



The ABCs of SBICs

A PilieroMazza Webinar

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Overview

- What is the Small Business Investment Company (SBIC) Program?
- SBA licensing process
- How SBICs are structured
- Unique advantages for small businesses in obtaining investments from SBICs
- How SBICs make investments
- How to find SBICs
- Special rules for SBIC investments in 8(a) firms

The SBIC Program

- Established by Congress through the Small Business Investment Company Act in 1958
- Unique private-public partnership
 - Private equity funding that is government supported for small businesses
- Multi-billion dollar program providing over \$70 billion of funding to more than 100,000 businesses
 - Examples include Apple Computer, Federal Express, Callaway Golf, Whole Foods Market, and Staples

What is an SBIC?

- A government supported, privately owned and managed investment fund
- Invests in small businesses
- Licensed and regulated by SBA
- Has access to financing facilitated by the SBA
- Approximately 300 active SBICs

How a Fund Becomes an SBIC

- Must obtain an SBIC license from SBA
- Different types of SBICs (i.e., Standard, Impact, and Early Stage)
- Multi-stage application process
 - Phase I – submit initial application
 - Phase II – raise capital and file application
 - Phase III – formal licensing approval
- Administered by the SBA's Investment Division

Application Process for SBIC License

▪ Phase I – Pre-screening

- The fund's management team files an initial application with SBA known as a Management Assessment Questionnaire (MAQ)
- SBA reviews the MAQ, performs due diligence, and SBA's investment committee meets to make initial assessment
- Target time frame: 8 weeks
- If MAQ is received favorably, SBA will invite the management team to make a formal presentation

Application Process for SBIC License

- Phase II – Green means go
 - After the management team’s formal presentation, and rigorous evaluation, SBA’s investment committee may issue a “green light letter” if it believes minimum criteria for the SBIC Program have been met
 - With green light, management team must:
 - File a complete license application within 18 months from the date of issuance of the green light letter
 - Secure binding investor commitments – generally SBA will want to see in the range of \$15M - \$20M
 - Pay application fee of \$15K

Application Process for SBIC License

- Phase III – Formal Licensing
 - SBA assigns licensing analyst to evaluate application
 - SBA's investment committee will meet to decide whether to recommend approval of the application which ultimately will be the final decision of the SBA Administrator
 - Target time frame is six months but difficult to predict under new Administration – may take a year or more

How SBICs Are Structured

- Commonly structured as a limited partnership
 - SBA's preferred structure
 - With a 10 year life – first 5 years making investments and second 5 years exiting those investments
- Limited partners are the investors making the contributions
- Managed by the general partner (GP)
 - General partner is set up as a limited liability company (LLC)
 - Active managers of the SBIC are the members of the GP LLC

How SBICs Are Structured

- Active managers of the GP LLC = SBIC's management team
 - Control operating and budget of the SBIC
 - Make final decisions on SBIC's investments and SBIC's exit from investments
- Each member of the SBIC's management team will be thoroughly vetted by SBA
 - Management team must possess outstanding credentials
 - Successful investment, technical, and managerial experience
 - Proven track record of superior investment returns

How SBICs Are Funded

- Investors (LPs) can be high net worth individuals or institutional investors like banks
- Advantages for Banks to Invest in SBICs:
 - Exempt from the Volcker Rule which prohibits investments in “covered funds” such as private equity or hedge funds
 - Falls within definition of “qualified investment” for purposes of credit to bank under Community Reinvestment Act
- Based on amount of private funds raised, SBA will typically contribute 2 times (could be up to 3 times that amount in certain instances)

SBA's "Leverage"

- SBA funded portion (known as "Leverage") is provided through SBA Debentures
- SBICs borrow Leverage by issuing Debentures
 - SBIC debentures (an unsecured debt instrument) are pooled with other debentures issued by SBIC funds and sold to investors in an SBA guaranteed (full faith and credit of the government) bond offering
 - Leverage Debentures interest rate is tied to Treasury Notes with 10 year maturities (i.e., very low rate)
- Effectively, Leverage Debenture is a 10-year unsecured loan requiring semi-annual interest

SBA's "Leverage"

- Leverage ceiling of \$150M to a single SBIC fund and \$350M for a family of SBIC fund (2 or more licenses under common control)
- SBIC pays a fee charged by the SBA which defrays the costs (and any losses) for the government
 - SBIC may need mezzanine financing to pay semi annual interest to the SBA
- By taking Leverage, SBIC is subject to:
 - Reporting requirements
 - Keep certain books and records subject to SBA examination

Types of Financing by SBICs

- Loans evidenced by a debt instrument;
- Equity financing through purchase of ownership in the small business; and/or
- Combine the first two options through purchase of debt securities which evidence a loan with an option to acquire equity in the small business or a loan that may be convertible to equity position

Raising Capital for Small Businesses

- Obviously critical for small businesses to raise capital
 - Manage “the float”
 - Establish financial wherewithal to be considered a responsible contractor
 - Likelihood of success for the 8(a) program
 - And many other reasons
- Our webinar last month touched on options and considerations for small businesses in raising capital
 - [Raising Capital - Options for Small Business Government Contractors](#)

Affiliation Implications

- Affiliation can cause you to lose eligibility for small business programs
 - When determining size, SBA combines the revenues or employees of the firm in question and all of its affiliates
- Raising capital can cause affiliation through the loan itself, negative control, economic dependence, ownership changes and conditions, and other reasons
- Generally, raising capital from a traditional lender (i.e., a bank) carries a lesser risk of affiliation than raising capital from a private party

Affiliation Based on Negative Control

- Arises when a minority owner or director has the right to veto or block the majority owner or director from taking certain actions on behalf of the company
- Negative control can affect small business status as well as eligibility for the 8(a), SDVOSB, HUBZone, and WOSB programs
- May be lurking in quorum, voting, transfer, and other provisions of your operating documents

Stock Options and the “Present Effect” Rule

- Loans that carry an option to be converted to stock ownership may cause a size or status issue under SBA’s “present effect” rule
 - SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern
 - This means SBA treats such arrangements as though the rights granted have already been exercised
- SBA will not give present effect to an agreement when it is merely to open or continue negotiations, or when the conditions are extremely remote or unenforceable

But...There Is an Affiliation Exception for SBICs!

- Found at 13 C.F.R. § 121.103(b)(1):
 - “Business concerns owned in whole or substantial part by investment companies licensed, or development companies qualifying, under the Small Business Investment Act of 1958, as amended, **are not considered affiliates** of such investment companies or development companies.”
- SBA’s Office of Hearings and Appeals has upheld the exemption in several cases
- Effectively eliminates the typical concern that the investor has too much control over the SB

Eligibility for SBIC Investments

- SBICs can “provide financial assistance and management services **only to small businesses**”
- For purposes of SBIC investment, a firm must meet either of the following tests to be considered a small business:
 - Financial Statements Test – the firm and its affiliates have a tangible net worth not in excess of \$19.5M and average net income not in excess of \$6.5M for the prior two fiscal years
 - Revenues/Employees Test – the firm is below the size standard applicable to the industry in which it is principally engaged (NAICS code)

Limitations on SBIC Investments

- SBICs may not make investments in:
 - “Passive businesses” – i.e., firms not engaged in a regular and continuous business operation
 - “Relenders” or “reinvestors” which are businesses whose primary activity involves providing funds to others, purchasing debt obligations, factoring, or long term leases
 - Insurance companies
 - A business if the funds will be used substantially for a “foreign operation” or if more than 49% of the employees or assets of the business are located outside of the U.S.
 - Projects (instead of ongoing businesses)
 - Farm land purchases

Key Terms for SBIC Investments

- **Term:**
 - SBIC financing must be for at least one year but may not exceed 20 years
 - There are exceptions where short term financing will be permitted
- **Interest:**
 - Interest rate will be capped depending on whether the SBIC is providing a loan (19%) or a debt security (14%)
- **Fees:**
 - There are regulatory caps on fees charged

Key Terms for SBIC Investments

- Control by SBIC
 - SBIC may exercise control over a small business “for purposes connected to [the] investment”
 - Control may be exercised through ownership of voting securities, management agreements, voting trusts, majority representation on the board of directors or otherwise
 - However, the period of control cannot exceed seven years unless approved by the SBA under special circumstances

Preparing for SBIC Financing

- Get “bank ready” by being able to tell the company’s story in a way that demonstrates strong creditworthiness by having:
 - Up-to-date corporate and ownership records
 - Complete financial statements
 - Strong management team
 - Solid business plan (show how company would achieve its goals with the loan)
 - Quality collateral – diverse portfolio of contracts

How to Find SBICs

- SBA website
 - <https://www.sba.gov/funding-programs/investment-capital>
- Small Business Investor Alliance (SBIC trade association) website
 - http://www.sbia.org/?page=SBIC_financing

SBICs and the 8(a) Program

- Several unique advantages for SBIC investments in 8(a) firms
- Exception to stock option rule:
 - “any unexercised stock options or similar agreements (including rights to convert non-voting stock or debentures into voting stock) held by non-disadvantaged individuals will be treated as exercised, except for any ownership interests which are held by investment companies licensed under the Small Business Investment Act of 1958” (13 C.F.R. § 124.105(e) (emphasis added))

SBICs and the 8(a) Program

- Ownership restrictions limit non-disadvantaged individuals with 10% or more in one 8(a) firm from having more than a 10% interest in another 8(a) firm in the developmental stage or 20% in the transitional stage
 - However, these limitations do not apply to SBICs
 - Therefore, SBICs may own greater amounts in multiple 8(a) firms

SBICs and the 8(a) Program

- Little-known statutory advantage for SBIC investments in 8(a) firms
 - “Notwithstanding any other provision of law, for the purposes of determining ownership and control of a concern under this section, any potential ownership interests held by investment companies licensed under the Small Business Investment Act of 1958 shall be treated in the same manner as interests held by the individuals upon whom eligibility is based.” (15 U.S.C.A. § 637 (a)(21)(E) (emphasis added))
 - Applies in the context of changing ownership or control of an existing 8(a) firm?

QUESTIONS?

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