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The ABCs of SBICs

Did you know…

• The U.S. Government is the single largest venture capital investor in America?

• Uncle Sam was an early investor in such healtcare companies as Medical Staffing Network, Cardio Logic, Inc., Healthcare Services of America and Healthsouth?

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• In addition to healthcare, the Federal government helped to start companies as diverse as America Online, Apple Computer, Callaway Golf, Costco Wholesale, Federal Express, Jenny Craig and Outback Steakhouse?

The common denominator among all these investments is a little-known but wildly successful program of the U.S. Small Business Administration known as SBICs or "Small Business Investment Companies."

Begun in 1958, the SBIC program has generated billions of dollars in economic prosperity, created millions of skilled and unskilled jobs, kept thousands of small and struggling young businesses alive, and created a template for how the government should walk the fine line between private versus public funding.

Last year alone, SBICs accounted for 58 percent of all venture financings completed in the U.S. That percentage has been rising steadily over the past five years. In 1997, for example, SBICs contributed only 38 percent of all venture financing transactions.

In Tennessee, SBICs financed 46 transactions in 2002 and invested approximately $20 million into those ventures. Several of these were young healthcare companies.

In 2002, of a total of $14.4 billion in "seed financings" were reported nationwide, with non-SBICs investing $5.1 billion and SBICs investing $9.3 billion. "Seed" financings are defined as investments in companies less than 18 months old and which are at the concept or product development stage.

At the end of 2002, SBIC investments supported over 10,800 entrepreneurial companies in 441 funds, with over $11.8 billion in private venture capital and another $5.1 billion in SBA matching funds.

The SBIC program was created in 1958 "to fill the gap between the availability of venture capital and the needs of small businesses in start-up and growth situations."

SBICs are privately owned and privately managed venture capital Funds, licensed and regulated by the SBA. They use their own capital, plus funds borrowed on favorable terms with an SBA guarantee, to make equity and/or debt investments in qualifying small businesses.

Here's how a sponsor sets up a SBIC Fund:

First, an experienced team of venture capitalists must secure commitments from private investors for either (a) $5 million or more for a "debenture fund" or (b) $10 million or more for an "equity fund." For debenture funds, the government will match private dollars 3:1; for equity funds, the match is 2:1.

In debenture funds, the government loans to the Fund and expects a payback with low interest after ten years. With an equity fund, the government participates in the profits but on a relatively low basis, leaving incentive to the private investor if the investments succeed.

Like most things, there are lots of details. For example, the investments can only be made into "small" businesses (net worth less than $18 million and two years after-tax income less than $6 million.) The government takes an active role in reviewing transactions, both before they are made (although it does not make actual investment decisions) and during periodic reporting audits.

The program was designed to be self-financing over time and has essentially worked that way, according to the SBA. Again, however, the devil is in the details. Of 170 equity funds, about 75 percent were not profitable from 1994 to 2002. About half of debt funds reported not being profitable during the same period.

Digging into those details shows that of the 42 funds distributing $281 million in profits to private partners during that period, over 50 percent of those distributions came from just four funds and 90 percent from only 14 funds. This means there is a wide variance in skills among fund managers. Some are clearly more successful than others and many just are not successful at all. The winners apparently make up for the losers, however, from the government's perspective.

The SBA lists 11 current SBIC licensees in Tennessee. That would mean that Tennessee's share of the total of 441 total funds licensed is only 2 percent. Given the success of the program nationwide, and the clear void among other sources of early stage financing for Tennessee ventures, the need exists for Tennessee investors to step forward and to form new Funds to invest in home-grown businesses, especially early stage. Our future depends on it.

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