NASBIC
America's Small Business Partners

Statement
of
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Committee on Small Business

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Increasing Access to Capital for Small Business

Chairwoman Velázquez, Representative Graves, and Members of the Committee,

My name is Carolyn Galiette. I am a senior managing director and co-founder of Ironwood Capital, an investment management firm located in Avon, CT. I speak to you today on behalf of the National Association of Small Business Investment Companies (NASBIC) regarding H.R. 3740, the Small Business Investment Company Modernization and Improvement Act of 2009 and H.R. 3738, the Early Stage Investment Act of 2009. We strongly support the rapid passage of H.R. 3740 with a few technical changes. H.R. 3738 is an excellent model that closely mirrors the NASBIC proposal. If enacted, it will address a critical small business need. With a few technical corrections added it will be able to achieve its goals. We congratulate and thank Representatives Luetkemeyer and Nye for introducing these bills and the Committee for advancing them. NASBIC would welcome the chance to offer our expertise in order to improve and then pass these important small business resources.

SBIC Program Overview

SBICs are private equity funds that invest exclusively in American small businesses. SBICs raise private capital and then get licensed by the Small Business Administration. Once licensed, debenture SBICs can draw leverage and thereby multiply the amount of money available for investment in small businesses. SBA is paid back with interest and thus there is no net cost to the taxpayer for the SBIC debenture program. Since this program's inception in 1958 over $55 billion has been invested in American small businesses. Some of the bigger name employers that received early SBIC investments include: Intel, Callaway Golf, Outback Steakhouse, PeopleSoft, Staples, and Quiznos and hundreds of NASDAQ listed companies.

Over the past eight years, Ironwood Capital has become a staunch supporter of the Small Business Administration and the SBIC program because of the success we have seen the program achieve. We manage three SBICs, the first of which was licensed on September 7, 2001 and the third of which was licensed in August 2007. We, like many other SBICs, have managed through turbulent times but have remained steadfastly focused on the objectives of the SBIC program- to provide capital and advice to eligible small businesses, to generate a return for our limited partners through the success of these small businesses, and to be thoughtful stewards of the taxpayers' money which lends capital to our funds. We have raised market priced capital from institutional investors which support our investment thesis. We fill a capital need that is unmet by other financial institutions, including banks which provide SBA guaranteed loans. To date, we have invested in 53 small businesses in places ranging from Moline, IL to Winterville, NC and to Brooklyn, NY. We also travel to invest in smaller cities such as Hockley, TX, Fitzgerald, GA and Middleburg, PA, places that are often overlooked by other capital providers. Our partnership with the SBA has enabled our portfolio companies to create approximately 4500 jobs and to increase revenues in these companies by over 50 % on average. Moreover, we have accomplished all of this while making 50% of our investments in companies owned and managed by women and minorities and businesses located in or employing residents of low and moderate income communities. We have provided capital where larger, more established financing sources would not, some of which are the very lenders and investors who recently received TARP financing. *Despite the success of the SBIC program and of Ironwood Capital, if the program is not reformed we and many other funds that are bona fide experts in growing domestic small businesses will be forced to leave the program.*

H.R. 3740 SBIC Modernization and Improvement Act of 2009

The SBIC Debenture program is an incredible resource for small businesses and the tax payer. This program is truly market-driven and operates at a zero subsidy rate. As the Chairwoman of our Board, Holly Huels and later Steve Swartzman (both of Missouri) testified earlier this year, despite the efficiency of the SBIC credit facility, the program is dramatically underused. Fiscal year 2009 used only about 20% of the SBA's $3 billion in capacity, denying domestic small businesses over $2 billion in SBA leverage and $1 billion in private growth capital. Today more than ever, the patient capital, market experience, and governance guidance that SBICs provide fill a capital chasm that threatens the ability of small businesses to emerge from the current recession. Congressional action is needed from you to realize improvements that are critical to providing capital to small business.

To correct this problem we proposed reauthorizing the program with a number of simple, but effective reforms:

Keep Successful SBICs in the Program by Fixing the Licensing Process
Currently the licensing process at SBA is slow, opaque and subjective. Licensing is the number one complaint of SBICs. Legislation should provide a transparent process, with clear standards, and a reasonable timeline for applicants.

The SBA often takes over a year to issue an SBIC license, even for successful SBICs that are seeking their second, third, or fourth license. Making repeat SBICs wait this long for a new license makes no sense. Further, it wastes SBA resources that should be used to review new funds that deserve more scrutiny, but for whom a one year licensing process is too long. For example, recently a successful SBIC fund applied for its fourth license. Despite its excellent record this SBIC waited over a year for its fourth license.

This bill would fix these problems while maintaining taxpayer protections.

Let SBICs Grow to Provide More Capital
Success is often rewarded by growth. Successful SBICs often start new funds that are larger than their previous fund. The problem is that successful funds can grow too large for the SBIC program. They still want to invest in the small business sector, but even the recently increased family of funds limit can effectively force out repeat funds as they become larger. These would-be repeat SBICs are solid investment vehicles with a wealth of experience and significant infrastructures that should be kept in the program. Again, we should not force funds out because of successful small business investing.

If we are truly to keep the best funds in the program and to provide billions in capital to small businesses, then we need to allow a continuum of investment funds. With a higher leverage limit and expedited relicensing, a successful fund could have a series of SBIC funds that run the 10 year life cycle of the funds. One fund could be winding down, another could be at peak, and another could just be ramping up. Under this scenario, good SBICs can constantly be providing funds to small businesses without having to graduate out and suffer for success by hitting a leverage-limit ceiling. Funds that were in distress would not be eligible for new leverage or expedited re-licensing.

It makes no sense to push successful funds out of the program because they have been too successful at growing small businesses. Raising the family of funds limit, combined with expedited relicensing, will ensure that proven small business experts stay in the program and provide more capital to small businesses.

This bill successfully addresses this issue.

Remove Unnecessary Barriers
H.R. 3740 fixes numerous technical issues that are individually modest, but collectively very burdensome. For example, there are a number of funds whose licensing was either seriously delayed or rejected outright because of the very low limit on state funds allowed in an SBIC. SBICs should not be penalized for partnering with their home states. Additionally, many high tech small businesses are denied access to growth capital because SBA does not allow Generally

Accepted Accounting Principles (GAAP) for a number of regulatory calculations.

This bill addresses this issue.

Increase Objectivity and Transparency to the Licensing Process for First Time SBICs
There is an obvious correlation between fewer SBIC licenses and less capital flowing to small businesses. The SBIC licensing process has been and continues to be in need of serious reform. The licensing process should have greater transparency for the applicant, objective criteria for licensure, an appellate mechanism, solid taxpayer protections and should not choke off the program. In FY 2008, only 6 licenses were issued – over a 90% decline from the peak of the 1990's. There has been modest improvement with 11 licenses in FY 2009. This number is low despite the fact that scores of quality funds, many repeat SBICs, are trying to get an SBIC license. The licensing process has done an abysmal job at attracting and licensing funds led by women and minorities. This lack of openness is compounded by the rigid application of subjective standards that effectively prohibit those whose experience is senior lending or investment banking from applying for an SBIC license

This bill addresses many of the transparency issues in licensing. Further language may be needed to open up the program to a more diverse set of fund managers.

Remove Regulatory Disincentives
SBICs compete in a free and open market as they invest in small business transactions. If the number of SBICs is to increase and thereby grow the amount of capital available for small businesses, then disincentives should not be placed on becoming an SBIC. For example, SBA currently limits the interest rates that SBICs earn if equity warrants are part of the investment package. SBA also limits enforcement of default rates. Both of these provisions need reforming because they limit taxpayer protections for being paid back and risk the SBIC's bottom line compared to non-SBICs. There should not be a penalty for partnering with SBA to invest exclusively in domestic small businesses. We would like to suggest a technical correction that would closely mirror existing regulations and therefore expedite implementation upon passage.

This bill successfully addresses many of these disincentives.

License more SBICs in Underserved Areas, like the Western U.S.
The SBIC program provides capital in areas of the country often overlooked by the rest of the private equity and venture capital community. Despite this fact, there are areas of the country that need more SBIC coverage. A concerted effort should be made to incentivize this program and to welcome new licensees, particularly from the western and less urban parts of the United States. Policymakers should also make it easier to raise capital for SBICs by allowing a higher percentage of capital to come from state sources.

This bill will allow greater resources to be used to bring new funds into the program including to underserved areas. SBA should use the opportunity created by this bill to license funds across the entire country, particularly in underserved areas.

<u>H.R 3738 the Small Business Early Stage Investment Act</u>

Small Business Desperately Needs Equity Investment
Capital for small business investment is in very tight supply, but demand is strong. In times of economic stress, small businesses must be nimble to take advantage of growth opportunities, but they need access to capital. Right now, seed and early stage investment has shriveled to exceptionally low levels. Growth and buy out capital is hard to come by. Senior lending by banks has pulled back dramatically.

The SBA previously had a tool that was successful at using the private market to steer equity investments into domestic small businesses. The program was excellent at getting equity capital to early stage businesses. While it lasted, the program invested over $13 billion in small businesses, created over 385,000 new jobs and saved hundreds of thousands more. While almost 70% of venture capital dollars go to high tech and life science industries, the SBA program successfully invested heavily in manufacturing all over the country. More than half of VC investments are made in California and Massachusetts, but the SBA program invested more than 70% of its capital in other states that are often starved for investment capital. However, the old equity program was structurally flawed and created a misalignment of interest between investors, the SBA and taxpayers. This bill shares the same risk and reward equally between the government and the investor, is structurally simpler and therefore promises to be a workable equity tool.

We are in a deep recession. This fact makes the availability of equity capital, or lack thereof, even more important to America's small businesses. Equity capital is the foundation upon which any company is built. A company's ability to raise senior debt and lines of credit—absolutely essential to business success—relates directly to its ability to raise equity capital. Congress and the Administration should review proposals that establish tools for SBICs to invest equity in a manner that protects the taxpayer and provides capital to worthy businesses. The SBIC platform, with its experienced SBA personnel and an established private sector network, is an excellent platform that could be used in conjunction with this bill to resuscitate private sector equity investing.

How to Improve the Bill

The structure of the bill mirrors very closely the NASBIC proposal for an efficient equity tool to address the drought in equity investing. NASBIC believes that an equity program needs to maintain strong taxpayer protections such as those adhered to in the SBIC program. There are still a number of issues, some technical and some substantive, that could be improved.

Ensure there is broad economic benefit by Opening the Program to Manufacturing and Other Industries Across the Country

Previous SBA tools successfully encouraged investment in areas consistently overlooked by venture capital and in industries overlooked by many Silicon Valley VCs. The bill in its current form is overly restrictive on the types of small businesses that are eligible for investment, limiting investment in such core sectors as manufacturing, industrial technologies, aviation, food production, and many others, particularly in the service industries. As written, the bill would likely limit the majority of investments to Silicon Valley and other areas of heavy venture capital density, where there is already a good deal of VC capital. In order to encourage economic and geographic diversity, the bill should be modified to provide capital to all areas and more industries in the country, particularly those commonly overlooked for equity investing.

Use 50 Years of SBIC Experience to Expedite and Improve Implementation

With over 50 years of experience of private capital partnering with the SBA, the law and regulations have established excellent taxpayer protections for its SBIC partnerships. Taxpayer funds need to be fully protected and therefore should only be handed over to funds that are have been properly vetted by SBA. This legislation recognizes that SBICs are already regulated specialists in small business investing. Holding an SBIC license is proof of having been vetted by SBA and should offer a faster track for grant approval. SBA should not limit currently licensed funds from participating.

This bill would benefit from adding reasonable regulations identical or similar to those already on the books including those regarding: investor diversification, management fees, investment, prohibitions on self dealing, etc. There are scores of taxpayer protections in SBA regulations that have been derived from lessons learned the hard way. New regulations and standards could be created, but that would take years. Rather than repeat the mistakes of the past, the taxpayer protections of the SBIC program should apply to this program.

Streamline the Qualification Process
SBA already has staff and processes specifically designed to screen for equity investing (which is one of the reasons that the debenture program licenses slowly). There is no point in reinventing the metaphorical wheel for licensing because doing so would delay implementation by years – small businesses cannot wait that long. Grant recipients should use the established licensing regime for equity investing. Established SBIC managers that have already been fully vetted and proven themselves, should therefore only have to have their business plan reviewed and should not have to revisit a process that repeats the process by which they received their license. The expedited relicensing process in H.R. 3740 would ensure that the program gets off the ground very quickly.

Conclusion

In summary, both of these bills are major advancements in using market forces to provide critical capital to small businesses. The SBIC program marries individual entrepreneurship with government assistance in a way that is productive for all and which is absolutely crucial to our nation's economic growth. We believe that this legislation is imperative for US small business and that our input can improve the proposed legislation. We seek legislation that benefits not only our members but, equally importantly, policies that benefit the U.S. taxpayer and the small businesses we serve, because without all these constituents, we cannot succeed. These bills should be passed into law as quickly as possible.