letter concerning the SBIC program.

Enclosed on separate sheets are the questions you have asked and our answers to those questions as we understand them.

If we can be of further assistance, please let us know.

Sincerely,

Peter F. McNeish
Deputy Associate Administrator
for Investment

Enclosures

1. Has SBA or any other organization measured the needs of the small business community for the types of assistance provided by the SBIC program; long-term loans and equity capital?

   The SBA and other organizations have made attempts to measure the needs of small business for long-term loans and equity capital, however, due to the paucity of raw data these attempts have not been fruitful.

2. Have these studies expressed these needs quantitatively with any reliability?

   No.

3. If quantitative expression is not possible, what factors have led SBA or other organizations to make conclusions about the needs of small business for this type of financing?

   Testimony taken at Hearings held in connection with legislation for, and Oversight of, the SBIC program has been the basis on which legislation has been passed providing for this type of financing.

4. To what extent are the needs of small business for long-term loans and equity capital being met by non-SBIC sources (e.g., the 7(a) program or private capital companies)?

   Since the needs have not been established reliably in quantitative terms, it is not possible to estimate the extent to which those needs are being met.

5. Are there differences between the investment policies and practices of private venture capital companies and SBIC's?

   Yes, the policies and practices of private venture capital companies are more flexible in that they do not have to comply with SBA rules and regulations and they do not have to limit their financing to small business.

6. In particular, do they both serve the same small business market?

   Partially, since in some cases they participate in the same financings.

7. In view of this, what justified the existence of these investment companies in the SBIC program?

   Since most businesses are proprietorships and partnerships, it is necessary for some SBIC's to make loans to provide assistance to that segment of the small business community.

   Further, since SBIC's are leveraged with debt capital, SBIC's must place a portion of their funds in interest-bearing obligations to provide cash flow for debt service.

8. Has data been developed concerning: (1) the extent to which portfolio companies of these SBIC's are publicly trading stock or are being absorbed by larger public corporations, and (2) the extent to which SBIC's retain such investments?

   Due to resource constraints, no data has been developed to show these two phenomena.

9. If banking laws and regulations were revised to allow banks currently participating in the SBIC program to make equity investments in small businesses, without having to obtain an SBIC license, would these banks continue to make such investments?

   Revision of Glass - Steagall prohibitions and other regulations would undoubtedly create an additional source of funds for small business equity investments, everything else being equal.

10. Has data been collected on the number of small businesses which have been jointly financed and the relative amounts of financing provided by SBIC and non-SBIC sources?

    Due to resource constraints, no comprehensive data has been collected in this area.

11. Why haven't SBIC's taken full advantage of SBA guaranteed funds?

    There are four reasons.

    (1) Some don't use leverage to any significant degree.

(2) Exiting from SBIC investments has become difficult due to capital market problems, thus, SBIC's have tended not to become overincumbered with leverage.

(3) There has been a lack of investment opportunities because of the sporadic economic recovery.

(4) Idle funds carrying cost is high due to the term structure of interest rates. Thus, SBIC's have only borrowed where funds could be put to work quickly. Economic conditions have not been favorable to this.

12. In view of this, do you feel that SBIC's have made full use of their investment funds available for investment in small business?

The statistics you cited indicate that of the total capital of $855.0, $575.0 million or 67% is outstanding to small business. As an average, 20% is retained in liquid assets leaving a residual of 13% for workout type assets. In view of this, we feel that they are making prudent and effective use of their resources.

13. Do you agree that reports prepared on the SBIC program should provide data on the operations of the various types of SBIC's into which the industry is segmented?

Yes, however resource constraints have prevented these types of analysis.

# PRINCIPAL SBA OFFICIALS RESPONSIBLE FOR ADMINISTERING THE ACTIVITIES DISCUSSED IN THIS REPORT

| | Tenure of office | |
|---|---|---|
| | From | To |
| ADMINISTRATOR: | | |
| A. Vernon Weaver | Apr. 1977 | Present |
| Roger H. Jones (acting) | Mar. 1977 | Mar. 1977 |
| Mitchell P. Kobelinski | Feb. 1976 | Mar. 1977 |
| Louis F. Laun (acting) | Oct. 1975 | Feb. 1976 |
| Thomas S. Kleppe | Jan. 1971 | Oct. 1975 |
| Hilary Sandoval, Jr. | Mar. 1969 | Jan. 1971 |
| Howard J. Samuels | Aug. 1968 | Feb. 1969 |
| Robert C. Moot | Aug. 1967 | July 1968 |
| DEPUTY ADMINISTRATOR: | | |
| Patricia Cloherty | Aug. 1977 | Present |
| Vacant | Mar. 1977 | Aug. 1977 |
| Louis F. Laun | Sept. 1973 | Feb. 1977 |
| Anthony Chase | Feb. 1971 | Sept. 1973 |
| Einar Johnson | June 1970 | Feb. 1971 |
| W. Donald Brewer | Oct. 1969 | June 1970 |
| Richard B. Blankenship | Mar. 1969 | Oct. 1969 |
| Howard Greenburg | Aug. 1967 | Mar. 1969 |
| ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT (note a): | | |
| John Trask | June 1977 | Present |
| Peter F. McNeish (acting) | Mar. 1977 | June 1977 |
| John T. Wettach | Sept. 1975 | Mar. 1977 |
| Ronald G. Coleman (acting) | Feb. 1975 | Sept. 1975 |
| Einar Johnson (acting) | Jan. 1975 | Feb. 1975 |
| David A. Wollard | Feb. 1973 | Jan. 1975 |
| ASSOCIATE ADMINISTRATOR FOR OPERATIONS AND INVESTMENTS (note a): | | |
| Stephen H. Bedwell, Jr. (acting) | Oct. 1972 | Feb. 1973 |
| Claude Alexander | Feb. 1972 | Oct. 1972 |
| Arthur H. Singer | June 1971 | Feb. 1972 |

| | Tenure of office | |
|---|---|---|
| | From | To |
| ASSOCIATE ADMINISTRATOR FOR INVESTMENTS (note a): | | |
| Arthur H. Singer | Mar. 1969 | June 1971 |
| Vacant | Dec. 1968 | Mar. 1969 |
| Glen R. Brown | Aug. 1967 | Dec. 1968 |
| DEPUTY ASSOCIATE ADMINISTRATOR FOR INVESTMENTS: | | |
| Peter F. McNeish | Sept. 1976 | Present |
| James T. Phelan | Aug. 1967 | Sept. 1976 |

a/The position responsible for the investment activity changed in June 1971 from Associate Administrator for Investments to the Associate Administrator for Operations and Investments. In February 1973 the investment activity was transferred to the Associate Administrator for Finance and Investments.

(07774)

DOCUMENT RESUME

04662 - [B0024900] (Restricted)

[Claim for Relocation Expenses Incident to a Permanent Change of Station]. B-189597. December 5, 1977. 2 pp.

Letter to James D. Belknap; by Robert L. Higgins, Assistant General Counsel.

Issue Area: Personnel Management and Compensation: Compensation (305).
Contact: Office of the General Counsel: Civilian Personnel.
Budget Function: General Government: Central Personnel Management (805).
Organization Concerned: Department of the Navy.
Authority: 29 Comp. Gen. 255.

W. Hanburt
Civ Pers

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

OFFICE OF GENERAL COUNSEL

IN REPLY REFER TO: B-188597

04662

December 5, 1977

Mr. James D. Belknap
7750 Ropalt Street
La Mesa, California 92041

Dear Mr. Belknap:

This is in reply to your letter dated August 18, 1977, concerning your claim for relocation expenses which you incurred incident to a permanent change of station. Reimbursement has been denied in your case on the ground that the purpose of your transfer from Pascagoula, Mississippi, to Port Hueneme, California, was to effect your voluntary retirement. Your letter restates in great detail the chronology and circumstances surrounding your case and requests further review based upon such circumstances. In addition, you set forth your view that your retirement was coerced and therefore for the benefit of the Government.

Our recent decision, B-188597 dated June 17, 1977, was rendered after consideration of the complete chronology and record in your case. The record clearly indicates, and your August 18 letter does not dispute, that the sole purpose of your transfer to Port Hueneme was to effect your retirement in California. As we explained in our decision regarding your claim, 29 Comp. Gen. 255 (1949) held that an employee may not be transferred to his former station for the purpose of being retired, notwithstanding that an ultimate return to that duty station was contemplated by both the employing agency and the employee at the time of the original transfer. Applying that rule to the facts of your case, we held that relocation expenses may not be reimbursed in view of the purpose of the transfer.

Regarding your contention that your retirement was coreced, we find nothing in either the official record or the documents which you submitted which supports such a conclusion. In fact, your documents include a memorandum dated July 26, 1974, from the Commander of the Naval Sea Systems Command to the Commanding Officer at Port Hueneme which states:

> "The on-site NSWSES member Mr. James Belknap has expressed an interest in returning to NSWSES and retiring upon completion of the one year extension of the GFI task."

It thus appears that, contrary to your present contention, it was your intention to retire from Federal service upon returning to California. In any event, the evidence presented does not support a determination that your retirement was coerced.

In view of the above, we find that there is no basis for reconsidering, our prior decision regarding your claim.

Sincerely yours,

Robert L. Higgins

Robert L. Higgins
Assistant General Counsel