Statement for the Record

U.S. Senate Committee on Small Business & Entrepreneurship
Hearing Entitled, “Investing in Idaho: Exploring ways to encourage small business innovation and startup.”

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Chairman Risch, thank you for the opportunity to testify today and for holding this hearing, "*Investing in Idaho: Exploring ways to encourage small business innovation and startup*." SBIA's members are proud of their role in creating small business jobs and are thankful to Congress and the Small Business Administration (SBA) for supporting American small businesses. Small Business Investment Companies have invested over 87 million dollars in Idaho's small businesses over the past 5 years, and we would like to invest more.

The Small Business Investment Company (SBIC) Program, administered by the Small Business Administration (SBA), has broad bipartisan support because the core features of the program address fundamental problems in the small business economy:

- We need more small business investment;
- We need to create more jobs here in the United States;
- We need to support jobs domestically and not outsource and offshore our economic dynamism;
- We need more investment in domestic manufacturing;
- We need to be very frugal and wise with the taxpayers' money and trust; and
- We need the government to serve Americans and their interests and not work against them.

My testimony is broken into two parts. The first section is a sampling of the underreported small business opportunity that exists. The second section is an overview of the SBIC program; commonly asked questions; and why the SBIC program is different and so successful at creating American jobs. I have also attached a 2017 non-partisan Library of Congress study on the extraordinary record of SBIC job creation and a state-by-state table of SBIC investment from 2014-2018.

Small Business Opportunities

Idaho is a fantastic place for small businesses to grow and reinvent themselves. It has a pro-business regulatory climate and a stable workforce. There are good reasons for growing businesses to move or grow into business-friendly states like Idaho. Idaho, like most of the Mountain West, has small businesses that have received SBIC investment. Idaho has received over 87 million dollars of small business investment over the last five years. Unfortunately, Idaho is also similar to most of the Mountain West in that there are not any SBICs headquartered in the State or who have offices in the State. SBIA would like to work with you to get more small business investment into Idaho and eventually an SBIC presence in the State.

Most of the press attention for small business is focused almost entirely on "startups" that are entirely technology based (the next Google or Facebook or Uber) - businesses that have just been created and in many cases have not yet really begun to operate. These startups are a critical part of the American success story. However, there is an absolutely massive part of the innovative small business economy that are not startups in the conventional sense. More than half of small businesses are owned by baby boomers.[1] Most of these small business owners started these businesses. There are approximately 12 million small businesses owned by baby boomers.[2] These are profitable, proven, and sustainable businesses and their owners are going to retire

[1] https://www.fierceretail.com/baby-boomers-dominate-smbs
[2] https://cabb.org/news/baby-boomers-incredible-numbers-are-buying-and-selling-businesses-part-1-2

eventually. There are millions of these businesses (manufacturing, business services, logistics, etc.), yet many of these owners do not have a succession plan. Their kids cannot run the business or are not interested in running the business. These businesses commonly have not received any outside investment, and the owners—being older and with a limited time horizon—often have not recently invested in applying new technologies or accessing new markets. Without a generational transition plan and outside investment, many of these small businesses will simply shut down when their founders retire. [3]

Entrepreneurs don't have to be in Silicon Valley to be successful. This generational transfer of small business creates all sorts of entrepreneurial and innovative opportunities. Often the only people that can take the reins of these small businesses are younger (relative to the founder) managers, but they do not have the capital to buy out the owner. SBICs can partner with the management team to buy out the retiring owners. Part of the money provides for the retirement of the founder, and the rest of the capital is used to reinvent, reimagine, and revitalize the business. The new owners now have the capital and the professional financial backing of the SBIC to do what they have wanted to do for years but were constrained by a lack of capital and a reluctance to take the risk of trying new things. New technologies are purchased and applied, which allow the business to sell nationally or globally; to operate more efficiently; to produce higher quality goods and services; and enable the business to grow and hire more employees. This way of handling the generational challenges of small businesses is one of the least discussed, but most important small business opportunities that exists today. There is a far higher success rate taking an existing business with a proven business model and revitalizing it than there is starting from scratch. Both are critically important to the American economy, and both deserve attention. SBICs can help both existing businesses and startup businesses, but a single SBIC cannot do both, which is why we need more SBICs and a greater variety of SBICs across the country.

The Small Business Investment Company Program Overview

It seems that only bad news gets attention, which does not make it easy for SBICs because SBICs are an American success story. For example, in FY2018, SBICs invested over $5.5 billion in American small businesses. Because of the work done when you were Chair of the Small Business Committee, the program is having the best (lowest) loss rates in its nearly 61-year history. There is currently unprecedented private sector interest in getting capital to small businesses via investment in SBIC funds. A 2017 Library of Congress study found that SBIC-backed businesses created 3 million new jobs and supported an additional 6.5 million jobs from 1995-2014 (a period that included the Great Recession and the tech bubble recession). These quiet successes were achieved while being the only major SBA program that was able to maintain its zero-subsidy rate - even through the Great Recession and Financial Crisis. With the help of Congress and SBA, SBICs have seen significant operational reforms to the program that have been producing positive results for the American small business economy.

SBICs are highly-regulated private funds that invest exclusively in domestic small businesses. At least 25% of an SBIC's investments must be made in "smaller enterprises." (Smaller enterprises are smaller than the SBA's normal small business standards.) SBA currently licenses two types of SBICs: non-levered SBICs and Debenture

[3] https://www.forbes.com/sites/forbesagencycouncil/2017/09/29/baby-boomers-are-selling-their-businesses-to-millennial-entrepreneurs-and-its-a-brilliant-idea/#57f7773c3181

(levered) SBICs. Both forms of SBICs invest in growing domestic small businesses, with non-levered SBICs tending to provide more equity capital and Debenture SBICs tending to provide more debt capital.

SBIC leverage significantly increases the amount of money invested into the small business economy. Private capital forms the foundation of an SBIC fund. SBICs raise capital from accredited investors and institutional investors (pension funds, university endowments, banks, etc.). After the SBIC applicant raises private capital, the SBA applies a rigorous licensing regime. If the SBIC applicant meets the legal and performance criteria, then an SBIC license is issued. Once licensed, an SBIC is permitted to access a line of credit (SBIC debenture leverage) to increase the amount of capital available for investment. For example, an SBIC may raise $50 million in private capital and then, after licensure, may access up to an additional $100 million line of credit (SBA leverage), which combines for a total of $150 million. The leverage is provided at a zero-subsidy rate and is eventually paid back in full (plus interest and fees). All this capital is to be invested in domestic small businesses and may not be used for "offshoring," relending, project finance, or for purposes that are not in the public interest. Unlike many government programs, the private capital is in first-loss position, which means the private investors lose their money before the taxpayer is exposed to risk of loss. This is an important taxpayer safeguard and a key reason why the SBIC program has been able to maintain its zero-subsidy rate. The program is effective and distinct because the private sector leads with its capital and investment expertise, and then SBIC leverage follows to augment the impact of the private investment. It is a mark of SBIC industry pride that the program maintained its zero-subsidy throughout the Great Recession.

- Since 1958, SBICs have invested over $80 billion in hundreds of thousands of small businesses.
- In FY 2018, SBICs invested over $5.5 billion in businesses that employ nearly 100,000 workers across the U.S.
- For FY 2018, 305 SBICs were operating across the United States, which is a similar number as were operating 10 years ago. These SBICs managed over $30 billion in committed capital resources.
- Of the 1,151 U.S. small businesses that received SBIC financing in FY2018, 23% were in Low-to-Moderate Income (LMI) areas of the country.
- The SBIC program has operated at a zero-subsidy rate since Congress mandated it in the late 1990s.
- A 2017 study by the Library of Congress found that the average small business backed by a Debenture (leveraged) SBIC Fund created approximately 125 new jobs, and non-levered funds created an additional 530 new jobs.
- Levered funds tend to provide more debt capital and non-levered funds tend to provide more equity capital.
- From 1995-2014 SBIC-backed small businesses created over 3 million new jobs and supported an additional 6.5 million jobs – all of which were in the United States.
- Many icons of American industry were once small business that received critical growth capital from SBICs, including: Apple Computer, Intel, Buffalo Wild Wings, Build-A-Bear Workshop, Callaway Golf, Costco, Federal Express, Gymboree, Jenny Craig, Restoration Hardware, and Staples.

SBIC Frequently Asked Questions

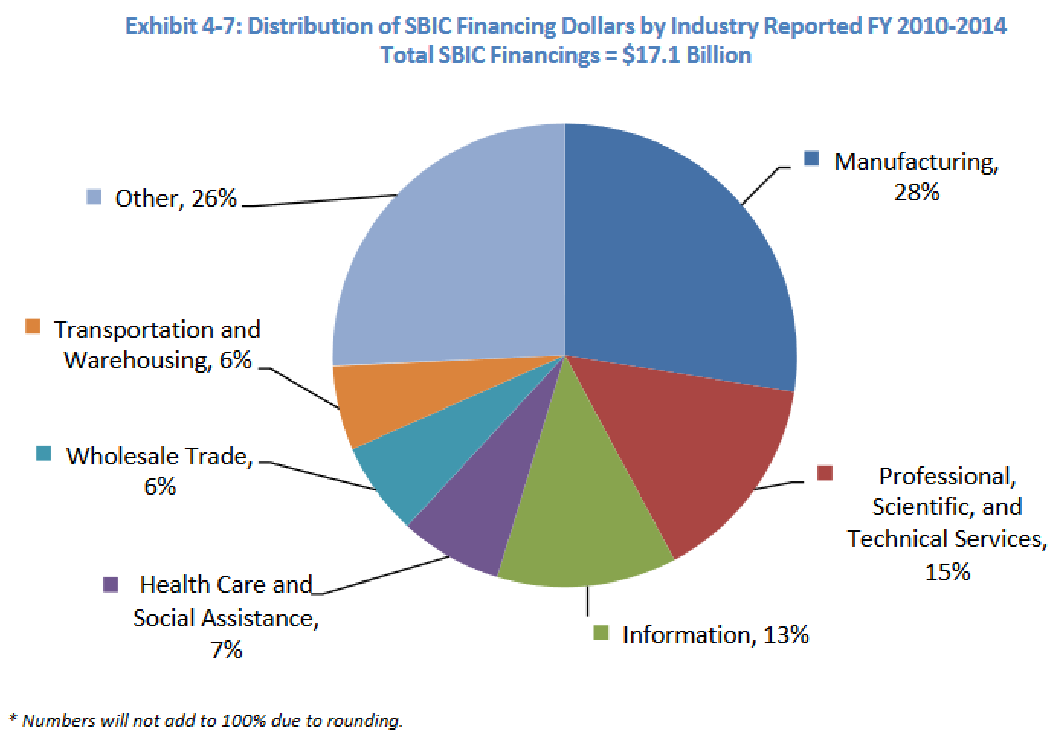
How does the SBIC Program Help the Taxpayer and the American Public?
The SBIC Program helps the taxpayer by providing capital to growing small businesses that in turn hire more employees, invest in capital improvements, and generally grow the economy. A 2017 study by the Library of Congress found that one new job was created for every 35 dollars of taxpayers' money spent administering the

program. (The leverage operates at zero subsidy, but there are still some administrative costs.) Correlation is not causation, but there is no doubt that the ability of successful small businesses to access growth capital empowers them to grow and hire more employees.

SBIC investments are made in areas of the country and in industry sectors that are commonly overlooked by conventional venture capital and private equity. The overwhelming percentage of venture capital is invested in Northern California and the New York to Boston corridor. While SBICs do invest in those areas, SBICs invest most of their capital in places other than this investment footprint. For example, 23% of SBIC investments are in areas certified as Low-Moderate Income. Even SBICs that are primarily located in population centers regularly invest well outside of their local area, so the SBIC program helps move capital to underserved areas – both urban and rural.

SBIC investments are commonly made in industry sectors largely passed over by many conventional venture capital and private equity funds, including manufacturing and asset-light services businesses.

Distribution of SBIC Financing Dollars by Industry
FY 2010-2014



Is the SBIC Program Effective?

- Yes. Multiple studies, including a 2017 Library of Congress study (attached) have found the SBIC program is very effective at supporting growing small businesses and creating jobs.
- With modest reforms, it could be even more effective, with broader benefits to more communities.
- There are additional studies completed by the Library of Congress that were supposed to be released in 2017 but have yet to be released by the SBA.

Is the SBIC Program an Efficient Use of Capital?

- Yes. It is one of the most efficient, job-creating programs within the government. According to a 2017 Library of Congress study, only $35 in administrative government costs were associated with creating each new job. There were only $11 in administrative costs for each additional job supported. Further, the fact that the SBIC program's leverage has successfully sustained its zero subsidy for so long is a testament to its operational effectiveness and efficient use of capital.

Is SBIC Investing the Same as Bank Lending?

- No. SBIC investing and bank lending are very different.
- SBICs provide education, training, and professional guidance to their portfolio companies that banks generally do not provide.
- Banks are often only able to provide conventional lending to a small business *after* an SBIC has invested in a small business.
- SBICs provide long-term capital that empowers small businesses to survive and recover from the inevitable surprises that can happen in business.
- SBIC capital can be in the form of debt, equity, or both.
- Banks and SBICs collaborate but offer different types of capital, so they do not compete.

Does SBIC Investment Displace Conventional Bank Lending?

- No. Banks are partners, not competitors.
- Banks are often only able to provide capital after a business has received SBIC capital because the SBIC capital changes the capital structure of the business and thereby makes it more "bankable."
- Over 500 banks, ranging from small community banks to large banks, are investors in SBIC funds.
- Some banks own non-levered SBIC funds and other banks are forming their own internal SBIC units to provide equity capital that the banks cannot otherwise provide.
- If small businesses could access this capital from banks, they would get bank loans because there are thousands of banks and conventional bank lending is less expensive.

	Bank	**SBIC**
Provide Debt	Yes	**Yes**
Provide Equity	No	**Yes**
Provide Convertible Debt	No	**Yes**
Provide Unitranche Capital	No	**Yes**

Can revoke capital on 30 to 60-day notice in the event small business hits a snag or if there is a macroeconomic disruption?	Generally, Yes	**No**
Are loans required to be fully collateralized?	Generally, Yes	**No**
Cash flow lending	Limited	**Yes**
Able to provide Capital to businesses that are not otherwise bankable	No	**Yes**
Commonly has a formal role on the Board of the Small Business	No	**Yes**
Provides management assistance to help the small business grow and have good governance	No	**Yes**

Does the Government Own Any Part of these Small Businesses?

- No. The government does not invest in or own any portion of any small businesses.
- There was a time (1994-2004) when the government effectively participated in the ownership of some types of SBIC funds, and therefore the small businesses, but that program ceased licensing funds 15 years ago (2004).

Is the Government a "Limited Partner" in SBIC Funds or Does It Own a Part of the SBIC Fund?

- No. The government manages access to and guarantees a private sector credit facility but is not a "Limited Partner." The government is in a more advantaged position than the private sector limited partners.
- The SBA does not own an interest in SBICs or their portfolio companies.
- The SBA stopped being a "fund of funds" and stopped being a "Limited Partner" with the end of licensing funds where the government participated in the profits (and losses) in 2004.
- The SBA is a regulator and a guarantor of credit facility.

Can the 7a and 504 programs do what the SBIC program is doing?

	SBA 7a	**SBA 504**	**SBA SBIC**
Government (Taxpayer) guarantee on each individual investment	Yes	Yes	**No**
Must the small business have collateral or a personal guarantee to loan against?	Yes	Yes	**No**

Does the Government Choose Which Small Businesses Receive Capital?

All SBIC investments are made entirely by the private sector via investing professionals without the government's direct involvement. Investments are made for real economic reasons. SBICs invest in growing small businesses and then notify the SBA which small businesses received capital after the investment has been made. There are size standards and other basic requirements and taxpayer protections that must be adhered to, but government involvement stops there. The program is successful at creating jobs and growing small businesses because it allows the private sector to find the businesses with the greatest growth potential and direct capital to them.

What Happens if an Investment Underperforms?

A single SBIC will invest in many different small businesses. Unlike the 7a and 504 programs, when a single investment underperforms or loses money, only private capital is lost, not taxpayer guaranteed capital (leverage). The profits from the other investments cover the losses from the isolated underperforming investment(s). If the profits from the other investments are inadequate to cover all the losses, then the private investors' capital is lost before taxpayer money is at risk. There is generally a large private capital cushion that would need to be burned through before the taxpayer guarantees would be realized. Even if the guarantees would be used, SBIC funds pay an annual fee on their leverage that is designed to offset losses and maintain the statutorily-required zero subsidy rate. SBA can cut off SBICs from accessing additional leverage or trigger an orderly liquidation process run. Even if a fund is ordered into orderly liquidation, it does not necessarily lose private capital or realize losses for the taxpayer.

What Built-in Accountability Exists in the SBIC Program?

There is extensive accountability built into the program. Private capital being in first-loss position is a very effective accountability tool because there is no "gambling with other people's money." Private capital being in first-loss position is an important, built-in taxpayer safeguard. The SBA has reporting obligations that ensure the SBA is fully apprised of the health of the fund, and the funds receive independent audits plus SBA examinations. The SBA can cut off underperforming SBICs from further leverage and can even require disgorgement if an investment does not meet the SBA's statutory and regulatory requirements. SBA can require an orderly wind down of the SBIC and limit compensation. In extreme cases, SBA can remove the fund managers.

Are Repeat Licensees a Good Thing?

Repeat licensees are exceptionally good for the small businesses and the taxpayer. Repeat SBICs specialize in small business investing, which is good for small businesses, the SBA, and ultimately the taxpayer. SBICs are only able to receive an additional license if their previous fund was a success and the private sector was willing to commit its own money first. The private sector leads, and only then can a license be issued: the market speaks before the SBA licenses. Keeping successful fund managers in the program and culling poor performers is one of the reasons the program has been so good at growing businesses and has been able to sustain its zero-subsidy rate. Congress recognized the importance of repeat licensees by raising the "family of funds limit" to allow more successful managers to continue to invest more money into more growing small businesses. The GAO studied this issue in 2016 and found repeat licensees were far less likely to be put into an orderly wind-down than first time funds.

Is the SBIC Program Stress Tested and Sound?

The Great Recession and Financial Crisis were a real-life stress test. Unlike other SBA programs, the SBIC Debenture program was able to maintain its zero-subsidy rate. Further, many small businesses were able to survive the Great Recession because they were backed by SBICs. Banks were forced by their regulators to pull lines of credit from thousands of small businesses, which then failed. SBIC-backed small businesses benefitted from the longer-term capital provided by SBICs and had a much better chance of surviving.

What can states like Idaho do to get more SBIC small business Investment?

Idaho is already doing a great job at welcoming entrepreneurs, but smaller states that are more difficult to travel to tend to get less investment. These states still get investment and can do things to get more. First, since investing in small business is very much dependent on personal relationships, we need to build more of those relationships in Idaho. These relationships commonly start with relationships with banks. Getting Idaho banks to invest in SBICs would not only provide solid returns to the banks, but it would also create a connection between SBICs and the small businesses served by the local banks. Banks that serve Idaho and the mountain west can, and I would be happy to help them, form their own SBIC fund. These bank-owned, non-levered SBICs can provide equity to small businesses and create relationships with both the bank for senior lending and other SBICs for subordinated debt access. Finally, investment bankers, business brokers, and small business owners themselves can reach out to SBICs and start the business relationship.

Conclusion

SBIA thanks you for considering the views of the SBIC industry. We also thank the SBA for their time and effort in working with SBICs to grow the small business economy. Without the support of the Congress, the SBA, and the private sector, this program would not be able to provide such a positive impact for the taxpayers.

I would welcome any question you may have for me.