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Testimony before the House Committee on Small Business: Access to Equity Capital and Business Opportunities Subcommittee; by Henry Eschwege, Director, Community and Economic Development Div.

Contact: Community and Economic Development Div.

Organization Concerned: Small Business Administration.

Congressional Relevance: House Committee on Small Business: Access to Equity Capital and Business Opportunities Subcommittee.

Authority: Small Business Investment Act of 1958.

The Small Business Administration's (SBA's) Small Business Investment Company (SBIC) Program was intended to stimulate and supplement the flow of private-equity capital and long-term loans to small business. SBICs are privately operated investment companies that are authorized to make equity investments in small businesses. In spite of the Federal Government's large financial commitment to the program and the benefits to some small firms, only a select group of small businesses are being serviced. These are usually larger firms with the greatest growth potential. Equity-oriented SBICs are profit-motivated and consider investments according to risk and growth potential, whereas loan-oriented SBICs are more concerned with the ability to repay loans. Some factors restricting the usefulness of the program are: there has been a decrease in the number of investment companies participating and financings made; few businesses get equity-type financing; a private industry provides equity financing to the same type of businesses; banks have made equity investments otherwise prohibited by law; and SBICs serve the same clientele as those of SBA's 7(A) program which offers better loan conditions. Before further funding is provided for the program, it should be reviewed and justified by the SBA. (HTW)

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STATEMENT OF
HENRY ESCHWEGE, DIRECTOR
COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE
SUBCOMMITTEE ON CAPITAL INVESTMENT
AND BUSINESS OPPORTUNITIES
COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ON

SMALL BUSINESS ADMINISTRATION'S
SMALL BUSINESS INVESTMENT COMPANY PROGRAM

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

WE ARE HERE AT YOUR REQUEST TO DISCUSS THE RESULTS OF
OUR REVIEW OF THE SMALL BUSINESS ADMINISTRATION'S (SBA)
SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM.

THE CHAIRMAN OF THE JOINT ECONOMIC COMMITTEE REQUESTED
US TO EVALUATE THE SBIC PROGRAM. THE COMMITTEE QUESTIONED
WHETHER THE PROGRAM WAS SATISFYING THE LONG-TERM LOAN AND
EQUITY CAPITAL NEEDS OF SMALL BUSINESSES. OUR REPORT WAS
ISSUED ON MARCH 3, 1978, (CEG-78-45).

BACKGROUND

BRIEFLY, I WOULD LIKE TO PROVIDE SOME BACKGROUND INFORMA-
TION ON THE PROGRAM. THE SMALL BUSINESS INVESTMENT ACT OF 1958

INTENDED THAT THE PROGRAM STIMULATE AND SUPPLEMENT THE FLOW OF PRIVATE-EQUITY CAPITAL AND LONG-TERM LOANS TO SMALL BUSINESSES FOR GROWTH, EXPANSION, AND MODERNIZATION. THE ACT AUTHORIZED SBA TO REGULATE AND LICENSE SBICS AND TO PROVIDE FEDERAL LOANS TO ENCOURAGE SBICS TO FORM AND GROW. THE GOVERNMENT MAY MAKE 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 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 STEP.

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, WHICH MEANS GENERALLY AN SBIC CANNOT OWN 50 PERCENT OR MORE OF THE OUTSTANDING VOTING SECURITIES OF THE BUSINESS BEING FINANCED. 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.

OUR REVIEW WAS INTENDED TO BRING TOGETHER THE INFORMATION RELATED TO SEVERAL OF THE ISSUES RAISED BY THE JOINT ECONOMIC COMMITTEE--(1) TOWARD WHAT SPECIFIC SEGMENT OF THE BROAD UNIVERSE OF SMALL BUSINESS IS THE PROGRAM DIRECTED, (2) HOW HAVE SBIC LOAN TERMS AND INTEREST RATES COMPARED WITH THOSE OF OTHER LENDERS, AND (3) IN RELATION TO SBA-GUARANTEED FUNDS, HOW MUCH PRIVATE CAPITAL HAS BEEN GENERATED BY THE PROGRAM. THE JOB WAS NOT EASY SINCE WE HAD TO DEVELOP CONSIDERABLE DATA NOT AVAILABLE IN SBA FILES. OUR REVIEW BROUGHT OUT TWO VERY IMPORTANT QUESTIONS: WHO DOES THE SBIC PROGRAM BENEFIT? IS CONTINUED FEDERAL PARTICIPATION WARRANTED?

SCOPE OF REVIEW

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.

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 ASSOCIATIONS AND OFFICIALS FROM 126 SMALL BUSINESSES THAT HAD EITHER RECEIVED OR BEEN DENIED SBIC FINANCING.

WHO GETS FINANCING?

OUR WORK SHOWED THAT 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. THESE BUSINESSES ARE GENERALLY LARGER FIRMS THAT HAVE THE GREATEST GROWTH POTENTIAL.

THE MOST RECENT DATE THAT INFORMATION WAS AVAILABLE-- MARCH 31, 1976--SHOWED THAT 277 SMALL BUSINESS INVESTMENT COMPANIES HAD OUTSTANDING INVESTMENTS OF ABOUT \$569 MILLION. THESE COMPANIES HAD ABOUT \$467 MILLION IN FEDERAL LOANS OUTSTANDING OR 64 PERCENT OF TOTAL FUNDING OF \$725 MILLION AUTHORIZED FOR THE PROGRAM AT THAT TIME.

INVESTMENT CRITERIA USED

AS WITH PRIVATE VENTURE CAPITAL COMPANIES, EQUITY-ORIENTED SBICS ARE PROFIT-MOTIVATED FIRMS OPERATING IN A COMPETITIVE MARKET. ACCORDINGLY, EACH 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.

ON THE OTHER HAND, WE FOUND THAT LOAN-ORIENTED SBICS 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.

REASONS FOR OUR DOUBT

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 SBICS 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.
- FEW BUSINESSES GET EQUITY-TYPE FINANCING SINCE THE SBICS, WHICH ARE EXTREMELY SELECTIVE, PREFER LARGER SMALL BUSINESSES THAT HAVE SIGNIFICANT GROWTH AND PROFIT POTENTIAL. OFFICIALS OF MOST OF THE 14 EQUITY-ORIENTED SBICS REVIEWED SAID THAT THEY HONORED ONLY ABOUT 1 TO 5 OF THE 200 TO 600 FINANCING APPLICATIONS RECEIVED ANNUALLY.
- A LARGE PRIVATE VENTURE CAPITAL INDUSTRY, NOT RECEIVING FEDERAL LOANS AND HAVING GREATER RESOURCES THAN THE SBIC INDUSTRY, ALSO PROVIDES EQUITY FINANCING TO THE SAME TYPE OF SMALL BUSINESSES.
- IN SOME CASES PRIVATE VENTURE CAPITAL COMPANIES AND SBICS FINANCED THE SAME SMALL BUSINESSES, AND

IN MOST CASES THE PRIVATE VENTURE CAPITAL INVESTMENTS GREATLY EXCEEDED THOSE OF THE SBICS.

--MUCH OF THE EQUITY CAPITAL THE PROGRAM PROVIDED TO SMALL BUSINESSES HAS COME FROM BANK-DOMINATED SBICS 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.

--THE 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.

WHEN AN SBIC LENDS 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. AS A RESULT WE FOUND THAT 39 OF THE 256 SBICS IN THE PROGRAM

AS OF MARCH 31, 1975, PROVIDED THE SAME TYPE OF FINANCING AS SBA'S 7(A) BUSINESS LOAN PROGRAM. MANY SMALL BUSINESSMEN STATED THAT AT THE TIME THEY APPLIED FOR SBIC FINANCING, THEY WERE EITHER UNFAMILIAR WITH THE 7(A) PROGRAM OR HAD HEARD IT TOOK AN INORDINATELY LONG TIME FOR SBA TO PROCESS SUCH LOANS.

THE CONGRESS ANTICIPATED THAT FEDERAL FUNDS TO SUPPLEMENT AN SBIC'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. IN ACTUALITY THIS DID NOT HAPPEN. FEDERAL INVESTMENT IN THE SBICS HAS GROWN IN RELATION TO PRIVATE MONEY INVESTED IN THESE COMPANIES. DESPITE THE LARGER PROPORTION OF 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.

COMPREHENSIVE PROGRAM EVALUATIONS ARE NOT BEING PERFORMED BECAUSE SBA DID NOT COMPILE THE NECESSARY INFORMATION NEEDED FOR SUCH AN EVALUATION. SBA SAID THAT IT LACKS SUFFICIENT RESOURCES TO PERFORM THIS FUNCTION.

PROGRAM SHOULD BE JUSTIFIED

IN SUMMARY, WE COULD NOT ISOLATE ANY UNIQUE CHARACTERISTIC OF SBICS TO DISTINGUISH THEM FROM PRIVATE VENTURE CAPITAL FIRMS IN THE CASE OF EQUITY FINANCING OR SBA (7(A) LOAN PROGRAM) IN THE CASE OF LOANS. ACCORDINGLY, WE CONCLUDED THAT BEFORE THE

CONGRESS PROVIDES FURTHER FUNDING, THE PROGRAM SHOULD BE THOROUGHLY REVIEWED AND JUSTIFIED BY SBA. THE SBA ADMINISTRATOR SHOULD BE REQUIRED 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 THE SIZE AND TYPE OF SMALL BUSINESSES BEING FINANCED BY THE PRIVATE VENTURE CAPITAL INDUSTRY AND 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 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.

--ASCERTAIN 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.

--DETERMINE WHETHER CONTINUED FUNDING OF LOAN-ORIENTED SBICS IS WARRANTED.

SBA QUESTIONED WHETHER OUR REPORT PORTRAYED A GOOD UNDERSTANDING OF HOW THE U.S. CAPITAL MARKET SYSTEM FUNCTIONS, THE DISTINCTIONS BETWEEN THE VARIOUS TYPES OF FINANCIAL INTER-MEDIARIES IN THE PROCESS, THE LENDING AND INVESTMENT OBJECTIVES OF THESE INSTITUTIONS, AND THE RELATIVE ROLE SBICS PLAY IN THIS PROCESS.

MR. CHAIRMAN, SBA'S COMMENTS WERE LARGELY UNRESPONSIVE 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 OR WHAT DISTINGUISHED SBIC OPERATIONS FROM THOSE OF OTHER SOURCES OF SMALL BUSINESS FINANCING. 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/FINANCING STRUCTURE OF SBICS MAKES THEIR USE SUITABLE ONLY FOR CERTAIN SEGMENTS OF SMALL BUSINESS FINANCING. SBA OFFERED 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 AT LEAST 10 TIMES THE SIZE OF THE SBIC PROGRAM, PLUS THE SBIC PROGRAM FOR CERTAIN TIERS OF THE MARKET.

OUR RESPONSE TO SBA'S COMMENTS WAS BASED IN PART ON OUR EXTENSIVE COVERAGE OF ALL FACETS OF THE SBIC INDUSTRY AND THE PRIVATE SECTOR AND INCLUDED DISCUSSIONS WITH REPRESENTATIVES OF SBICS, PRIVATE VENTURE CAPITAL FIRMS, INVESTMENT BANKERS,

ASSOCIATIONS OF VENTURE CAPITALISTS AND SMALL BUSINESSES
NATIONWIDE.

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 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.

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THIS CONCLUDES OUR PREPARED STATEMENT, MR. CHAIRMAN. WE WILL BE PLEASED TO RESPOND TO YOUR QUESTIONS.