Chapter 14

SMALL BUSINESS INVESTMENT COMPANIES

INTRODUCTION

As a source of funds, Small Business Investment Companies (SBIC's) are one of the best kept secrets in capital markets. The list of companies that have used this little known funding source reads like a who's who of the corporate world. They include: Federal Express, Sun Microsystems, Apple Computer, America On-line, Peoplesoft, Amgen, Staples, and Restoration Hardware.[1]

SBIC's are a creation of Congress and the Small Business Administration. Their mission is to provide capital to small and emerging companies that may not be able to get capital economically through other sources.[2] The funding structure of Small Business Investment Companies allows them to raise capital relatively cheaply which gives them a unique risk reward profile. They are more risk tolerant than banks because they are less regulated, and because their funding sources demand less of a return than venture capital limited partners, they don't have to be as aggressive in seeking high payoff ventures. They also have a Congressional mandate to focus on small business which limits their field of operations and focuses them on start-ups and emerging businesses.

In this chapter we will discuss how SBIC's operate; their source of funds and how that affects their risk / reward characteristics; the size and types of investments they usually make; the nature of companies that qualify for SBIC funding; and types of investments that are prohibited. We will also

discuss how to find an SBIC; evaluate whether a particular SBIC is right for a company and the types of information an SBIC will need to make a favorable decision on a funding request.

CHARACTERISTICS OF SBIC INVESTMENTS

SBIC's fill an important funding gap. Individual Angel investors typically invest $25,000 to $250,000 and groups of angels invest $250,000 to $1,000,000. On the other hand, the average venture capital investment is over $6 million. SBIC's help fill this gap by making average initial investments in the range of $750,000 to $2,750,000. One issue to consider when selecting a funding source is its willingness and ability to provide follow-on financing should the company grow. Figure 14-1 is an analysis SBIC Funding by Round.[3] In 2000, SBIC's invested about 70% of funds in first round financing, and about 30% of their funds in follow-on financing for firms already in their portfolio.

Figure 14-1 SBIC Funding by Round

Round Of Financing	(millions)	% $	Number of companies	Average investment (millions)
Initial Financing	$3,859.7	70.6%	2,251.0	$1.7
Follow-On Financing	$1,606.6	29.4%	2,388.0	$0.7
Total Financing	$5,466.3		4,639.0	

Equally important to an entrepreneur is the type of funding provided. Figure 14-2 Analysis of Funding Type[4] indicates that 73% of investments in 2001 were straight equity with another 20% of investments in the form of debt with equity features, like convertible bonds or bonds with warrants. Less than 7% of investments were pure debt.