OCTOBER 2024

THE LP'S GUIDE TO SBIC INVESTING

As the private credit market continues to grow and evolve, the Small Business Investment Company (SBIC) program has consistently outperformed and offers a compelling opportunity for investors seeking both strong financial returns and meaningful economic impact.

ABOUT SMALL BUSINESS INVESTMENT COMPANIES

Launched in 1958, the program has a long history of success helping domestic small businesses access long-term, patient capital for growth and job creation. Administered by the U.S. Small Business Administration (SBA), SBICs utilize the talent of experienced private investment fund managers to achieve critical public policy objectives. According to data compiled by SBA, as of 2024 the SBIC program has:

- Deployed **over $130 billion** of capital;
- Made more than **194,000 investments** in U.S. small businesses; and
- Licensed nearly **2,400 funds**.

Today, there are more than 300 licensed SBIC funds representing $30+ billion in domestic capital.

In August 2023, SBA implemented significant reforms to the SBIC program, creating two new SBIC licenses to expand the spectrum of private sector capital supporting U.S. small businesses. The Accrual SBIC license is designed to support longer-term equity investments. The Reinvestor SBIC license aims to increase the geographic reach of the program and foster the next generation of fund managers.

Fund management teams that successfully complete the SBIC application process may access low-cost leverage up to two times the private capital they raise. These funds then invest in a portfolio of U.S. small businesses - creating jobs, fostering innovation, and fueling economic growth.

A 2017 Library of Congress study found that SBIC-backed small businesses created almost 3 million new jobs and supported an additional 6.5 million jobs over a 20-year period.

THE PERFORMANCE OF SBICS

In a first-of-its-kind study, the Institute for Private Capital analyzed the performance data for SBIC funds licensed between 2000 and 2020. Key findings in the report include:

- Over the 2000-2020 period, SBICs had an average internal rate of return (IRR) of 15.46%, which is 3.55% higher than a comparable set of non-SBIC peer funds.
- The average multiple on invested capital (MOIC) for SBICs is 2.3x, which is 0.74 higher than for non-SBIC funds.
- On average, all SBIC strategy types and levels of leverage have superior performance when compared to a non-SBIC peer group.
- Taking into account potential survey selection bias, SBICs still produce an average IRR that is 2.7% higher than non-SBIC funds (using SBICs identified in MSCI-Burgiss data).
- Higher leverage ratios does not always equate to higher returns; the optimal leverage ratio for best performance (relative non-SBIC peer funds) is 1.00x to 1.75x. This suggests that SBICs offer a well-balanced approach to leverage and optimize returns while mitigating risk.
- SBICs remain an indispensable source of capital for American small businesses.

BENEFITS BEYOND THE POTENTIAL FOR ENHANCED RETURNS

- **Rapid Deployment of Funds:** SBA leverage can help shorten the fundraising cycle, allowing managers to begin investing quickly.
- **Exemption from the Volcker Rule:** Bank investments in SBICs are exempt from the 3% cap set forth by the "Volcker Rule" under the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL-111-203).
- **Community Reinvestment Act (CRA):** Bank investments in SBICs are presumed qualified for CRA credit.
- **Flexible Terms:** With a long duration and no prepayment penalty, SBA leverage is compatible with most investment maturities.
- **Flexible Fund Structure:** SBICs may utilize a variety of fund structures, including "drop-down" and "side-car" structures.

RIGOROUS UNDERWRITING CRITERIA

To be considered for an SBIC license, applicants must demonstrate the same key qualifications sought by private investors.

- **Manager Assessment:** A cohesive team of individuals with strong reputations and years of investment experience.
- **Performance Analysis:** A high-quality track record of analogous investments that have yielded strong returns and successful exits.
- **Strategy Evaluation:** A well-articulated investment strategy that is compatible with leverage and which targets small businesses.
- **Fund Structure & Economics:** Sufficient fund infrastructure to support the strategy and a strong alignment of incentives between the fund's general partner, limited partners and SBA.

MYTHS ABOUT SBICS

SBIC are for new fund managers.
FALSE. SBIC managers must have a significant successful track record of raising and investing private funds before they can get an SBIC license. SBIC managers go through a rigorous vetting process and they must have market validation from LPs to get licensed.

SBIC leverage adds more risk than reward for LPs.
FALSE. Leveraged SBICs have consistently produced better returns than peer funds over the past 20 years.

SBIC managers need permission from the government before they can invest in a business.
FALSE. Once licensed, SBICs are able to move at the speed of business, deploying capital to the businesses they choose in a manner consistent with their strategy.

SBICs are all private credit.
FALSE. SBICs have widely varying investment strategies and several types of leverage tools that align with their investment strategy. SBICs are now commonly mezzanine, unitranche, growth equity, buyout, and venture capital.

Banks only invest in SBICs because of CRA requirements.
FALSE. Banks invest in SBICs because they offer an excellent risk adjusted return on their capital. Many banks see the reputational and regulatory benefits as an added bonus to their base returns.

529 14th Street, NW
Suite 400
Washington, DC 20045

www.sbia.org

info@sbia.org

SBIA SMALL BUSINESS INVESTOR ALLIANCE™