Small Business Investment Companies

TL;DR

Small Business Investment Companies (SBICs) are privately owned investment funds, licensed and regulated by the Small Business Administration (SBA).

Background

Congress established the Small Business Investment Company program in 1958 to create another pathway for long-term capital to be made accessible to small businesses. After an SBIC is licensed and approved, the SBA makes a commitment to provide a set amount of leverage over several years. The application process to become a registered SBIC is rigorous, but once registered, fund managers have the ability to leverage federal money to capitalize their investment funds at a matching rate of 2:1 for every dollar of private capital raised. This uniquely subsidized capitalization structure, paired with the stringent fund requirements, ensures that SBICs can provide small businesses with various capital products that are often more favorable than traditional bank loans or venture capital investments.

Since its inception, the SBIC program has provided over $100B in capital to entrepreneurs across the country. These funds have helped transform small firms into powerhouse job-creators. Early-stage small businesses that received SBIC investments include Apple, Costco, FedEx, and Intel. In fiscal year 2020, SBICs financed 1,063 small businesses, with an average amount of just under $2M. These funds helped entrepreneurs acquire new companies, refinance debt, conduct R&D, purchase equipment, and generally operate their enterprise. In 2020, the SBA licensed 26 new SBICs, up from 18 in 2019. And, in 2021, they broke the record again, licensing 32 new SBICs.

One common and important criticism of the SBIC program is its lack of demographic diversity—both among fund manager participants and small businesses funded. In 2007, the SBA formally acknowledged that women and minorities participated in the program at low rates. Today, the diversity numbers haven't budged; for example, in 2020, SBICs only made up around 5% of their total financing to minority-owned small businesses. The numbers were even worse for businesses owned by women and veterans.

What is an SBIC?

SBICs are licensed private fund managers who receive low-cost, government-backed capital from the SBA to invest in US small businesses. Roughly 300 exist currently, and a full list of all current SBICs can be found on the Small Business Administration’s website.

SBIC Funds can offer the following types of capital for small businesses:

- **Debt:** A typical SBIC loan ranges from $250K to $10M, with an interest rate between 9% and 16%.
- **Equity:** SBICs invest in a business in exchange for a share of ownership in the company. Typical investment amounts range from $100K to $5M.
- **Debt/Equity Hybrid:** Financing includes a combination of loans and ownership shares. Loan interest rates are typically between 10% and 14%. Investments range from $250K to $10M.

Key features of SBICs:

- Under the most common and broadest “standard” SBIC license, SBA provides up to 2x leverage to private LP capital in a fund, up to $175M max fund size.
- SBICs may invest in companies using debt, equity, or “debt with equity features.” SBICs may control a small business for up to seven years (or longer with SBA approval).
- At least two managing members of the SBIC must have 10+ years of experience investing in or supporting small businesses.

- Application to register as an SBIC is highly competitive and lasts at least 1 year. Further application FAQs can be found on the Small Business Administration's SBIC web page.
- Benefits for "Impact SBICs" include a potentially accelerated application process and additional support.
- SBICs are typically not permitted to invest in project finance, real estate, or passive entities such as a nonbusiness partnership or trust. Proceeds from the SBA's capital match "debenture" can only be used to invest in small businesses per the regulations and parameters defined by the SBA's Office of Size and Standards.

Benefits of forming a SBIC:

In addition to having a positive impact on small businesses and the economy, the SBIC program offers multiple benefits to fund managers:

- **Rapid Fund Deployment:** The potential to capitalize as much as two-thirds of a fund with SBA leverage means managers spend less time fundraising and more time investing.
- **Flexible Terms:** The duration of SBA's financing instruments can easily be matched up with short- or long-term investments.
- **Exempt from SEC Registration:** SBICs are exempt from SEC registration, yet LPs benefit from SBA's careful monitoring of each fund's performance and regulatory compliance.
- **Exempt from Volcker Rule:** SBICs are exempt from the bank investment limitations set forth in the Volcker Rule as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- **Increased Financial Scale**: SBA leverage allows funds to scale up their strategies and extend their financings to more businesses.
- **Enhanced Returns Potential:** SBA-guaranteed capital is low cost and does not participate in profit.
- **CRA Credit:** Investments in SBICs are presumed to be a "qualified investment" for Community Reinvestment Act credit.

SBIC Benefits to Investors:

For more than a decade, SBICs have delivered returns to their investors that are in line with those available from other private equity funds in the market. Since 1998, SBICs that benchmark in the top half of private equity have delivered a 5- to 10-point boost in the IRR delivered to LPs as a result of SBA leverage.

Costs of forming a SBIC:

- The accounting, bookkeeping, and back-office rigor required to establish and maintain an SBIC fund is greater than that associated with a typical private investment fund. Therefore, an SBIC fund typically requires a more significant investment in the organizational entity itself, especially in staff time and outsourced legal and accounting.

- The timeline to establish and formally register an SBIC from idea to completion typically takes 12 to 24 months. For opportunistic investors, this timeline often is the major constraint that inhibits use of the program.

Small Business Investment Company Case Study

STONEHENGE
CAPITAL

Overview

Stonehenge Capital is a nationally focused investment company, managing funds of various types in geographies across the US. Established in 1999, Stonehenge makes high impact investments in areas targeted for economic revitalization, primarily using federal and state tax incentive programs. To date, the firm has managed more than $1.1B in federal and state New Markets Tax Credit allocations, including several loan funds with place-based strategies designed to address the capital needs of small businesses in underserved communities. Stonehenge also manages one Small Business Investment Company (SBIC) fund, called Stonehenge Community Impact Fund LP.

This SBIC fund builds on Stonehenge's existing experience deploying capital to businesses within economically distressed or disadvantaged communities. The criteria for the Stonehenge Community Impact Fund is similar in many regards to the firm's other investment funds: targeting lower-income census tracts, HUB Zones, and minority entrepreneurs.

The fund holds roughly $225M in total assets, and thanks to the unique and highly valuable incentive structure provided by the SBA, the Stonehenge team only had to raise roughly $75M in private capital for the fund, which was then matched 2:1 by federal government debentures.

The lion's share of the Stonehenge SBIC fund's Limited Partner (LP) investors are banks and financial institutions—for whom an investment in this fund both satisfies their institution's motivation to generate profits, and also in many cases allows the banks to count this investment toward their total Community Reinvestment Act (CRA) obligations.

Investment in the Stonehenge Community Impact Fund works much like any other private investment fund. For instance, the fund adheres to the following, traditional criteria:

- 7- to 10-year hold period of private capital before returns to investors
- Standard fund-level "economics" including a 2% management fee charged by the General Partnership, and a nondisclosed but traditional "waterfall" structure for distributing carried interest

Investment Strategy:

Typical check size: $5M - $15M

Terms: Senior secured, senior-stretch, and unitranche debt—often including equity kickers or warrants

Target firm size: Revenue of $5M - $75M and EBITDA of $1M - $10M

Business use(s) of funds: General growth capital, equipment purchases, facility acquisitions or expansions, management buyouts, company acquisitions, generational transfers. Various uses of funds that banks typically are less likely to approve for secured debt.

Specific Focus on Low-to-Moderate Income (LMI) Communities: Qualified locations may include but are not limited to Opportunity Zones, NMTC-eligible census tracts, rural communities, and other locations targeted for economic development.

Cost of Capital: High single-digit APRs for entrepreneurs (8-10%)

Track Record:

As of July 2022, Stonehenge SBIC has deployed $45M of its $225M in capital into four deals.

Case Study: PosiGen Solar - Portfolio Company

PosiGen®
Solar Energy and Energy Efficiency

PosiGen is a residential solar contractor focused on low- to moderate-income communities, based in New Orleans, Louisiana. The company also provides energy-efficient solutions to homeowners. Not only was PosiGen based in the appropriate geographic location for the Stonehenge SBIC fund to invest, but the business also creates a positive social and environmental impact in the community, making the deal attractive from an impact standpoint.

PosiGen needed a total of $24M for working capital to grow the business, plus debt-refinance funding to decrease monthly debt expense and improve margins. The Stonehenge SBIC fund provided $8M in a senior working capital facility and specifically took a risk by refinancing the company's debt for a work in progress, which allowed the company to grow more quickly without having to wait for project completion to refinance.