GAO

Fact Sheet for the Chair, Committee on Small Business, House of Representatives

August 1995

SMALL BUSINESS

SBA's Preferred Stock Repurchase Program

GAO/RCED-95-249FS

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-262173

August 18, 1995

The Honorable Jan Meyers
Chair, Committee on Small Business
House of Representatives

Dear Madam Chair:

The Small Business Administration (SBA) formerly provided investment capital to Specialized Small Business Investment Companies (SSBIC) by, among other means, purchasing their 3-percent preferred stock.[1] In November 1989, the Congress authorized SBA to permit SSBICs to repurchase that stock; the terms, conditions, and price were to be determined by SBA. Following a pilot program, in April 1994 SBA implemented the Three Percent Preferred Stock Repurchase Program allowing SSBICs to buy back their stock at 35 percent of the price paid by SBA. Accrued unpaid dividends were either forgiven or allowed to be fully amortized (written off) over a 5-year period. In May 1995, we reported to you that 17 SSBICs had repurchased their stock under the program.[2] Since that report, an additional 4 of the current 90 SSBICs have repurchased their stock.

You subsequently asked us to provide information on each SSBIC participating in the stock repurchase program, including (1) the repurchase price paid, unpaid dividends forgiven or allowed to be amortized, and method used to finance the repurchase; (2) the company's private capital, SBA financing, and capital impairment at the time of the

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[1]Up until November 1989, SBA could provide funding to SSBICs by purchasing preferred stock carrying a 3-percent annual dividend (generally referred to as 3-percent preferred stock).

[2]Small Business: Information on SBA's Small Business Investment Company Programs (GAO/RCED-95-146FS, May 12, 1995).

stock repurchase;[3] and (3) the company's investments in small businesses over the last 5 years and the value of the investment portfolio at the time of the company's most recent report to SBA. We are providing under separate cover and summarizing herein certain detailed information that SBA regards as proprietary, such as the value of each SSBIC's investment portfolio.

In summary, we found the following:

- The 21 SSBICs paid SBA $17.7 million to buy back stock that the agency had earlier purchased for $50.3 million. SBA forgave or allowed to be amortized $15.3 million in accrued unpaid dividends owed to it in connection with the stock. Of the 21 SSBICs, 19 repurchased with cash, 1 used a note to SBA to pay for the stock, and 1 used a combination of cash and a note to SBA.

- The private capital of all 21 SSBICs increased from the date of licensing to the time of the stock repurchase. Thirteen of the SSBICs had private capital ranging from $1 million to $2 million at the time they repurchased their stock. The SSBICs' SBA financing at the time of the repurchase ranged from $700,000 to $10 million; currently, seven SSBICs have no SBA financing outstanding. Seven SSBICs received additional SBA financing after the repurchase. Seven of the 21 SSBICs had a capital impairment greater than 10 percent at the time of the repurchase.

- During the 5-year period--fiscal years 1990 through 1994 --the 21 SSBICs provided 1,242 financings to small businesses totaling $116 million; 9 of the SSBICs had fewer than 10 new financings in each of the 5 years. As of March 31, 1995, the SSBICs' total investment portfolios were valued at $117 million, covering investments in approximately 830 small businesses.

Section 1 of this report presents data on the SSBICs' participation in the program, including the repurchase terms and financing, capitalization, and investments.

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[3]Capital impairment, as defined by SBA for the repurchase program, is the ratio of the cumulative actual losses (from operations and investment transactions) and unrealized losses (from decreases in the value of securities) to the capital invested in the SSBIC.

The information presented in this report covers the 21 SSBICs that had completed their stock repurchase under the program as of May 31, 1995. The information came from interviews with SBA officials and from SBA data sources containing the most recent information reported by the SSBICs as of May 31, 1995. The data sources included databases on licensing, capitalization, and investment information as well as the agency's files on each SSBIC. We did not verify the accuracy of SBA's data nor conduct reliability assessments of the agency's databases. We conducted our review from May through July 1995.

We met with SBA's Associate Administrator for Investment and other agency officials to obtain SBA's comments on a draft of this report. While the officials agreed with the accuracy of the factual data in the report, they identified certain information as proprietary. This included SSBIC-specific data such as the value of the portfolios and the method used to finance the stock repurchase. We deleted those data from this report and are providing it to you under separate cover. The Associate Administrator for Investment also provided written comments, presented in appendix I of this report, that outline the purpose of the Three Percent Preferred Stock Repurchase Program and SBA's rationale for setting a repurchase price of 35 cents on the dollar and for forgiving, or allowing SSBICs to write off, the accrued unpaid dividends. We incorporated where appropriate the officials' suggestions for clarification.

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Unless you publicly announce its contents earlier, we plan no further distribution of this report until 14 days after the date of this letter. At that time, we will send copies of the report to interested congressional committees, the Administrator of SBA, and other interested parties. We will also make copies available to others upon request.

Please call me at (202) 512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix II.

Sincerely yours,

Judy England-Joseph

Judy A. England-Joseph
Director, Housing and
Community Development Issues

CONTENTS

ABBREVIATIONS

GAO	General Accounting Office
SBA	Small Business Administration
SSBIC	Specialized Small Business Investment Company

SECTION 1

DATA ON PARTICIPATION IN THE PROGRAM

This section presents information on the 21 Specialized Small Business Investment Companies (SSBIC) that had repurchased stock under the Small Business Administration's (SBA) Three Percent Preferred Stock Repurchase Program as of May 31, 1995. The section includes data on the repurchase terms, method of financing, capitalization (both private capital and funding from SBA), extent of capital impairment, investments over the past 5 years, and value of investment portfolios.

REPURCHASE TERMS AND FINANCING

Table 1.1 shows that the 21 SSBICs together paid SBA $17.7 million to buy back stock that SBA had earlier purchased for $50.3 million. SBA forgave or allowed to be amortized (written off) $15.3 million in accrued unpaid dividends owed to it in connection with the stock.

Table 1.1: SSBICs That Had Repurchased Stock as of May 31, 1995

Dollars in thousands

Licensee	Par value paid by SBA	Repurchase price paid by SSBICs	Amount discounted	Dividends forgiven/ amortized
Alabama Capital Corporation	$ 1,550	$ 542	$ 1,008	$ 72
Alliance Enterprise Corporation	2,700	945	1,755	1,309
Capital Dimensions Venture Fund, Inc.	10,000	3,572	6,428	2,364
East Coast Venture Capital, Inc.	1,000	350	650	136
Freshstart Venture Capital Corp.	1,520	551	969	82
Future Value Ventures, Inc.	1,000	350	650	227
Ibero American Investors Corp.	1,750	625	1,125	382
LaiLai Capital Corporation	700	245	455	155
Motor Enterprises, Inc.	2,000	700	1,300	859
Pacific Venture Capital, Ltd.	700	245	455	293
Peterson Finance & Investment Company	1,035	362	673	214
Pierre Funding Corporation	2,371	830	1,541	6
Rutgers Minority Investment Co.	905	314	591	484
Security Financial & Investment Corporation	500	175	325	0
Syncom Capital Corporation	3,125	1,083	2,042	1,236
TSG Ventures, Inc.	10,295	3,603	6,692	4,679
Tower Ventures, Inc.	3,000	1,050	1,950	1,386
Transpac Capital Corporation	2,000	700	1,300	385
United Capital Investment Corp.	1,000	362	638	47
United Oriental Capital Corp.	2,000	700	1,300	613
Venture Opportunities Corp.	1,150	403	747	398
Total	**$50,301**	**$17,707**	**$32,594**	**$15,327**

Source: GAO's analysis of data from SBA.

Nineteen of the 21 SSBICs repurchased their stock with cash. One used a note to SBA to pay for the stock, and one used a combination of cash and a note to SBA. Of the 19 that repurchased with cash, 12 raised the cash from new private capital, 3 raised the cash from a combination of new capital and the capitalization of retained earnings, 1 raised the cash from the capitalization of retained earnings, 1 raised the cash from the capitalization of retained earnings and idle funds, 1 raised the cash from third-party borrowing, and 1 raised the cash from third-party borrowing and the capitalization of retained earnings.[1]

The guidelines establishing the repurchase program state that participating companies would structure payment of the repurchase price in one of four ways: (1) all cash, following the raising of new capital; (2) a promissory note (with SBA-stipulated conditions) payable to SBA in exchange for the preferred stock; (3) all cash from third-party unsecured financing; or (4) a combination of any of the above. In an August 1994 notice in the Federal Register clarifying the guidelines, SBA stated that under certain conditions, an SSBIC's idle funds could be used as a temporary source of funds for the repurchase.

CAPITALIZATION

Table 1.2 shows the SSBICs' private capital, SBA financing outstanding at the time of the repurchase, and SBA financing currently outstanding. Thirteen of the SSBICs had private capital ranging from $1 million to $2 million at the time of the repurchase. The smallest amount of private capital was $536,000, and the largest amount was a little over $8 million. Eleven of the SSBICs had $3 million or less in SBA financing outstanding at the

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[1]The capitalization of retained earnings is increasing private capital with funds that could have been eventually distributed to owners--that is, permanently reinvesting otherwise distributable earnings into the business.

time of the repurchase. The smallest amount outstanding was $700,000, and the largest amount was $10 million. Seven SSBICs had no SBA financing outstanding as of May 31, 1995, while seven SSBICs had received additional SBA financing since the repurchase.

Table 1.2: SSBICs' Capitalization and SBA Financing

Dollars in thousands

Licensee	Private capital at time of repurchase	SBA financing outstanding at time of repurchase	SBA financing outstanding as of 5/31/95
Alabama Capital Corporation	$ 1,550	$ 2,650	$1,100
Alliance Enterprise Corp.	3,030	2,700	2,250
Capital Dimensions Venture Fund, Inc.	7,343	10,000	5,744[a]
East Coast Venture Capital, Inc.	1,011	3,000	2,000
Freshstart Venture Capital Corp.	2,210	6,510	5,750
Future Value Ventures, Inc.	2,532	1,000	0
Ibero American Investors Corp.	1,851	3,740	3,976[a]
LaiLai Capital Corporation	1,125	3,375	2,675
Motor Enterprises, Inc.	1,500	2,000	0
Pacific Venture Capital, Ltd.	1,250	700	0
Peterson Finance & Investment Company	1,035	1,035	0
Pierre Funding Corporation	2,761	7,112	4,741
Rutgers Minority Investment Co.	1,499	905	0
Security Financial & Investment Corporation	536	1,500	1,500[a]
Syncom Capital Corporation	2,250	3,125	0
TSG Ventures, Inc.	8,200	10,295	0
Tower Ventures, Inc.	2,000	3,000	1,475[a]
Transpac Capital Corporation	1,016	4,000	2,000
United Capital Investment Corp.	1,440	2,800	2,300[a]
United Oriental Capital Corp.	1,000	3,700	1,700[a]
Venture Opportunities Corp.	1,525	5,475	6,025[a]

[a]Includes financing that the SSBIC received after the repurchase.

Source: GAO's analysis of data from SBA.

Under the program, the accrued unpaid dividends of financially distressed SSBICs are forgiven.[2] Financially distressed SSBICs are defined by SBA as those companies that, as of the end of fiscal year 1993--preceding the April 1994 notice in the Federal Register implementing the repurchase program--had undistributed realized losses and capital impairment of at least 10 percent.[3] Table 1.3 shows that 7 of the 21 had a capital impairment greater than 10 percent; 5 of these were over 50-percent impaired. Capital impairment, as defined by SBA for the purposes of this program, is the ratio of the cumulative actual losses (from both operations and investment transactions) and unrealized losses (from decreases in the value of securities) to the capital invested in the SSBIC.

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[2]Under a pilot for this program, the accrued dividends were forgiven for all SSBICs that completed the repurchase even if they were not financially distressed.

[3]Undistributed realized losses represent cumulative net losses (offset by gains, if any) resulting from the sale, write-off, or other disposition of investments and the cumulative results of operations.

Table 1.3: SSBICs' Capital Impairment at the Time of Stock Repurchase

Number of SSBICs	Range of percentages
14	0 to 10
0	11 to 20
0	21 to 30
1	31 to 40
1	41 to 50
2	51 to 60
2	61 to 70
1	71 to 80
Total **21**	

Source: GAO's analysis of data from SBA.

INVESTMENTS

As table 1.4 shows, during fiscal years 1990 through 1994, the 21 SSBICs reported to SBA that they had provided 1,242 financings totaling $116 million. Nine SSBICs had fewer than 10 new financings in each of the 5 years.

Table 1.4: SSBICs' Investments in Small Businesses, Fiscal Years 1990 through 1994

Dollars in thousands

Licensee	Number of financings	Total dollars	Number of states
Alabama Capital Corporation	74	$ 4,117	3
Alliance Enterprise Corp.	22	3,835	7
Capital Dimensions Venture Fund, Inc.	82	6,929	12
East Coast Venture Capital, Inc.	54	1,828	3
Freshstart Venture Capital Corp.	265	12,641	4
Future Value Ventures, Inc.	5	617	2
Ibero American Investors Corp.	65	5,370	3
LaiLai Capital Corporation	54	6,404	1
Motor Enterprises, Inc.	20	2,229	3
Pacific Venture Capital, Ltd.	16	1,777	4
Peterson Finance & Investment Company	23	1,412	3
Pierre Funding Corporation	223	27,784	2
Rutgers Minority Investment Co.	5	360	1
Security Financial & Investment Corporation	20	1,670	5
Syncom Capital Corporation	4	145	3
TSG Ventures, Inc.	24	10,460	11
Tower Ventures, Inc.	13	2,029	5
Transpac Capital Corporation	28	4,250	10
United Capital Investment Corp.	24	2,946	2
United Oriental Capital Corp.	81	4,932	3
Venture Opportunities Corp.	140	14,011	3
Total	**1,242**	**$115,746**	[a]

[a]The column of states was not added because the numbers included duplicates. Also, the numbers include U.S. territories.

Source: GAO's analysis of data from SBA.

Together, the 21 SSBICs reported to SBA that their investment portfolios included investments in approximately 830 small businesses with a combined value of about $117 million as of March 31, 1995. In addition, their investment portfolios included a total of about $22.7 million in cash and investments in U.S.-insured or -guaranteed securities.

As of January 31, 1995, all SSBICs were required to adopt an investment valuation policy approved by their boards of directors or general partners consistent with SBA's guidelines outlined in 13 C.F.R. part 107, app. III. As part of their annual audits of SSBICs' financial statements, independent certified public accountants are responsible for reviewing the SSBICs' valuation procedures and implementation of these procedures, including the adequacy of the documentation. According to the guidelines, when the accountants cannot satisfy themselves that valuation requirements have been fulfilled, they must specifically so state. The guidelines further note that the independent public accountant is not to be an appraiser determining the value of the SSBIC's securities and is not required to perform an audit of the businesses in the investment portfolio. Before these guidelines, SBA relied upon a valuation policy established in 1975, which, according to SBA, was more general than the new guidelines and did not carry the authority of a regulation.

COMMENTS FROM THE SMALL BUSINESS ADMINISTRATION

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

August 15, 1995

Ms. Judy A. England-Joseph
Director, Housing and Community
Development Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. England-Joseph:

We appreciate the opportunity of reviewing a draft of your proposed report entitled: Small Business: SBA's Preferred Stock Repurchase Program (GAO/RCED-95-249FS).

The data presented in the report was developed by the SBA Investment Division, which is responsible for the preferred stock repurchase program, and to the best of our knowledge it is accurate. To understand the meaning and significance of this data, however, we believe it is essential that the reader understand what the program is, what it is meant to accomplish, and the rules under which it is being implemented. Before we initiated the full program, we published the attached Federal Register Notice, dated April, 1994, to review all of these points, and to solicit public comment. The only comment received was from the industry, expressing an opinion that the proposal was too restrictive.

It is particularly important to note the following:

1. This program was authorized by Congress in PL 101-162, November 21, 1989, and SBA was strongly encouraged by many members of Congress to implement it.

2. While the repurchase of the stock at a price of 35% of its original cost must be accounted for as a loss to the government, in most cases no cash at all would have been received by the government had the discount not been offered. The preferred stock has a dividend rate of 3%, and no requirement for redemption or repurchase. Much of this stock was purchased by SBA twenty or more years ago, and would never have been repurchased at any price were it not for the repurchase program which is the subject of your report.

At a price of 35% of face value, the preferred has an equivalent yield of approximately 9% (3% divided by .35), which is equal to or lower than yields on marketable preferred stocks which are more attractive as investments, because they readily can be sold in the public markets..

3. The basic purpose of the program is to allow Specialized SBICs to strengthen their

financial condition, in order to be able to raise additional capital for future investments in small businesses. The forgiveness of dividends accrued by "distressed" SSBICs is consistent with this, since most of these SSBICs are lenders, which cannot look forward to capital gains to offset accumulated losses. Preferred dividends must be paid out before any distribution is made to investors; consequently, if these old accruals were not forgiven or amortized, it is unlikely that any of the SSBICs could have raised new capital to accomplish the repurchase.

4. Similarly, the amortization of accrued dividends by healthy SSBICs is intended to assure they will remain active investors in small businesses, and to improve their ability to raise additional capital.

5. The repurchase program sets forth specific and narrow parameters for the method of payment allowed for the preferred stock. The licensees are strongly encouraged to use cash raised from a new capital infusion into the SSBIC, or from the capitalization of earnings (i.e. agreement to retain permanently in the SSBIC earnings which otherwise could have been distributed to shareholders). Of the 21 SSBICs which have repurchased their preferred, 19 have used cash from these sources. While the program allows the use of promissory notes to SBA in exchange for the preferred stock, such notes must meet rigorous credit standards and be secured by all the assets of the SSBIC. Consequently, no SBA debt financing has been used to date.

We request that this letter and the enclosed Federal Register Notice dated April 1, 1994 be included with your report, so the readers may understand the program, as a basis for considering the data presented.

Yours sincerely,

Robert D. Stillman
Associate Administrator for Investment

Federal Register / Vol. 59, No. 63 / Friday, April 1, 1994 / Notices 15491

SMALL BUSINESS ADMINISTRATION

Specialized Small Business Investment Companies

AGENCY: Small Business Administration.

ACTION: Notice.

SUMMARY: The Small Business Administration (SBA) has completed the 3% Preferred Stock Repurchase Pilot Program for Small Business Investment Companies licensed under section 301(d) of the Small Business Investment Act (15 U.S.C. 681(d)) (Specialized SBICs or SSBICs), and now will offer each currently licensed SSBIC that was not in the Pilot Program the opportunity to apply for the repurchase of its 3% preferred stock held by SBA. This Notice sets forth the guidelines SBA is intending to follow in its implementation of this Repurchase Program.

DATES: This Notice is effective on April 1, 1994 Written comments on this Notice must be received no later than May 2, 1994.

ADDRESSES: Written comments should be sent to Robert D. Stillman, Associate Administrator for Investment, U.S. Small Business Administration, suite 6300, 409 Third Street SW., Washington, DC 20416.

FOR FURTHER INFORMATION CONTACT: George Dale, Investment Division, U.S. Small Business Administration, 409 Third Street SW., Washington, DC 20416, (202) 205-7595.

SUPPLEMENTARY INFORMATION: On June 19,1992, SBA published a Notice in the **Federal Register** (the Pilot Notice) announcing the commencement of the 3% Preferred Stock Repurchase Pilot Program for Small Business Investment Companies licensed under section 301(d) of the Small Business Investment Act of 1958, as amended (Specialized SBICs or SSBICs). See 57 FR 27503.

Policy Statement

The policy for the Repurchase Program was stated in the Pilot Notice, and is repeated verbatim as follows:

"SBA's policy is to administer the Repurchase Program in such a way as to maximize the capacity of SSBICs to provide financing to businesses owned by persons whose participation in the free enterprise system is hampered by social or economic disadvantage

SBA will structure each transaction with the aim of:

1. Encouraging and facilitating the investment of new private capital into SSBICs;
2. Conserving the cash resources of each participant;
3. Conserving the borrowing potential of each participant;
4. Conserving the direct and guaranty budget of the Specialized SBIC program;
5. Improving the financial status of the participating SSBICs;
6. Rehabilitating (where necessary) weak SSBICs to improve their financial and operating effectiveness without undue risk to SBA; and
7. Discouraging voluntary liquidations of SSBICs and the premature surrender of licenses.

The methodology of computing the price at which the 3% preferred stock is sold back to an SSBIC will be a function of four factors independent of any SSBIC, and four factors that are variable with each SSBIC. The independent factors are:

1. Average SBIC Treasury-based 10 year rate,
2. Barron's Junk Bond Spread over Treasury,
3. Preferred stock dividend rate (3%), and
4. The adjustment to the price for non-marketability of shares.

The four factors that are variable with each individual SSBIC are:

1. Number of years that dividends are in arrears,
2. Financial rating of SSBIC, as rated by SBA,
3. Ability of SSBIC to have paid dividends, and
4. Par value of stock to be purchased.

The above policy will be executed in such a way as to prevent windfall opportunities to SSBICs, their managements, or owners; and to avoid transfer of cash flows from SSBICs into SBA to the detriment of the program's effectiveness and liquidity."

Implementation of the Repurchase Program

In accordance with the Pilot Notice, SBA selected nine Specialized SBICs which had indicated an interest in participating in the Pilot Program. The nine licensees represented a cross-section of the industry, including both financially distressed and non-distressed companies. SBA considered and structured each repurchase transaction in accordance with the policy restated above.

Of the nine companies selected to participate in the Pilot Program, six have completed the repurchase of their stock. Of the remaining three companies, one withdrew voluntarily, one never submitted an application, and one was denied participation because of regulatory violations which would not have been cured by the repurchase.

As stated in the Pilot Notice, the objective of the Pilot Program was to test SBA's Repurchase Program procedures and to suggest changes that might facilitate future transactions. Many of the issues raised during the Pilot Program concerned the following:

1. Development of a formula for determining the repurchase price;
2. Special considerations dependent on the financial condition of SSBICs;
3. Application of the Repurchase Program to companies which are involved in change of ownership transactions; and
4. Methods and conditions of financing the repurchase. Approaches to these issues, and their resolution for the Repurchase Program, are described below:

1. Repurchase Price Formula

A repurchase price formula was developed in general accordance with the methodology included in the policy statement repeated above, and applied to the particular situation of each of the pilot participants. The formula for the preferred share price was a substitute for fair market value, since there is no market for these shares. Based on the recommendations of two independent expert studies, the formula for computing the percentage of par value to be used in the Pilot Program was the sum of three elements:

(1) The percentage of par which represented the differential between an instrument paying 3% and the "all-in" cost of the June 1991 SBIC funding rate. This differential represented a discount from par, since a 3% return was significantly below the market rate at June 1991. The percentage of par value remaining after subtracting the discount computed to 32.05%.

(2) An adjustment based on the financial rating of the particular SSBIC, plus an adjustment based on a junk bond spread over Treasures, plus an adjustment for lack of marketability of the 3% preferred stock. In practice, these adjustments added only 2% to 4% to the price for individual companies in the Pilot Program.

(3) The third element represented the present value of the benefit to the SSBIC from deferring payment of preferred dividends which it had the capacity to pay.

In view of the very small effect of the second element on overall valuation, the complexity of its computation, and the extent of financial data and analysis required for its determination, SBA has decided to substitute a fixed input of 3% for the Repurchase Program. This was the midpoint of the range of adjustments for this element in the Pilot Program.

SBA also determined that the third element may be duplicative of the continuing obligation of a licensee to pay accrued dividends under certain conditions enumerated herein. Consequently, only the first two elements will be utilized in determining the price for the preferred shares being repurchased.

For the Repurchase Program, SBA intends to fix the sum of the two elements at 35% of par value, using the June 1991 interest rate inputs in recognition of the extended delay in completing the Pilot Program. Thus, the price to be paid by any SSBIC repurchasing 3% preferred stock under this Program will be 35% of par. This compares with a range of repurchase prices calculated for all of the pilot participants of 34.6554% to 36.2257% of par value.

To avoid a windfall, and to assure the desired result of retaining funds in an active SSBIC program, repurchases below par during the Pilot Program were made on condition that if the licensee became inactive or was liquidated during a five year period following the repurchase, SBA would have a preferred liquidating interest in the licensee. SBA intends to continue this practice for the remainder of the Repurchase Program, as described below under "Other critical terms of the repurchase transactions."

2. Special Considerations Dependent Upon Financial Condition of SSBIC

SBA's evaluation of the Pilot Program has led it to conclude that in order to be consistent with the stated policy objectives of the Program, the amount and the timing of any required payment of accrued dividends should be related to the financial strength of the particular SSBIC purchasing its preferred stock from SBA.

For an SSBIC which has no practical prospect of making dividend payments, the Repurchase Program will assist in strengthening the licensee's financial condition and enabling it to attract new capital.

For those SSBICs which are financially strong enough to make dividend payments, the program objectives are met if the deferral or reduction of dividend payments provides an incentive for the SSBIC to remain active in its investment program, and to defer distributions to its shareholders.

Accordingly, the following guidelines have been developed to distinguish between the two categories of SSBICs and to provide for the treatment of accrued dividends for each category:

(a) Companies which lack any reasonable prospect of paying accrued dividends are defined as those which, as of the licensee's fiscal year end immediately preceding the publication of this Notice, have undistributed realized losses and a capital impairment percentage (as defined in 13 CFR part 107) of at least 10%. These licensees are referred to as "distressed" for purposes of the Repurchase Program. For distressed licensees, the accrued dividends will be extinguished completely at the time of repurchase. This will remove a contingent liability which would otherwise impede their efforts to raise new capital. In the distressed licensee's repurchase agreement with SBA, the company will agree to remain active for a five year period and to be subject to the guidelines for change of ownership transactions discussed below.

(b) For the remaining "non-distressed" SSBICs, which have a reasonable prospect of being able to pay accrued dividends, forgiveness of the dividends by SBA will be used as an inducement to defer distributions of cash out of the program, either to SBA or the owners. In these cases, forgiveness is conditioned on their agreement to remain active in the SSBIC program for a five year period, during which time the accrued dividends are reduced on a straight-line basis over a period of five years or the term of any debt incurred to finance the repurchase, whichever is longer. Distributions to owners may be made only after paying the remaining dividends payable to SBA. The licensee will agree to be subject to the guidelines for change of ownership transactions discussed below.

3. Change of Ownership Transactions

For SSBICs that engage in a change of ownership either before or after the repurchase of their 3% preferred stock, it is necessary to avoid having the benefits of the repurchase result in a windfall to the seller or buyer, rather than increasing the funds available for investment by the SSBIC. To avoid having a prospective repurchase of 3% preferred stock affect the purchase price of the company, the following policy has been adopted:

(a) Where the selling SBIC is "distressed", the dividends accrued at the time of repurchase will be forgiven. The preferred stock may be repurchased at the formula price, subject to the agreement of the purchaser to operate as an active SSBIC, and if operations are discontinued or the SSBIC liquidated within five years, to pay SBA the amount of its liquidating interest, as described under "Other critical terms of the repurchase transactions" below.

(b) Where the selling SSBIC is not "distressed", the remaining balance of accrued dividends as of the date of the change of ownership must be paid before any future distributions are made by the licensee. In addition, the purchaser must agree to the conditions concerning active operation described in the preceding paragraph.

4. Financing the Repurchase

Since the purpose of the Repurchase Program is to strengthen the financial condition of SSBICs, the most desirable source of financing for the repurchase transaction is new capital invested in the SSBIC. Financing with cash already in the SSBIC is inconsistent with the policy of avoiding the transfer of cash flows from SSBICs into the SBA. Experience in the Pilot Program, however, confirmed that new capital is not available to all participants, particularly those which are in financial distress. Consequently, payment of the repurchase price for the participating companies was structured in one of four ways: (1) All cash, following the raising of new capital, (2) a promissory note payable to SBA in exchange for the preferred stock, (3) all cash, from third-party unsecured financing, or (4) a combination of any of the above.

Where borrowings from SBA or third parties are used to finance the repurchase, they are intended to provide interim financing while permanent equity capital is raised. SBA loans made for this purpose will be at an interest rate which is 2% higher than the Treasury rate for a comparable maturity, and any such loans must fully amortize if longer than five years. SBA loans will provide the Agency with a security interest in the licensee's assets and will contain restrictive covenants and conditions.

Long-term financing by SBA in the form of guaranteed debentures or 4% preferred stock is intended to be used to increase the capacity of SSBICs to invest or lend money to small businesses; consequently, it is inappropriate to use these as sources of financing for the preferred stock repurchase.

SBA shall, in its sole discretion, determine the form of payment it will accept for a licensee's 3% preferred stock, including cash or an amortizing or non-amortizing note, or a combination thereof.

Third party debt used for the repurchase must be unsecured since granting a security interest in the SSBIC's assets reduces the value of SBA's liquidating interest.

For licensees financing their repurchase through SBA or a third party, the liquidating interest held by SBA will amortize over a period of five years or the term of the repurchase debt, whichever is longer.

It is contemplated that the SSBIC will increase its private capital by an amount equal to the repurchase price, either from the proceeds of new capital invested in the SSBIC since April 1, 1993 or through the permanent capitalization of retained earnings available for distribution as permitted under program accounting rules. The amount that may be capitalized for this purpose is limited to profits generated since the licensee's fiscal year end immediately preceding the publication of this Notice.

Other terms required in connection with the use of debt financing of the repurchase are included in "Other critical terms of the repurchase transactions" below.

Further Discussion of the Repurchase Program

The Repurchase Program is intended to strengthen the SSBIC Program and enable it to provide additional financing to small businesses. It is not intended to transfer value from SBA to the owners of SSBICs without consideration. The proposed terms of the Repurchase Program assure these intentions are fulfilled.

It should be noted that the 3% preferred stock to be repurchased under the Repurchase Program has no provision for a "put" by SBA or mandatory redemption by the SSBIC. Further, the SSBIC is not required to pay accrued dividends to SBA; however, distributions to other shareholders may not be made until any such dividends have been paid.

The repurchase price to be paid for the preferred stock is based on actual market indicators, and is intended to represent a reasonable substitute for fair market value, since these securities are not publicly traded. For an SSBIC which does not intend to liquidate or transfer ownership in the foreseeable future, the difference between par value and the repurchase price is an unrealized loss already sustained by SBA. In this case, the sale itself does not create the loss.

An SSBIC which intends to liquidate or transfer ownership would be required, in the absence of the Repurchase Program, to pay its accrued dividends and repurchase its 3% preferred at par before any liquidating distributions could be made to its other shareholders. Nevertheless, there is often insufficient value in the licensee under such circumstances for SBA to recover the full amount due.

To avoid the opportunity for a windfall through repurchase at a price below par value and/or the forgiveness of accrued dividends, the Repurchase Program requires that as consideration for the repurchase, the SSBIC agree to remain active for a five year period. If the SSBIC liquidates or becomes inactive prior to the end of this period, it is required to pay a declining proportion of the difference between the par value and the repurchase price of the shares. This is consistent with the purpose of the Program: To encourage SSBICs to continue investing or lending funds to small businesses.

Similarly, the terms of forgiveness of accrued dividends are designed to further the purpose of the Program without providing a windfall to the SSBIC, its owners or management.

In the case of an SSBIC in financial distress, with no reasonable prospect of paying its accrued dividends, SBA is not surrendering value when it forgives such dividends. At the same time, the SSBIC program benefits from such forgiveness because it strengthens the financial condition of the SSBIC and increases the licensee's opportunities to secure additional financing or to be acquired by owners who would commit to remain active in the program.

A non-distressed SSBIC can gain the benefit of the dividend forgiveness only by agreeing to remain active in the program for five years, and to pay the dividends on a declining scale during that period (or during the term of any repurchase debt, if longer) as a precondition to any distributions to its other shareholders. This should encourage these SSBICs to defer distributions, and therefore have greater resources available for investments or loans to small businesses. Should the SSBIC become inactive, SBA will have the right to demand payment of the accrued dividends as of the end of the fiscal year for which the licensee became inactive.

In the event of a change of ownership of an SSBIC, the potential forgiveness of accrued dividends would be a factor in determining the purchase price to the new owner. To avoid the possibility that the benefit of such forgiveness might therefore benefit buyer or seller, without increasing the financial strength of the SSBIC, the terms of the repurchase provide that in this case the remaining balance of dividends accrued as of the date of the ownership change (which may have been reduced by the terms of the preferred repurchase, if completed earlier) must be paid, either at the time of sale, or later, but before any distributions are made by the new owner.

It should also be noted that SSBICs with regulatory violations that would not be cured by repurchasing their stock at a discount will be ineligible to participate in the Repurchase Program.

Other Critical Terms of the Repurchase Transactions

SBA has determined that it is necessary to include the following provisions in the agreements to repurchase 3% preferred stock:

1. To evidence the agreement of the SSBIC to remain active as a consideration for the opportunity to repurchase, an SSBIC repurchasing its preferred stock at a discount will be required to grant SBA a preferential limited ownership interest (the "liquidating interest") in a newly created capital account. As soon as the

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repurchase is completed, this account will be credited by the SSBIC in an amount equal to the discount at which the stock was repurchased. The value of SBA's liquidating interest in the account will decline on a straight line basis over time (generally five years or the duration of any repurchase financing, whichever is longer). In the event of a change of ownership of the licensee, SBA's liquidating interest continues in effect on the same terms as would have applied had the change of ownership not taken place.

The balance in the new capital account may be included in the licensee's private capital only for purposes of calculating the licensee's "overline" limitation and its capital impairment percentage.

In order to make the SBA liquidating interest a matter of public record, the SSBIC will be required to evidence it by an amendment to its Articles of Incorporation.

2. An SSBIC that finances its repurchase through SBA or a third party lender will be expected to agree that, during the term of the financing, or until private capital in the amount of the repurchase price is raised (whichever is earlier), it will not:

a. Make any distribution in favor of any non-SBA shareholder or associate (as defined in 13 CFR 107.3) of the licensee, except with the prior approval of SBA. This is to protect the value of SBA's liquidating interest.

b. Prepay the financing without SBA's approval. This is intended to conserve the cash resources of the SSBIC, avoid the use of its idle funds for the repurchase, and avoid the transfer of cash resources from the SSBIC to SBA.

c. Apply for new leverage from SBA. This is meant to encourage the SSBIC to raise new capital for the repurchase. Refundings of existing leverage would not be restricted by this provision.

d. Grant a security interest in its assets to any party other than SBA. This is to protect the value of SBA's liquidating interest.

Application Procedure

After considering any comments received concerning this Notice, SBA will distribute a Policy and Procedure Release to all SSBICs announcing the commencement of the Repurchase Program and explaining the application procedures. All licensees with outstanding 3% preferred stock will then have one year to apply to repurchase their stock from SBA. No applications will be accepted after that date.

SBA intends to consider applications and process repurchases in the order in which the applications are received, subject to any special needs of severely distressed licensees. SBA anticipates that all repurchases will be completed within three years from the effective date of the final rule.

Authority: Title III of the Small Business Investment Act, 15 U.S.C. 681 *et seq.*; 15 U.S.C. 687(c); 15 U.S.C. 683; 15 U.S.C. 687d; 15 U.S.C. 687g; 15 U.S.C. 687b; 15 U.S.C. 687m, as amended by Pub. L. 102-366.

Dated: March 24, 1994.

Erskine B. Bowles,

Administrator.

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