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Capital-Raising Alternative for Middle Market Companies: Small Business Administration's SBIC Program

Navigating Funding and Licensing Requirements to Access Leverage Commitments

TUESDAY, APRIL 24, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Michael B. Staebler, Partner, **Pepper Hamilton**, Southfield, Mich.

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THE SMALL BUSINESS ADMINISTRATION'S SBIC PROGRAM

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OVERVIEW

I. SBICS ARE PRIVATELY FORMED AND MANAGED INVESTMENT FUNDS WHICH, IF LICENSED BY SBA, CAN POTENTIALLY TRIPLE THEIR PRIVATELY-RAISED CAPITAL FOR INVESTMENTS IN MOST MIDDLE MARKET COMPANIES. SBICS OBTAIN SBA LEVERAGE BY ISSUING SERIES OF TEN-YEAR BALLOON NOTES WITH LOW FIXED INTEREST RATES (NOW ABOUT 3.5%); NO PROFIT TO SBA. MAX LEVERAGE IS \$150 MM; MAX INVESTMENT PER COMPANY 30% OF PRIVATE CAPITAL. OBAMA ADMINISTRATION HAS ENHANCED, STREAMLINED, EXPANDED AND ACCELERATED SBIC PROGRAM.

The SBIC Program: What it Is

- Established in 1958; thousands of SBICs licensed
- Over 400 SBICs currently operating (Foley Hoag has represented over 150)
- Annual Congressional Authorization is \$3 billion; Obama Administration seeks \$4 BB.
- No Appropriation needed – program self-funded and off budget
- Only about \$1 billion utilized annually.

Scope and Impact of SBIC Program

- Total Licensees: 145 with Debenture Leverage; 130 with older equity (PSec) Leverage; 30 non-levered; (others).
- Total recent SBIC financings in small businesses: \$1.6 Billion in FY 2011
- Leverage economics -- best ever -- 3.5% fixed for 10 years; no amortization of principal; no prepayment penalty
- Additional charge to balance budget: about 80 BPs for FY 2012 (started 10/1/11); keeps program off federal budget and without need for appropriation.

New SBIC Formations in 2011

- Total funds licensed in FY 2011 (ended 9/30/11): about 30
- Total “green light” letters issued by SBA in FY 2011: about 50
- Average time to Licensure: about 6 months from MAQ filing; SBA goal is 80% within 6 months
- Success ratio of Applicants: 50% of MAQ filers invited to present to SBA Licensure Committee; 23% ultimately licensed (includes fund-raising and other attrition).

What an SBIC Can Invest In

- Must invest in “Small” Businesses – “small” means “most”
- “Small” Business defined as \$18 Million tangible net worth and \$6 Million net income after taxes, average for last two fiscal years; or, alternative NAICs Code qualifications
- Most industries are included
- Few exclusions: most real estate development; projects (power plant; oil well; ship); financial intermediaries; holding cos.; foreign cos.; casinos; farms
- SBICs can invest up to 30% of their private capital in any one portfolio company (“Overline”).

Leverage Parameters

- Max Leverage per SBIC: lesser of \$150 million or 3:1
- Total outstanding Leverage committed by SBA: \$9.1 billion; \$5 billion outstanding Debenture Leverage drawn; \$1.2 billion Debenture Leverage committed in 2010 FY
- Average outstanding Leverage ratio: 1:1
- Licensees receiving some third tier Leverage: about 20
- Average Debenture spread above comparable ten-year Treasury rate: 50-60 BPs
- Current Debenture interest rate: 3.5% [incl. 80 Bps].

Leverage Description

- Designed for a debt fund; but equity investments allowed
- 10-year “balloon” notes (Debentures) issued to SBA, with no amortization of principal; no prepayment penalty
- Interest due twice a year; currently 3.5%, fixed for 10 years
- One time 3.5 % charge on all Leverage
- SBA receives no profit; all profit goes to private investors
- LMI partial zero-coupon Leverage available.

Leverage Mechanics

- First establish forward Leverage Commitment – removes political risk; pay 1% of amount Committed, other 2.5% deducted from Leverage proceeds when drawn
- Leverage draws 1st and 3rd Wednesdays each month; \$\$ available 10 days after filing; draw filings short and simple
- SBICs file quarterly “468” reports; annually examined on site by SBA Examiners for regulatory compliance
- SBA Exam does not cover financial safety and soundness.

Management Fee Structure

- SBA formula: SBICs may charge management fee of 2.5% X their private capital X3 (in each of first 5 years) on private capital (PC) up to \$20 million
- Rate drops to 2% ratably between \$20MM and \$40 MM PC, and is 2% thereafter – all back to first dollar.
- Base after 5 years is net invested capital
- Most SBICs negotiate fees below SBA max.

Regulatory Issues

- SBICs operate much like non-regulated funds. SBA does not review or approve deals (with few exceptions)
- A few, but not many, restrictions on SBIC deal terms
- SBICs can be BDC subsidiaries – max BDC Leverage
- SBICs exempt from new “Volcker Rule”
- SBICs not “affiliated” with their portfolio cos. – advantages.
- Nonprofits may avoid UBTI.

II. Many Common Misconceptions about the SBIC Program

A. The SBIC Program was suspended and defunded in 2004.

No. Only a temporary (1994-2004) equity Leverage program was suspended. The Debenture (debt) Leverage program continues unaffected, as since 1958.

B. Managerial qualifications for SBICs are impossible to meet. No.

Former standards modified; new standards more flexible, but require 2 Principals with significant debt deal experience. Some managers with both debt and equity experience may qualify.

C. Licenses take forever to obtain – a long, risky process. No.

Former process modified; new process accelerated. Pre-MAQ short-form screening process available. Overall process time reduced.

D. Must raise significant private capital before applying for license.

No. MAQ process can start without funds raised or application fee paid. If “green light” letter results, must have \$15 million committed (not paid in) to ensure continued processing. Private investor Capital Commitments can be conditioned on approval of fund documents and SBA licensure.

- E. UBTI consequences result from investments in debt-type SBICs.** Not always. Recent legislation allows significant investments by pension funds and other nonprofits in SBICs without UBTI consequences.
- F. Small size standards are difficult to meet.** Not generally. If can't meet 18/6 standards, can often use procurement NAICs codes.
- G. Many industries are off limits for SBIC investments.** No. Only a few industries are off limits; exceptions for real estate; foreign; holding cos; projects.
- H. The Leverage Draw process is cumbersome.** No. Can draw 1st and 3rd Weds. each month. Funds available in 10 days. Applications simple; can fragment "takedowns" during 60-day period.
- I. Debenture SBICs cannot do equity deals.** No. Many do equity deals. SBA favors debt + equity instruments, but pure equity deals can be done within limits.

J. SBA must preapprove all SBIC investments. No. Most deals do NOT require prior or (post) SBA approval, except for certain “Associate” (and certain limited other) transactions.

K. SBIC appropriations could run out. No. No actual appropriation is needed, because program fees offset expected annual losses. Current \$3 BB Authorization intact. Obama Admn. seeks \$4 BB.

L. Second and subsequent funds are very difficult to obtain and Leverage is limited. No. New “Fast-Track” process for follow-on funds available; max Leverage for affiliated fund groups raised to \$225 MM.

M. Post-licensure SBA regulation is complicated and costly. No. Limited prior deal approval. Minor transactional impact. Quarterly reporting straightforward. Annual SBA exams for compliance only. Unlike other industries, SBA regulation has remained relatively stable.

N. SBICs cannot obtain 3:1 Leverage. No. Obama Stimulus Act legislated 3:1 cap, but implementing Regs seemed to limit Leverage to 2:1. Recently SBA has approved partial 3:1 in some cases.

O. SBICs cannot control portfolio companies. No. Old control reg changed. SBICs now can control for 7 years w/o SBA approval.

P. SBIC deal terms are off-market. Some are: cost-of-money limits; certain fees regulated; minimum one-year term; redemption (put) price regulated; default remedies limited.

Q. Debenture SBICs can do only mezzanine debt deals. No. SBA allows all forms of debt (and equity) deals, including 1st lien; unitranche; royalties.

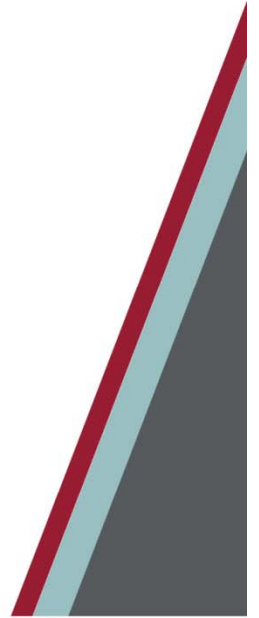
R. SBICs cannot distribute cash to private investors until all SBA Leverage is repaid. No. SBICs can distribute rolling cumulative profit (“READ”) to private LPs prior to repayment of Leverage.

MICHAEL K. WYATT

- Mike Wyatt was General Counsel of SBA in 1990-93, where he was engaged in all SBA programs and managed 300+ lawyers. During his tenure major regulatory and policy changes were implemented in the SBIC and other SBA programs, including creation of the participating-security SBICs and major changes in the regulations affecting debenture SBICs.
- Since then Mike has represented over 200 SBICs, over 100 groups seeking SBIC licenses, many investors in SBICs and portfolio companies receiving SBIC investments. He has also represented Section 7(A) SBA-guaranteed lenders and government contractors in small business set-aside, SBIR and other matters. He is the author of The Small Business Compliance Adviser (Thompson, 1995), Chapter 3A on SBICs in the Aspen treatise on Venture Capital and numerous other articles.
- Mike is a graduate of Princeton (AB), Oxford (UK) (MA) and Harvard Law School (JD).

Debenture Leverage

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EDWARDS
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Debenture Leverage

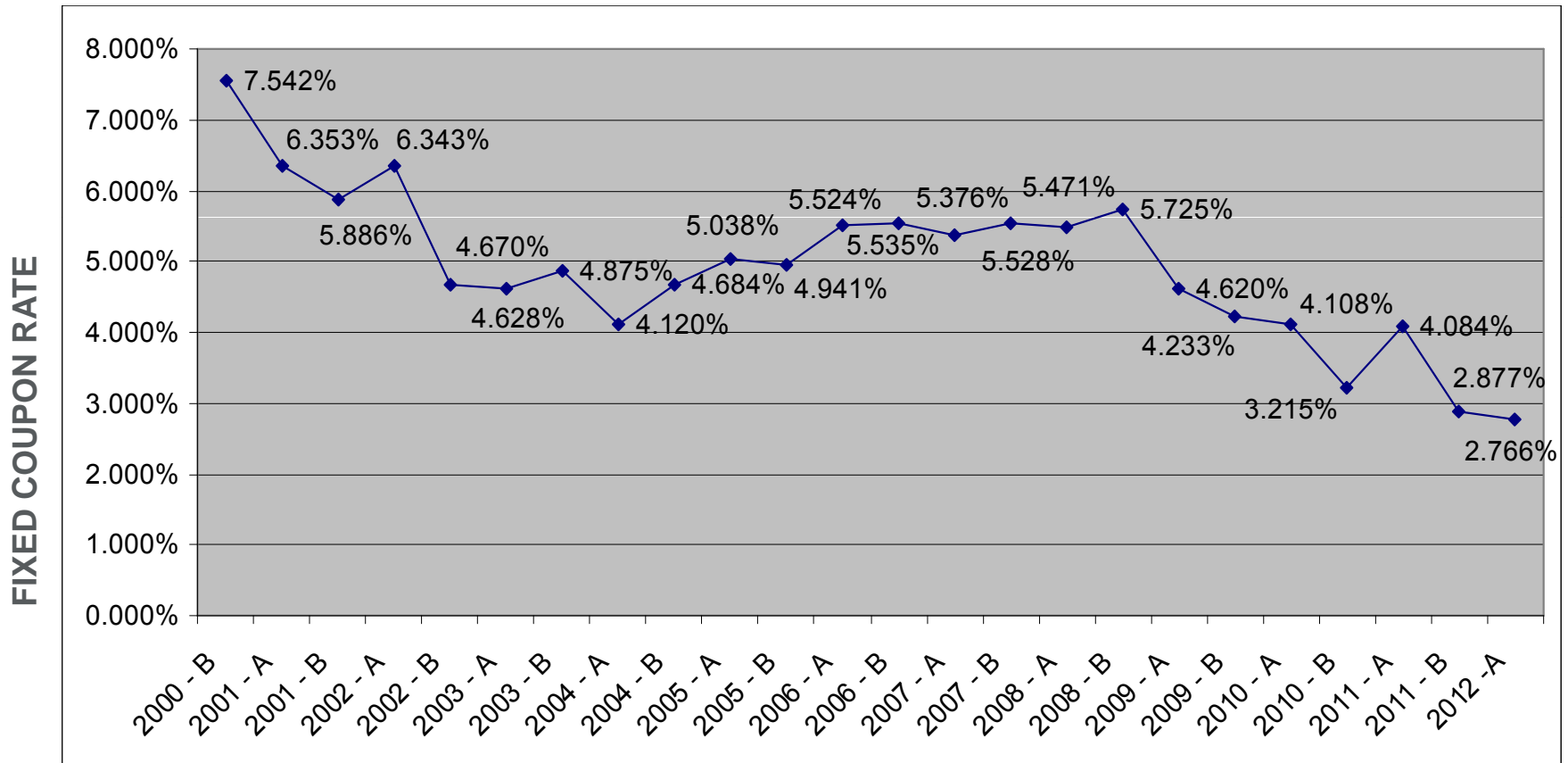
- ◆ SBICs receive leverage in proportion to their private capital
- ◆ Previously, an SBIC could receive leverage in “tiers” up to an aggregate maximum cap of \$137.1 million
- ◆ New simplified formula:
 - ◆ Maximum amount of leverage that an individual SBIC may obtain from the SBA is the lesser of \$150 million or 300% of the SBIC’s private capital
 - ◆ Maximum for a family of funds increased to \$225 million
 - ◆ However, SBA has indicated that 3X leverage will only be available after a fund has demonstrated exceptional performance

Debenture Terms

- ◆ Interest only payments, payable semi-annually
- ◆ Ten-year maturity, non-amortized, unsecured
- ◆ Cost is market driven:
 - ◆ Trust Certificates sold semi-annually
 - ◆ Debenture cost is set post draw down
 - ◆ Cost is based on rate for Treasury Notes with 10-year maturities plus a market driven premium
 - ◆ Most recent cost was 3.57% (rate + premium)

Debenture Terms

SBIC DEBENTURE PRICING



Debenture Terms *continued*

- ◆ Additional Debenture Fees:
 - ◆ 1.00% leverage fee on issuance of original commitment paid within 30 days of receipt of written commitment
 - ◆ 2.00% leverage fee deducted from each draw
 - ◆ .375% underwriters fee deducted from each draw
 - ◆ .05% administrative fee deducted from each draw
 - ◆ .804% annual charge on outstanding leverage
- ◆ No prepayment penalty
- ◆ Subordinate to loans from non-Associate lenders up to the lesser of \$10 million or twice the amount of the SBIC's capital from private investors

Accessing Debenture Leverage

- ◆ SBICs Must Prepare a Leverage Commitment Application
- ◆ Can Apply for One Tier of Leverage During the Licensing Process Through the Licensing Analyst
- ◆ If Not Done During Licensing May Apply Anytime After License is Issued Through Operations Analyst
 - ◆ Thereafter May Apply for Additional Commitments Up to Two Times Per Year
- ◆ Once A Commitment is Issued Must Be Accepted Within Thirty (30) Days and Payment of the 1% Fee
 - ◆ Annual Charge is Confirmed

Accessing Debenture Leverage *continued*

- ◆ Balance of Fees are Paid When There is a Drawdown
- ◆ Commitment is Good for 4 Full Fiscal Years and Stub of the 5th Year.
- ◆ Just In Time Financing
 - ◆ Submit Draw Request on 1st and 3rd Wednesday of Each Month
 - ◆ In essence a 10 Day Process
 - ◆ Approved Draw Requests Good For 59 Days
 - ◆ Must Submit a Legal Opinion for Each Draw Request
 - ◆ Leverage Draws May Be Used for Investment and Expenses
 - ◆ Must Submit Appropriate Bank Letter

SBA Additional Leverage Initiatives

- ◆ Start-up American Impact Investment
 - Proactively Identify Experienced Private Equity Fund Managers
 - Expedited Licensing For Funds Managing “Impact Investment SBICs”
 - \$1 Billion commitment over 5 years
 - Focus on Underserved Communities or Sectors of National Security
- ◆ Early Stage Innovation Fund
 - \$1 Billion Committed Over the Next Five Years
 - Targeting Early-Stage Firms in the So-Called “Valley of Death”
 - Companies Seeking First Dollar Institutional Capital
 - 1:1 Leverage with Maximum Leverage of \$50 Million Per Fund
- ◆ Energy Saving Debentures

Edwards Wildman Palmer LLP

- ◆ The result of a merger between legacy firms Edwards Angell Palmer & Dodge LLP and Wildman, Harrold, Allen & Dixon LLP
- ◆ 625 attorneys spanning 14 offices in the US, UK and Asia
- ◆ Dow Jones Private Equity Analyst: Ranked 9th overall based on the number of private equity and venture capital deals closed in 2011, according to its ranking of the "Most Active Law Firms"
- ◆ Prequin Global Private Equity Report: one of the top 25 leading law firms in fund formation
- ◆ Represent over 90 Current and Former SBIC Licensees

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Alan B. Roth, Esq.

Alan B. Roth is a partner at Edwards Wildman and Co-Chair of the Fund Formation Practice Group. His practice is focused primarily in the areas of venture capital and private equity representation, including SBIC licensing, investment and compliance, fund formation, corporate acquisitions, and representation of closely-held corporations and individuals. He has been recognized by Chambers USA as a leader for his work in the area of Corporate/M&A and Private Equity.

Alan has built a strong reputation in the venture capital and private equity community. He leads one of the most active SBIC practices in the country and his specialized knowledge of the SBIC program provides clients with an additional investing edge. Alan regularly counsels venture capitalists and private equity professionals on fund formation including becoming licensed as small business investment companies, encompassing both the pre-licensing and post-licensing stages of the process. He works closely with the Small Business Administration and the Small Business Investor Alliance.

Alan graduated from Washington University with a J.D, and from New York University with a LL.M in Tax. He received his Bachelors from Duke University.

Capital-Raising Alternative for Middle Market Companies

Small Business Administration's SBIC
Program, Navigating Funding and Licensing
Requirements to Access Leverage
Commitments

April 16, 2012

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SBA Licensing Criteria and Process



- Historically
 - Minimum capital very small – no third party validation of management team
 - Initially -- \$150,000 minimum capital; 1992 – \$2 million
 - No diversity of management and ownership before 1997
 - No more than 70% owned by a single owner (including affiliates)
 - At least 30% owned by investors unrelated to the management team
 - A single manager could run the show
 - No track record necessary
 - No discernible criminal record

Toughening the Standard



- Began in August 2000

Current Requirements



- Preferably 3 -5 principals (at least 2 and no more than 6)
- At least 2 of the principals need:
 - 5 years of partner level investment decision making experience
 - During the last 10 years
 - Only deals done as a principal count
 - Investment banking deals are not track record
 - Commercial bank loans are not generally track record
 - Doing deals that bear a relationship to what is proposed for the SBIC
 - If not on investment committee may get attribution – sourcing, due diligence, monitoring and exiting

Current Requirements



– Successful Track Record

- At least some of the deals must be structured like planned SBIC deals
- Upper 2 Quartiles for vintage year—but more importantly—must have IRR over 10% (hopefully a good bit more) and decent cash on cash returns
- Minimum of 8-10 deals with 4-6 exits. More is better
- Historic deal flow must have similarity to deals planned for the SBIC
- The track record **MUST BE REPORTABLE** on a deal by deal basis
 - Company name, industry
 - Amount and date invested
 - Type of security
 - Amount realized (including fees, interest, dividends, etc.)
 - Realization date
 - IRR and cash on cash returns

Current Requirements



- Complementary skills
 - If 1 principal has a longer record, it will compensate for some shorter records
 - But there must be at least 2 strong decision makers
 - Not all principals must have a qualifying track record—but at least 2 must. other team members can have complementary skills.
- Foreign nationals – not U.S. citizen or green card holder
 - May be principal
 - Track record will not be taken into consideration in evaluating the team

Current Requirements



- Horizontal, not vertical management team
 - No “one man band”
 - Carried interest is the primary way of evaluating the true dynamics of the principals
 - If only 2 principals – must be divided 50-50
 - If 3 or more, no principal may have 50% or more
 - Certain principals may have veto rights over investment decisions, but a majority of the principals will be required to make investment decisions (if not unanimity)

Current Requirements



- Time commitments
 - At least two of the principals must spend the majority of their time with the SBIC (general rule—there are exceptions)
 - “Track record” principals must spend enough time to provide reasonable assurance of significant involvement for SBA. Must receive substantial compensation—including carried interest
 - Facts and circumstances of each team is independently evaluated

Current Requirements



- Minimum capital
 - At least enough to carry out business plan – minimum of \$15 million
 - Management and ownership diversity requirements
 - Participation by prior investors – carefully evaluated

Licensing Process



- There are two required steps for new funds, and a third optional procedure that can be used
 - Optional procedure – executive summary screening process
 - Mandatory procedure – Step One: Management assessment questionnaire

Optional Procedure

Executive Summary Screening Process



- If your situation is not “clear cut” you may wish to prepare an “Executive Summary” and submit it to a preliminary screening by the SBA program development staff.
- Materials:
 - 2-3 page summary of planned activities: fund size; leverage sought; investment strategy—industries; stage; geography; number and size of investments; company characteristics by EBITDA and revenues; deal structures; targeted returns.
 - Description of management team
 - Detailed biographies
 - Detailed track record for each Principal
- Program development staff reviews and does a 1 hour call to give feedback and identifies areas of concern

Mandatory Procedure

Step One: Management Assessment Questionnaire



- Very detailed 2 part questionnaire
 - Part I: Detailed business plan
 - Identifies principals – time commitment; share of carried interest; compensation; role in the SBIC
 - Amount and sources of money to be raised
 - Investment strategy
 - stage of investment
 - size and timing of investments
 - geography
 - sole, lead or co-investor
 - industries

Mandatory Procedure

Step One: Management Assessment Questionnaire



- Economic terms and pricing methodology (Term sheets attached)
 - Deal flow processing
 - sourcing
 - logging in
 - due diligence process (check-list attached)
 - investment criteria
 - preparation of investment memoranda (copies attached)
 - Investment committee meetings—frequency and voting procedures
- Etc. etc. etc. – a very thorough and involved process

Mandatory Procedure

Step One: Management Assessment Questionnaire



- Part II: Personal data and track records
 - Detailed resumes and about 15-20 references in specified categories
 - Detailed track records
 - Questionnaires concerning prior litigation and time commitments

Mandatory Procedure

Step One: Management Assessment Questionnaire



- Filed with SBA’s Office of Program Development
 - 60-120 days processing time
 - Telephone interview of each principal
 - SBA’s licensing committee meets and decides whether to invite the team in for 1 hour interview
 - Interview by SBIC of all principals
 - If successful, issued a “green light letter”
 - Not guaranty of license –but very high probability
 - May file formal application when minimum capital (at least \$15 million) raised
 - Good for 18 months

Mandatory Procedure

Step Two: Formal License Application



- May be filed when have received commitments for minimum capital
- Entire MAQ is updated (to the extent necessary) and incorporated in application
- Additional materials
 - Legal documents – SBIC partnership agreement, general partner’s documents, resolutions
 - Fingerprint cards and questionnaire asking whether principals have ever been arrested, charged with a crime, or become the subject of a government investigation (note—not convicted or indicted)
 - Final organization chart (also in MAQ)
 - Various other forms
 - Capital certificate – giving name and capital commitment of each investor and indicating status as an “Institutional Investor”
 - Private placement memorandum

Mandatory Procedure

Step Two: Formal License Application



- License application fee – generally \$15,000
- Reviewed by Office of Licensing
 - Analyst assigned
 - Art Spivey – chief
- SBA reviews.
 - FBI check
 - Business review of all submitted materials and reference calls
 - Review of legal documents by Office of General Counsel
 - Comment letter(s)

Mandatory Procedure

Step Two: Formal License Application



- Approval by Divisional Licensing Committee
 - Basically the same people who interviewed the Principals and voted to give green light letter
- Approval by Agency Licensing Committee
 - At least \$2.5 million of private capital must be paid in (pro rata from all investors) prior to Agency Committee approval
- Signature of SBA Administrator approving the License
- Typically taking about 6 months

Operations During Licensing Process



- May have a closing and commence operations after filing formal license application
- All principals may attend SBA regulations class (day long class usually held in Washington, D.C.)
- Need request prior SBA approvals to make investment (for regulatory compliance and consistency with business plan)
- May apply for a leverage commitment for 1 “tier” of leverage at end of licensing process
- Leverage typically available about 60 days after formal license issued
- Interim bank line

Pepper Hamilton LLP



- 500 attorney, full service, national law firm
- Extensive middle market transactional and advisory expertise

SBIC Practice



- Largest and most active SBIC practice
- Approximately 195 licensees since 1994
- Largest experienced legal team – real depth and expertise
- Licensing, partnership structuring and formation, securities, tax and bank regulatory advice
- Strong transactional experience

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Michael B. Staebler



- Assisted approximately 195 successful licensees since 1994 - approximately \$20 billion under management
- President, Michigan Capital & Service, Inc. (1975-1980) - Successful Michigan SBIC sold to Michigan's largest bank
- Represented more than 225 SBICs in connection with licensing, formation and fundraising, operations, investments, and SBA compliance
- Advisor to SBIC Industry trade association in connection with legislative initiatives, SBA regulations and policies and SBA forms, and tax, banking and securities laws and regulations
- Frequent seminar organizer and presenter and public speaker concerning SBICs
- Honors graduate: Harvard College and Michigan Law School