

SBIC Fund CFO Conference

June 19, 2012



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Small Business Investment Company Accounting



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Agenda

- New and proposed accounting pronouncements impacting GAAP reporting
- Technical resources for SBIC funds
- Start up issues for new funds
- GAAP vs SBA accounting
- Management fees
- Other accounting matters

New and Proposed Accounting Standards

- Fair Value
 - Additional disclosure requirements
 - Elimination of the highest and best use concept for financial assets
- Consolidation of Investment companies

Technical Resources

- 13 CFR 107 – Small Business Investment Companies (SBICs)
 - Changes in ownership, control, or structure
 - Managing the operations (back office operations)
 - Recordkeeping and reporting
 - Financing of small businesses
 - SBA leverage
 - Noncompliance issues
- SBIC TechNotes
- SBA accounting guidelines
- SBA chart of accounts
- SBA valuation guidelines

Start Up Issues

- Organization costs
- Syndication costs
- Initial management fees computations
- Back office set up
- Accounting policies
- Establishment of Internal controls
- Closing schedules and calendar
- Accounting systems

GAAP Differences

- Unrealized gains (losses)
 - Are reported as direct increases/decreases to partners' capital for SBA reporting purposes
 - Are not included on the statement of operations (GAAP)
- Financial highlights are not required by the SBA
- Valuation policy is not GAAP
- Derivative accounting not required for participating security funds.
- Installment sale reporting

Management Fees

- Include expenses related to the development, investigation and monitoring of investments, as well as salaries, bookkeeping and other office expenses
- The LP agreement must be followed
- Fees are generally limited to 2.0% of Regulatory Capital plus an assumed two tiers of leverage (see your LPA and the SBA TechNote)
- Fee income from portfolio company services or closing fees subject to 100% offset
- Fees related to additional LP commitments may only be charged in the quarter in which the SBA is notified
- See SBIC TechNote Number 7 for more information – also see TechNote 7a for newer funds
- Accounting for fee waivers and impact on 468 and capital certificate

Other Significant Accounting Matters

- Amortization of SBA leverage fees
- Revenue recognition:
 - Accounting for gains and losses:
 - Escrow payments
 - Installment sales
 - Interest, dividends
 - Contingent consideration
- Accounting for fee income
- Partners' capital allocations
- Accounting for debt issued with detachable warrants

Other Significant Accounting Matters

- Non-cash income
 - PIK interest/dividends
 - Gains on sales of portfolio companies
 - Impact of write-downs on investments that have PIK included in the basis of the investment
- Partners capital allocations
- Consolidation issues

Valuations

Regulatory Requirements for Valuations

- Tech notes on valuations
- Frequency of valuations – at least semi-annually
- Minutes
- Dissenting opinions need to be documented in the minutes
- Formal resolution
- Documentation
- Common problems

Valuation Guidelines

- The SBA valuation policy is required to be used for all SBIC Funds
- Valuations are the responsibility of the GP – “a careful, conservative, yet realistic approach”
- Investment companies report investments at “fair value”
- The equity method is not used for investment companies
- “The very nature of these investments makes the determination of fair market value problematical”

SBIC Valuation Guidelines - Private Companies

- Cost is presumed to represent fair value unless other conditions exist, including
 - Significant deterioration of performance or potential
 - Anticipated financing at a lower valuation - (Anticipated financings at a higher valuation are not considered)
 - A financing by a sophisticated new investor
- Limitations on unrealized appreciation for strategic investor financings must be considered

SBIC Valuation Guidelines - Private Companies

- An income or market approach can be used if the company has been self-financing and has positive cash flow from operations for two years
- Liquidations value can be used for situations involving bankruptcy or discontinuation of operations
- Warrants and options are valued at the excess of the value of the underlying security over the exercise price

SBIC Valuation Guidelines - Public Companies

- Public securities are valued at the average of the price at the close and the preceding two days
- Restricted stock is discounted until it is freely traded. Such discounts range from 10% to 40%
- Thinly traded stocks for which the fund owns substantially more shares than the daily trading volume should be discounted at least 10%

SBIC Valuation Guidelines - Debt Securities

- Valued at cost, with unrealized depreciation recognized when value is impaired
- Ranking system is recommended
- Collateral value is considered when the valuation is heavily reliant on asset values vs. earnings
- Convertible debt may be adjusted to reflect the value of the underlying equity security
- Accrued interest

Factors to Consider When Estimating “Fair Value”

- Nature and history of the enterprise
- Financial standing of company
- The quality of the business plan
- Comparison of plan to actual results
- Marketing strength and the ability to maintain a competitive position
- Liquidity of the market
- Pending offers to sell
- Other pending transactions

Other “Fair Value” Factors

- Ability of the company to obtain financing
- Changes in economic conditions
- Recent purchases of company stock
- Range of products and services and related diversity of the earnings base
- Adequacy of facilities and status of labor relations
- Governmental regulations
- Control vs. minority ownership

Auditor Responsibility for SBIC Valuations

- The Auditor does not act as an appraiser and does not audit the portfolio companies
- The Auditor must determine the following:
 - Does the fund have a written valuation policy?
 - Do the valuations reflect consistent adherence to the valuation policy?
 - Has the fund documented the basis for its valuations and does this documentation indicate a reasonable analysis of available information?

SBA Valuation Guidelines vs. GAAP

- SBA guidelines requires the portfolio company to be self-financing for two years and have positive cash flow from operations for two years
- For public stock the SBA guidelines uses the average of the last three trading days - GAAP uses the value on the final day of the year
- SBA guidelines require a discount for thinly traded stock
 - GAAP prohibits this in most cases
- Full and partial write-offs can occur earlier in an SBA Fund - this can be positive or negative to the fund based on the facts

Taxation of Private Equity Funds, Including SBICs



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Questions for Panelists

- What's new from last year and what to expect for 2013?
- What are the positives and negatives of investing in limited liability companies?
- FATCA – Does it really apply to me?
- What tax issues come up most often when drafting the partnership agreement?
- How do most clients use their tax professionals in an efficient manner?
- When can I take a loss on a portfolio company that I have not yet sold? Does it matter whether it is an LLC or corporate stock?
- What should I know as a newly licensed SBIC?
- What tax issues should I be aware of when restructuring debt?
- State tax – What opportunities and pitfalls are out there?
- Do you have any additional tax reading materials regarding private equity?

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The SBIC Match For Private Equity

The SBIC Licensing Process

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What's In It For You?

- ◆ SBIC Program provides leverage at below-market cost to qualified funds
- ◆ SBA Leverage can improve a fund's returns
- ◆ Bottom Line: Up to 3X leverage in exchange for following SBA guidelines

The SBIC Program

- ◆ Founded by Congress in 1958 to stimulate long-term investment in American small businesses
- ◆ Since 1958, SBICs have provided over \$50.6 billion of funding to over 100,000 small businesses
- ◆ As of February 2012, the SBA had over \$8.6 billion invested in 292 funds, plus another \$2.09 billion in outstanding commitments
- ◆ As of February 2012, private capital committed to those 292 funds topped \$8.75 billion

SBIC – A Public/Private Partnership

- ◆ The function of SBICs is to provide capital in the form of equity financing, long-term loans, and management services to U.S. small businesses, for their growth, expansion and modernization
- ◆ The principal reason for a fund to become licensed as an SBIC is access to low-cost financing (i.e., leverage) provided by the SBA
- ◆ Leverage is available through SBIC Debentures--unsecured notes issued by the SBIC that have interest only payments, payable semi-annually, and a ten-year maturity
- ◆ Since 2005, Congress has authorized \$3 billion of Debenture leverage annually, yet less than \$1.8 billion has been committed in any given year

Debenture Leverage

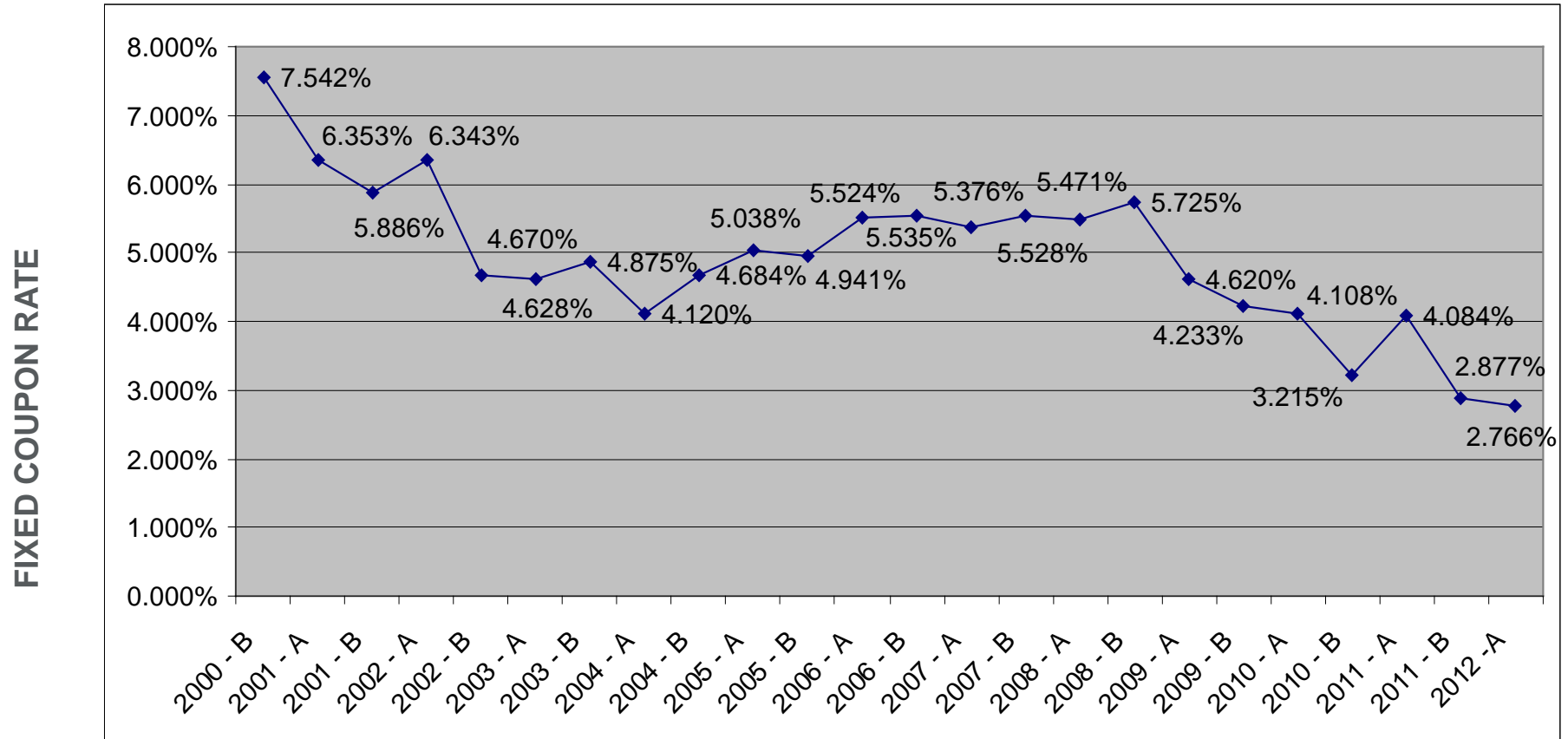
- ◆ SBICs receive leverage in proportion to their private capital
- ◆ Previously, an SBIC could receive leverage in “tiers” up to an aggregate maximum cap of \$137.1 million
- ◆ New simplified formula:
 - ◆ Maximum amount of leverage that an individual SBIC may obtain from the SBA is the lesser of \$150 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

Distribution Guidelines

- ◆ SBICs using Debentures may distribute:
 - ◆ undistributed net realized, cumulative earnings less unrealized depreciation
- ◆ Distributions may not reduce investor capital by more than 2 percent in any fiscal year without the SBA's prior written consent

Investment Limitations*

Maximum Size

- ◆ SBICs may only invest in businesses that have:
 - ◆ A tangible net worth of \$18 million or less and average taxable income of \$6 million or less for the two preceding fiscal years; or
 - ◆ Have fewer than a certain number of employees or revenues based on their industry class utilizing the NAIC code

Portfolio of Smaller Businesses

- ◆ SBICs must invest at least 25% of financings in businesses that have a tangible net worth less than \$6 million and average net income after taxes for the preceding two years no greater than \$2 million

**Please note that these investment limitations are intended to be illustrative only and not definitive or complete. Please consult with counsel for additional information.*

Investment Limitations *continued*

- ◆ Cost of Money – SBA’s Usury Provision
 - ◆ 19% for Loans
 - ◆ 14% for Debt Securities (Debt with Equity Features)
- ◆ “Overline Limit” (portfolio diversification)
 - ◆ 10% of the sum of an SBIC’s private capital plus the total amount of leverage projected by the SBIC in its business plan, as approved by the SBA at the time of licensing
 - ◆ In most instances this will result in a limit of roughly 30% of private capital

Investment Limitations *continued*

◆ Prohibited Investments:

- ◆ Re-lenders or re-investors (venture capital firms, banks);
- ◆ most real estate projects;
- ◆ single purpose projects;
- ◆ use of proceeds outside of the United States;
- ◆ passive businesses;
- ◆ businesses that use 50% or more of the funds to buy goods or services from an associated supplier

Fund Restrictions

◆ Minimum Size

- ◆ Regulations require \$5 million in committed private capital
- ◆ Reality - need at least \$15 million in committed private capital for leveraged fund; \$10 million for an unleveraged fund
- ◆ Meritocracy for funds that file with additional capital
- ◆ Ability to execute business plan with amount of capital raised

◆ Investor Limitations/Considerations

- ◆ May be domestic or foreign individuals or entities
- ◆ 33%+ owners must submit background information
- ◆ 10%+ owners must disclose their 10%+ owners
- ◆ UBTI Exception
- ◆ CRA Credit

Fund Restrictions *continued*

◆ Management Fee Limitations

- ◆ The maximum management fee that may be charged for the first five years of operation by the fund's management company is prorated based on the size of the fund and the time elapsed since the fund was licensed (generally 2.0% of private capital + assumed leverage)
- ◆ Second five years management fee is based on cost basis of assets
- ◆ The SBA requires that most fees received by management or affiliates be offset against any management fee charged

◆ Diversity of Ownership

- ◆ No single investor may own more than 70% of an SBIC's private capital
- ◆ At least 30% of an SBIC's private capital must come from three or more investors who are unrelated to management
- ◆ Exception for traditional investment companies

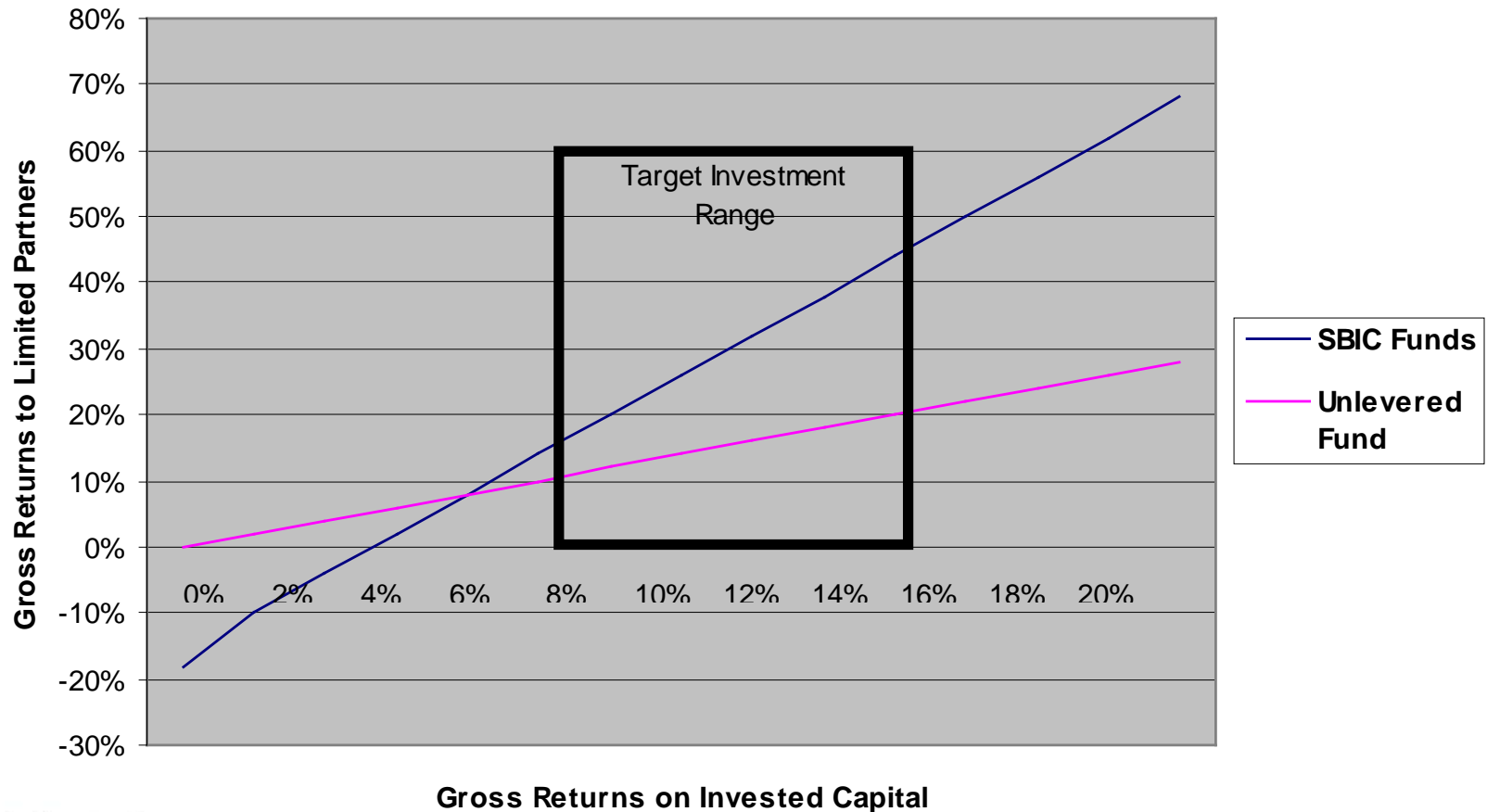
Benefits to Investors

Levered vs. Unlevered Returns to Limited Partners		
	Leverage	
	Without	With
Initial Investment		
LP	\$9,000,000	\$3,000,000
SBA Leverage: 2-to-1	-	6,000,000
Gross Return (15.0%)	1,350,000	1,350,000
Less:		
SBA Interest Expense (4.6%)	-	(275,940)
SBA Fees (2.4% SBA Capital Draw)	-	(145,500)
One-Time SBA Commitment Fee (1.0%)	-	(60,000)
Gross Return ¹	1,350,000	868,560
Gross ROI to Investors¹	15.0%	29.0%

1. Excludes management fees and other expenses

Benefits to Investors

Levered vs. Unlevered Returns to Limited Partners



SBA 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

SBIC Licensing Process

Prescreening
&
Qualifications

Preparation of
“MAQ”

Approval Process

Fundraising

File License
Application

Receive Leverage &
Access to Funds

Key issues:

- ◆ Two or more Principals must be qualified
- ◆ Experience working together as a team
- ◆ Demonstrated track record of comparable investments and multiple successful exits

SBIC Licensing Process

Prescreening &
Qualifications

Management
Assessment
Questionnaire

Approval Process

Fundraising

File License
Application

Receive Leverage &
Access to Funds

Key issues:

- ◆ Management team qualifications
- ◆ Investment track record
- ◆ Investment philosophy

SBIC Licensing Process

Prescreening &
Qualifications

Preparation of
“MAQ”

Approval
Process

Fundraising

File License
Application

Receive Leverage &
Access to Funds

Key actions:

- ◆ Submit MAQ to the SBA gatekeeper for consideration
- ◆ Initial investment presentation to SBA Investment Committee following its review of MAQ

SBIC Licensing Process

Prescreening &
Qualifications

Preparation of
“MAQ”

Approval
Process

Fundraising

File License
Application

Receive Leverage &
Access to Funds

Outline of Presentation to SBA Investment Committee:

- I. Overview of the Fund: Targeted Capital Raise, GP Commitment, Location, General Investment Thesis
- II. Principals and Advisors: Principals’ experience; Identify other staff and Advisory Board members
- III. Principals’ Track Record
- IV. Market Dynamics: Need for the Fund in the Targeted Geographic Area
- V. Investment Focus: Target Investment Size and Structure, Company Characteristics, Returns

SBIC Licensing Process

Prescreening &
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Application

Receive Leverage &
Access to Funds

Outline of Presentation to SBA Investment Committee Continued:

- VI. Investment Process
- VII. Due Diligence and Approval Processes
- VIII. Deal Flow and Fundraising Status
- IX. Summary of Key Economic Terms: Distribution Scheme, Management Compensation, Carry, etc.
- X. Conclusion
- XI. Appendix with Select Case Studies

SBIC Licensing Process

Prescreening &
Qualifications

Preparation of
“MAQ”

Approval
Process

Fundraising

File License
Application

Receive Leverage &
Access to Funds

Key actions continued:

- ◆ “Green Light” Letter issued permits fund to file a License Application
- ◆ Second time funds may forego MAQ submission and simply request a Green Light Letter
- ◆ New TechNote # 14 – Fast track process for a subsequent license request

SBIC Licensing Process

Prescreening &
Qualifications

Preparation of
“MAQ”

Approval Process

Fundraising

File License
Application

Receive Leverage &
Access to Funds

Key issues:

- ◆ Fund has 18 months to raise the minimum amount of private capital to file a license application
- ◆ Principals must attend a class on SBIC regulations in D.C., prior to grant of license
- ◆ Draft governing agreements to comply with current SBA/SBIC requirements
- ◆ SBA has issued a new Model Limited Partnership Agreement

SBIC Licensing Process

Prescreening &
Qualifications

Preparation of
“MAQ”

Approval Process

Fundraising

**File License
Application**

Receive Leverage &
Access to Funds

Key issues:

- ◆ Must file within 18 months after receipt of Green Light Letter
- ◆ Submission includes updated MAQ, legal documents and exhibits

SBIC Licensing Process

Prescreening &
Qualifications

Preparation of
“MAQ”

Approval Process

Fundraising

File License
Application

Leverage
Received

Key issues:

- ◆ Expedited process for issuing leverage commitment
- ◆ Just-in-Time program of funding leverage

SBIC Licensing Process

Prescreening Qualifications

- Identify two or more Principals who have track record successfully working as a team
- Prepare Executive Summary

Preparation of "MAQ"

- Compile management team's qualifications, track record and investment philosophy

Approval Process

- Invitation to make presentation to SBA Investment Committee
- Issuance of "Green Light" Letter indicates approval

Fundraising

- Must raise at least \$5M in private capital within 18 months of receipt of Go-Forth Letter

File License Application

- Submit updated MAQ, legal documents and Exhibits within 18 months of receiving Go-Forth Letter

Receive Leverage

- Expedited process for issuing leverage commitment
- Just-in-time Program

1 – 3 months

1 – 2 months

3 – 18 months

3 – 6 months

Process can take 8 - 29 months

Conclusion – Why An SBIC

- ◆ Compelling Economics
 - ◆ Low Cost of Capital: SBA Debenture leverage interest rates based on 10 year Treasury plus market-based spread for liquidity and prepayment risk.
 - ◆ Enhanced Returns to Private Investors: The low cost of capital increases returns to private investors in good performing funds.
 - ◆ Rapid Deployment of Funds: Ability to raise typically two-thirds of a fund's capital from SBA, thereby minimizing the time they spend fundraising and focusing their efforts on investing.
 - ◆ Flexible terms: Ten year debenture term with semi-annual interest payments avoids problem of duration mismatch.
 - ◆ Increased Financial Scale: SBA leverage provides increased capital from which SBICs may fund more investments or increase funding to portfolio companies.

Conclusion – Why An SBIC

- ◆ Friendly to Bank Investors
 - ◆ Volcker Rule Exemption Benefits: Banks investments into SBICs are exempt, from the 3% cap set forth by the Volcker Rule enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL-111-203).
 - ◆ Community Reinvestment Act: Investments in Small Business Investment Companies are presumed qualified for Community Reinvestment Act credits.
- ◆ The Opportunity of “Small Business”
 - ◆ Despite being the bedrock of the American economy, the small business community it underserved and represents a value opportunity for investors.