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PRIVATE EQUITY FOR SMALL FIRMS: THE IMPORTANCE OF THE PARTICIPATING SECURITIES PROGRAM

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BEFORE THE

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HOUSE OF REPRESENTATIVES

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PRIVATE EQUITY FOR SMALL FIRMS: THE IMPORTANCE OF THE PARTICIPATING SECURITIES PROGRAM

WEDNESDAY, APRIL 13, 2005

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The Committee met, pursuant to call, at 2:15 p.m., in Room 311, Cannon House Office Building, Hon. Donald A. Manzullo [Chair of the Committee] Presiding.

Present: Representatives Manzullo, Akin, Velazquez, Bordallo, and Moore.

Chairman MANZULLO. Good, afternoon, and welcome to this hearing on the very important topic for small businesses around the country—access to capital.

A key part of economic security is creating the environment for entrepreneurs to take risks in starting or growing businesses, thereby creating jobs. The question becomes, what should the Federal Government do to foster a better economic climate for small businesses to grow?

This Committee can play a key role in achieving economic security by ensuring that the Federal Government and America's small businesses work together in a sound partnership to spur growth in the economy.

In February, this Committee held its first hearing of the 109th Congress to go over SBA's budget and key programs within that budget. One of the topics dealt with small business investment companies, SBIC; specifically the Participating Securities program.

In the hearing it was noted by SBA's own analysis that participating securities funds licensed between the years of 1994 through 2000 have performed as well as non-SBIC venture funds of the same vintage years in which CalPERS, the California Public Employees Retirement System was invested. Over $2.5 billion in leverage was invested in 3 years, 1998 to 2000, immediately before the collapse of the economy.

I asked Administrator Barreto how much of the losses in the program can be attributed to the recession. He said, ″I would be happy to go back and research this for you.″ I expect the SBA to answer that question today.

I also asked him if he would be willing to commit to working towards a solution of this problem, to which he replied, ″Absolutely.″

I want to congratulate the Administrator and his team for following through on a commitment to find a solution to this thorny

problem in the Participating Securities program. I will let our witnesses get into the details of how significant the program is for start-up and early stage funding.

The SBA Inspector General's report for May of 2004 states, ″Over the last 10 to 15 years the General Accounting Office and the Office of Inspector General have found that SBA's policy of allowing extensive time for financially troubled SBICs to attempt rehabilitation has allowed SBIC assets to decrease and reduced SBA's potential for recovery. SBA's policies of allowing capitally impaired SBICs to charge significant management fees, and the way SBA applies distributable gains from SBICs also contribute to program losses.

″The standard operating procedure for the SBIC program has not been revised since March of 1989, and existing guidance does not provide a systematic approach for estimating the level of financial risk, ensuring the implementation of restrictive operations, transferring capitally impaired SBICs to liquidation status, or liquidating SBICs receiving participating securities.″

The report goes on to state that, ″The structure of the SBIC funding process for participating securities and the quality of SBA oversight have contributed significantly to the losses in the SBIC program in recent years.″

Some believe the notion that if it is a good business plan, then someone will fund it. As our witnesses will attest, this simply is not true. According to the Council on Competitiveness National Innovation Initiative Report, dated December of 2004, ″For those ideas that are pursued commercially, only 7 out of every 1,000 business plans receive funding.″

Mr. Steve Vivian, board member of the National Association of Small Business Investment Companies, testified at our hearing on the budget back in February that the Participating Securities program accounts for roughly half of all SBIC investment dollars and, since inception in 1994, has infused nearly $9 billion into U.S. small businesses. In fact, he goes on to note that 35 percent of that $9 billion went into small and growing U.S. manufacturing companies.

[Chairman Manzullo's statement may be found in the appendix.]

Chairman MANZULLO. According to Mr. Vivian, these are investments that would not have been made by traditional venture capitalists or banks. But for the equity participation of the SBA, these jobs, products, revenues, and taxes would likely not exist.

Listen to these quotes:

″SBIC financings work to fill the gap in private equity markets, especially at the earliest stage of a company's growth.″

″By encouraging private risk taking, the program is capable of supporting thousands of entrepreneurs through the slow economic period with the prospect of growing leading-edge businesses out of the down cycle.″

These comments did not come from a trade association or an industry guru, but from the SBA's special report on the SBIC program, dated June of 2002. SBA's report goes on to highlight that:

"SBIC's financings represented 64 percent of seed financings during fiscal year 1994 to 2002."

"The SBIC portfolio companies in the year 2002 created 73,000 jobs, sustained 176,309 jobs, and supported over 1 million jobs."

"Revenues in the SBIC portfolio companies in fiscal year 2002 were 14.8 billion."

"SBICs generated $6 billion in taxes in fiscal year 2002."

"Between fiscal year 1994 and 2002, SBICs provided 65 percent of financing to nontechnology and life sciences as compared to the overall venture industry with only 9 percent of venture financing dollars in that category."

The SBA feels pressure to say the program doesn't work as evidenced by the losses sustained. SBA must take some responsibility for how the program currently works. Again, from the IG report, and I quote, ″Capitally impaired participating securities, securities SBICs that have been transferred to liquidation, are not being liquidated by the SBA. To improve the program's ability to limit risk and prevent major avoidable program losses, officials should pursue legislative reforms and act in a timely manner in dealing with and liquidating capitally impaired SBICs.″

We are not going to solve all the problems today. Nevertheless, my hope is that the SBA would take an open and honest look at the program and recognize its necessity. It is an accepted fact that there are structural problems in the program, but I believe it can be fixed between willing participants. I am willing; industry is willing. According to Mr. Barreto's previous testimony, the administration is willing.

One final quote from the SBA report: ″Our mission is to improve and stimulate the national economy in general and the small business segment thereof, in particular, by establishing a program to stimulate and supplement the flow of private equity capital which small businesses need for the sound financing of their business operation and for their growth, expansion, modernization, and which are not available in adequate supply.″

In light of the SBA's own words as to the positive aspects of the Participating Securities program, they have an obligation to work with industry to resolve this problem, and I trust that will take place.

Senator Talent advised me they may not be able to make it, but if he does make it, I promised him that we would stop whatever testimony is going on, immediately take his testimony, and then resume other testimony. His statement will be made part of the record without objection.

[Senator Talent's statement may be found in the appendix.]

Chairman MANZULLO. I now turn to the ranking member for her comments, Mrs. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

There is no doubt that our Nation's small businesses need all the help they can get when it comes to accessing affordable capital. Being able to successfully secure capital is what allows our nation's entrepreneurs to reach their goals, stimulate economic growth, and create jobs.

The challenges in accessing capital are not easier with venture capital; it is extremely difficult for start-ups to get capital, and this is a key area where demand is greatest. This is of particular concern in minority equity investment. Minority-owned businesses

have traditionally had a more difficult time accessing venture capital. Currently, minorities only get 3 percent of venture capital investment. Clearly, there is a need for getting seed venture capital in the hands of start-ups.

We are here today to look at the SBIC Participating Securities program, which is the program that has filled this gap in the past and has been internationally proclaimed as innovative. The SBIC Participating Securities program has also been credited as being the most reliable source of equity capital during times of recession.

Despite the obvious need for start-ups to access venture capital, the administration wants to take away the only program that makes that possible. We are hearing today from the administration that there is no longer a demand for the SBIC Participating Securities program; it is showing huge losses and is costing the American taxpayer too much money. The administration blames the industry and the program, but in the midst of these excuses, it fails to accept any of the blame themselves. The administration has yet to step up and take responsibility for the poor management and lack of leadership in this program.

It is evident that this program has deteriorated over the past 4 years. From 1994 through 2000, the SBIC Participating Securities program received $225 million in profits and no defaults occurred. But 4 years later, under the Bush administration, it was taken to a zero subsidy rate and placed costs on the small businesses and lenders; and there has been $1.1 billion in losses since then. Clearly, this program has been mismanaged to the point where it is functioning far below its capacity.

The fact is that the administration has been negligent in intervening with the SBIC Participating Securities program. The Agency should have stepped in, liquidated investment—and liquidated investments in the program. Instead, they choose to take no action when companies were struggling, which only caused the program to decline further.

What this Committee needs to know is that if the SBIC Participating Securities program is not the right way to get seed venture capital to start-ups, then what is? In the past, it seems as if the answer from the administration was to simply do nothing.

Well, let me tell you, that is not an option. The bottom line is that our Nation's small businesses are not getting the venture capital they need. We clearly cannot expect the capital market to be relied upon solely to fill this gap on its own. Given the tacit support that has been shown for the New Markets Venture Capital program in the past, I want to know what the options are. If it isn't the New Markets Venture Capital program that can serve this vital program and it isn't the SBIC Participating Securities program that can provide seed capital to start-ups, then tell me what can.

We cannot afford to not take action right now. There is a need from start-up firms across the country to tap into the venture capital market, and these needs deserve to be met. As the main job creators, our Nation's small businesses require that venture seed capital be available to them. This Nation's entrepreneurs already face enough challenges accessing capital. By working to repeal this

program and explore our options, we are broadening the availability of venture capital to small businesses across the country.

Thank you, Mr. Chairman.

Chairman MANZULLO. Thank you.

Chairman MANZULLO. Our first witness is Jaime A. Guzman-Fournier, who is speaking on behalf of Administrator Hector Barreto. He is the Associate Administrator For Investment at the U.S. Small Business Administration.

We have a 5-minute clock, and if you could follow that, it would be okay. But because you have got a load here, I am going to set your clock at 7 minutes and the rest would be at 5. But you can end any time before 7 if you want, okay?

Thank you.

STATEMENT OF JAIME GUZMAN-FOURNIER, ON BEHALF OF U.S. SMALL BUSINESS ADMINISTRATION ADMINISTRATOR HECTOR BARRETO

Mr. GUZMAN-FOURNIER. Mr. Chairman, Ranking Member Velazquez, members of the Committee, my name is Jaime Guzman-Fournier, Associate Administrator for Investment in the Office of Capital Access at SBA. Administrator Barreto asked me to testify on his behalf, and I appreciate the opportunity to discuss with you today the Small Business Investment Company Participating Securities program.

I know the Committee shares the President's goal of a fiscally responsible government, and understands why we cannot continue operating a structurally flawed program that loses taxpayers' money. At the end of fiscal year 2004, 2.7 billion of losses were projected on the more than 6 billion disbursed. As shown in chart number 1, you can see it to the right here, the cash flow minus appropriations was a negative 1.3 billion; 29 percent of participating securities SBICs licensed prior to fiscal year 2001 have failed to repay their obligation to the Federal Government. In contrast, only 5 percent have fully repaid their leverage.

While fund performance is part of the problem, the fact that several failed SBICs were able to pay back their private investors, but not the taxpayers, demonstrates the flawed structure of the program. In fact, of the SBIC funds that fully repaid their private investors, over 75 percent had not fully repaid SBA as of the end of fiscal year 2004.

Let us look at the Participating Securities instrument. In essence, the Federal Government borrows money by guaranteeing SBICs on the securities they issue to the public. Then SBA pays the associated interest on behalf of the SBICs and is paid back only if and when they become profitable. The SBICs invest that money in long-term equity investments such as patient capital for seed and early-stage companies. The SBA is supposed to be paid back out of the returns of these investments.

We have identified several problems with the structure I have just described. One problem is that SBA defers interest on the money SBA borrows. This accumulated interest can often exceed the original investment and is often never repaid. In fact, we have one fund that owes the SBA approximately 25 million in interest payments, but owes less than 20 million in principal.

Another flaw in the program is the profit distribution formula. SBA typically contributes two-thirds of the capital of an SBIC, but receives less than 10 percent of the profits, if any, of the fund. Moreover, Participating Securities SBICs distribute capital based on a formula that allows SBICs to minimize distributions to the SBA and maximize profit to private investors.

The key problems with this formula are, number one, profits to all investors are paid before SBA leverage; number two, SBICs can make optional tax distributions providing even more of the profits to the private investor at the expense of the taxpayer; and number three, when SBA is less than 50 percent of the capital in the fund, it gets only its profit participation, typically less than 10 percent.

For example, as shown on chart number 2 here to the right, one SBIC made a single distribution of $207 million. Because the SBA percentage of outstanding leverage to total capital was only 49.5, the SBA received less than $18 million, while 189 million went to the private investors and general partners of the fund. This was a 650 percent return on their initial investment.

While this distribution, by itself, is disconcerting, the SBA's percentage of outstanding capital was under 50 percent only because 2 weeks prior the SBIC had made a distribution of less than 37 million which dropped the SBA's percentage. Had the SBIC made a single distribution, SBA would have been paid back all leverage plus a profit distribution, and the private investors would still have had a 400 to 500 percent return.

As shown in chart number 3 to the left, on a community basis this structure has allowed private investors to receive 1.9 times their paid investment, where the taxpayers have lost 50 percent of their investment. As of the end of fiscal year 2004, Participating Securities SBICs had 4.9 billion in outstanding leverage and 5.7 billion in unfunded commitments.

The important issue that the administration must continue to address is: How do we manage this program in order to minimize losses? SBA, in consultation with outside experts, is implementing clearer policies to ensure all necessary steps will be taken to protect the taxpayers' money.

Finally, I want to say that SBA's role in venture capital is not ended. We continue to support and encourage the SBIC debenture program. While it focuses on later-stage financing, it produces results without the fiscal difficulties inherent in the Participating Securities program.

I thank you again for the opportunity, and I look forward to your questions.

Chairman MANZULLO. Thank you.

[The Honorable Barreto's statement may be found in the appendix.]

Chairman MANZULLO. Our next witness is Professor Colin Blaydon. He is the Buchanan Professor of Management and Founding Director of the Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth. We look forward to your testimony.

STATEMENT OF COLIN BLAYDON, TUCK SCHOOL OF BUSINESS, DARTMOUTH UNIVERSITY

Mr. BLAYDON. Thank you, Mr. Chairman, Ranking Member Velazquez, and members of the Committee. My center—and I am accompanied today by our Executive Director, Fred Wainwright, who is here with me—was asked by the National Association of SBICs to examine the data from the SBA and data available about private investment and venture capital, and to compare the patterns to see what gaps might be present.

One thing I would say at the outset is that it is well known in academic research that the private equity markets for venture capital are inefficient. Those inefficiencies are one of the contributors to the very high returns that people expect from these high-risk investments. But inefficiencies, while also indicating the presence of high possible returns, also, almost by definition, assure that there will be gaps. The question is, where do those gaps exist?

The preliminary data that we have been able to look at so far would say that there are gaps in three areas, and I think you will hear some of my fellow panel members discuss them in more detail in their testimony. The three areas are in financing, in geography, and in industry sectors.

The financing comes about really in both the size of the investments that are made in companies and the stage at which investments are made. The private venture capital funds have raised enormous money in recent years. They have also become newly cautious after the bursting of the tech bubble. As a result, they are trying to put to work very large amounts of money, and they are trying to put them to work much more safely. As a result, their investment in seed and early-stage investments has fallen to about 2 percent of the total amount of investing capital that they are making today, down from 16 to 20 percent in the mid-1990s.

In addition, the idea that this will be made up by angel investors or by a large overhang of capital that these venture funds still have to invest, I think you will hear other panel members talk about. I won't say anything about the angel investors here because I know my colleagues will say something more about it. But I would like to say something about the venture capital overhang.

It is pointed to a great deal in the press, but our research indicates that much of this overhang is, in fact, money that these funds have reserved for follow-on investments in their portfolios. So while it is not yet spent, it certainly is not available and certainly is not available for the kinds of businesses that we are talking about and are concerned with here today.

The second area in which there is a gap is geography. The venture capital industry, the private venture capital industry, is bicoastal, with a few other centers that are much smaller around the country, but basically Silicon Valley and Route 128, the Boston/New England area. By contrast, the criteria that have been used for funding SBICs have permitted SBICs over the last 20 years to grow from being in about 25 States to being in 45 of the 50 States today. So the geographic coverage and availability of this type of private capital goes places where the private venture capital industry simply does not operate.

The third area is by sector. The private venture capital arena invests heavily in high tech, in life sciences, in software, biotech, medical devices. The SBICs, by contrast, are much more broad in their investment. They are investing heavily in manufacturing; 28 percent of SBIC's investment post-bubble has been in the manufacturing sector, one that is almost totally ignored by the private venture capital funds.

Lastly, I would want to say something about what the bubble did. The bubble did the same thing for SBICs that they did for private funds.

Chairman MANZULLO. How are you doing? Your bubble is about ready to burst.

Mr. BLAYDON. My bubble is about to burst. I will reserve the rest of my comments, Mr. Chairman, for questions that you may have for me.

Chairman MANZULLO. Thank you very much. I appreciate it.

[Dr. Blaydon's statement may be found in the appendix.]

Chairman MANZULLO. Our next witness is Susan Preston who, like my wife, is a microbiologist. She also has her J.D. She is currently an Entrepreneur-in-Residence at the Kauffman Foundation.

Ms. Preston, we look forward to your testimony.

STATEMENT OF SUSAN PRESTON, DAVIS WRIGHT TREMAINE

Ms. PRESTON. Thank you very much.

Chairman Manzullo, Ranking Member Velazquez, and members of the Committee, thank you very much for inviting me here to testify today before the Committee on this important issue of the continuance of the SBIC Participating Securities program. I am going to speak to you specifically regarding angel investing and the funding gap.

To define the funding gap for you, historically we have looked at in the early 1990s a funding gap that was between a half million and 2 million. That funding gap has extended to between $2 million and $5 million, and that number of the funding gap is supported when you look at some of the statistics that have already been noted of the move of the venture capitalists out of funding anything in the seed and start-up stage. In fact, in 2004, only 1.7 percent of the dollars invested by venture capitalists went into seed and start-up stage, in only 171 deals. That is a 90 percent decrease in the last 6 years in seed and start-up stage.

In addition to that, if you look at the average investment amount that venture capitalists make, it is around 7 million—$6 million to $7 million per deal—clearly, again, above the funding gap that we are looking at of 2 to 5 million or half a million to $5 million.

Now, let us look at the angel investors. Angel investors have become very active in recent—and I will talk in a moment about the Angel Capital Association. But if we just look at the specific numbers, it is estimated last year, in 2004, that angels invested around $22.5 billion.

To put that into context, that was into 48,000 deals. We are early stage investors, clearly, but if you do your simple mathematics, 48,000 deals into $22.5 billion comes up with an average investment of just under half a million dollars, clearly under the range of the funding gap that we are talking about.

What is important to understand about angel investors—and is important to understand also for the SBIC program—is it is patient money. These are very early-stage investors. We understand the need to wait up to 10 years to see return on our investments and understand that in the earlier stages of possibly a 5-to-7-year time frame the return is still going to be negative. And we need to understand that we need to allow the companies to grow, but we also need to understand that we need the follow-on funding.

One of the biggest issues for angel investors right now is we look at this as the best of times and the worst of times. Valuations are very low, but we fear that there is no follow-on funding, because our average investment, again, is between 25- and 250,000 for individual angels, and then through angel groups it is up to half a million, but still clearly outside the funding gap.

Through Kauffman Foundation we have started an organization called the Angel Capital Association, which is a professional alliance of angel organizations. We have only been in existence for about 1 year, but we already have 85 groups as members. It is a phenomenal success for us and a recognition by the Kauffman Foundation of the need to finance entrepreneurs in this early stage.

It also recognizes that angels are not necessarily investing up into the funding gap, but that angels understand the potential for the lucrative return on early-stage investing. And so we are not leaving this funding area, but in fact returning to it and understanding the need to fund into the early-stage companies.

We are just starting, as angel groups, to talk about syndication, which may give the opportunity to build those numbers of investment dollars, but it is clearly not there yet. Most angel groups and individual angels are very geocentric in their investing, and only invest locally both because of their interest of staying connected with the companies they invest in but also because they want to give back to their community. So to look to the angel industry to fill the gap is unrealistic at this time or anywhere in the near future.

The other thing that I would like to point out as far as angels are concerned is that when we invest, we are much more sophisticated about our investment now. And when we look at a company that is carrying debentures or debt on their balance sheet, it makes for an unattractive company, particularly when money is being paid to interest on those debentures. Any money that we put into companies or any other early stage, we want that money to work to build the company rather than to repay on notes. And so having a Participating Securities program is extremely important to do that.

The last point that I want to make is that in order to have the ability for the lower and middle class to fund companies rather than only the upper class that can self-fund their companies, we do need something that fills the funding gap; and the SBIC Participating Securities program does that, particularly for women and minorities.

Thank you.

Chairman MANZULLO. Thank you.

[Ms. Preston's statement may be found in the appendix.]

Chairman MANZULLO. Our next witness is Mark Redding. He is the CEO of Banner Service Corporation.

And, Mr. Redding, we look forward to your testimony.

STATEMENT OF MARK REDDING, BANNER SERVICE CORPORATION

Mr. REDDING. Thank you, Chairman Manzullo, Ranking Member Velazquez, and members of the Committee. I appreciate the invitation to testify at this hearing.

The Participating Securities program has been of great importance to me. My name is Mark A. Redding; I am the Chairman and Chief Executive Officer of Banner Service Corporation in Carol Stream, Illinois. Banner is a manufacturing company with about 60 employees engaged in the precision steel bar industry.

For the past 30 years, I have worked in the metal products industries, from an early position as a production control analyst to now, twice, being a Chief Executive Officer. I have worked in both large and small firms. In 2003, I led the effort to purchase Banner from its founding family. Two licensed SBIC private equity firms, Prism Capital and Alpha Capital Partners joined with me to make that purchase and revitalization of Banner possible.

For one to understand the importance of these issues to us, I would like to briefly describe our business. Originally, Banner was a small metal distributor. During the course of its history, it expanded many times, added additional equipment, and created new jobs. Eventually, it outgrew its facility and began to look for a new home.

In 1997, as the U.S. economy blossomed, Banner relocated to a new facility, but at significantly higher cost. As a result of this, Banner's business grew in sales revenue to over $25 million. However, there was trouble ahead for Banner at its new scale. Much of that growth was based upon making bars for the office products industry, such as computer printers. Much of the demand for these bars evaporated as the office product sector moved offshore. Later, the recession impacted many other clients, and the result was a serious decline in Banner's revenues to less than $17 million. Liquidation studies were conducted with the possible result of simply ceasing to operate the business.

Our transaction to buy Banner occurred over a time frame from May to September of 2003. During that period, I was working on dual fronts to negotiate the terms of the purchase while also attempting to raise equity capital.

Armed with a letter of intent signed by the seller, I searched the financial community to attract investors to combine with capital of my own. I contacted more than 8 firms in the greater venture capital market. I committed not only to invest my own personal capital in the venture but also my full-time leadership. There was little interest. The investor market for deals of this nature and size was very limited.

I was able to meet Steve Vivian of Prism Capital, who showed interest in this opportunity, and he visited the company with me. We met with Andrew Kalnow of Alpha Capital and enlisted his support to join us, which he did. The transaction closed on September 3, 2003.

What has happened thereafter is quite a success story. During what remained of that year, Banner was able to make a profit and have a positive cash flow. With a firm financial structure anchored by SBIC-backed equity, we had the time to reposition the business. By the end of 2004, Banner was able to regrow its revenue back to $24 million and more than double its free cash flow. It met every one of its debt payments, increased its employment, added new products, and invested $600,000 in additional production line. It provided work for machine installers, electricians, plumbers, truck drivers, and others. New, permanent jobs have been created.

Also, this transaction supported by the SBIC and Prism created a new class of ownership at Banner. Four long-term employees became eligible to participate in the common unit plan. This included one gentleman over 60 years of age and one woman over 55. The plan also provides for future key members of Banner's management team to qualify for ownership.

In summary, new life has been given to Banner Service Corporation. It is my opinion much of the success was due to the Participating Securities program and its cooperation with small business—the small business community through SBIC licensees like Prism and Alpha.

With help from the SBIC Participating Securities program there could be many more stories like Banner. Please consider us and those other small businesses when you consider the future of the Participating Securities program.

Thank you. It has been a privilege to participate in this process.

Chairman MANZULLO. Thank you very much.

Chairman MANZULLO. Our next witness is a constituent, Red Clark, who has a dual role as a manufacturer and somebody who also has had to raise a tremendous amount of money for venture capitalist purposes.

And I have got to get over there and take a look at both of your factories. Any time anybody has got a new process—and I want to check out this Ford modulator system. I drove General Kinematics nuts because I wanted to know how they make objects move uphill on a conveyor. They finally gave me a little bit of knowledge as to what it was, and I want to see what that system does.

Red, we look forward to your testimony.

STATEMENT OF REDMOND CLARK, METALFORMING CONTROL CORPORATION

Mr. CLARK. Thank you.

Thank you, Chairman Manzullo, Ms. Velazquez, and members of the Committee. I appreciate the opportunity to be here.

I am the guy you are spending money on. I am the guy that receives the money and puts it to use in the field in companies. I am a serial entrepreneur. I have been operating and turning around venture-backed companies for the last 20 years. The fact that I am a serial entrepreneur also means that I am a slow learner.

I have raised approximately $50 million for the companies that I have managed over the years, and a significant fraction of that money in two of the most recent deals that I have operated have come from the SBIC.

My colleagues have already mentioned some of the trends that I have seen in venture capital. I will just touch on them again for emphasis.

Venture capital investment in the private sector is growing. It is up 250 percent over the last 10 years. At the same time, seed investment has dropped by 75 percent in the same period. There is more money going into venture capital in the private sector, more money coming into the public sector, and less money going to seed.

In addition, you have already heard that it is a bicoastal market. Most of the venture capital is available on the East Coast and on the West Coast, and there is a very limited amount available in the Midwest and in the center of the U.S. as a whole. And I can give you some experiential information on what it is like to raise money in that marketplace.

In the last two start-ups that I have run, we were backed by the SBIC. We raised $1 million to $3 million for each of the companies. They are both headquartered in the Chicago area, and we had to go 800 miles from Chicago in order to find capital or investors that were willing to place their capital into our organization, into the sector that we are working in and into the geography that we are working in. The funds that we found which were distant from the Chicago area were SBIC funds that were investing in our sector.

It was very, very difficult to find money in the 1990s; it is very difficult to find money in the 2000s, no matter where you are, if you are a sector or a geography that is not in favor. The SBIC is one of the programs that literally applies capital with a degree of quality throughout the U.S. and makes it available and gives us a chance to operate.

Very simply, my experience is a guide, I think, for all of us; and that is, if there is no money, there will be no companies. The private sector may supply some of the money, the public sector may supply some of the money, but if there is not a sufficient amount of money, the companies will not exist.

What did the SBIC money get in our companies? I will give you a brief list here: to date, in excess of $50 million in sales.

We are actively reducing the weight of vehicles in the United States with one of our technologies. And, according to the DOE, if we continue to commercialize successfully, we will cut oil imports by approximately 1 billion gallons per year.

We have reduced, eliminated, or recycled somewhere in the area of 1 million tons of industrial toxic waste.

We have removed lead paint from more than 100 million square feet of metal surfaces throughout the United States.

All of these things that have happened over the last decade happened with SBIC money as the lead investor and the lead player. Without SBIC, we are not in business.

Just a few concluding thoughts: As I mentioned a moment ago, as I mentioned several times, the SBIC is one of the few programs that supplies capital throughout the U.S. It is very important.

The second comment I would make is that what the SBIC does today is not going to bear fruit in our business world for another 6 to 10 years. That means money that was invested 6, 7, 8 years ago is only now beginning to bear fruit. This is a long-term invest-

ment. It is unusual that governments get involved at this level at this length of time, but it is very important for us.

The SBIC funds are biased towards seed. The gap is real. We need to continue to address that gap wherever possible. If you look at the total amounts of dollars that the SBIC has invested in what we would call ″seed areas″ over the past 7, 8, 9 years, you find that they are a major, major player in this sector of investment.

Lastly, the venture capital community passes through cycles of good and bad times. Companies pass through cycles of good and bad times. The SBIC program, from where I am sitting, is no different. There have been wonderful times to invest, there are poor times to invest, and there will be in the future. But the continuity of the program I think gives you a greater opportunity to get an acceptable rate of return as long as you, in fact, do structure the programs so that you share in the successes just as you share in the losses.

Just one last concluding remark, and that is, we all understand how important small businesses are to our economy. We are a job creation engine. We make things happen. We make things change. We keep our economy competitive. We need whatever support the government can offer in this area.

Thank you very much.

Chairman MANZULLO. Thank you.

[Mr. Clark's statement may be found in the appendix.]

Chairman MANZULLO. Our next witness is Daniel O'Connell, who joined the College of Business at the University of Illinois at Urbana-Champaign with nearly 30 years of venture capital and small business investing experience.

We look forward to your testimony.

STATEMENT OF DANIEL O'CONNELL, UNIVERSITY OF ILLINOIS AT CHAMPAIGN URBANA

Mr. O'CONNELL. Thank you, Mr. Chairman, Ms. Velazquez, and members of the Committee. I am the guy who has written checks to the people such as the two people next to us over all the years. And I can tell you that it is people like this that make our job both infuriating, but so satisfying when you pick the right team, and you are able to support them.

More than 30 years ago I was introduced to the venture capital industry when, as a summer intern, I was at the then-First National Bank of Chicago. Over the ensuing years I have been all around the venture table, acting at various times as a general partner, a limited partner, or an investor in a wide range of private equity situations.

In the early 1990s, I was a NASBIC governor, and I had the honor to serve on a Committee whose work ultimately led to the creation of the Participating Securities program. So I was kind of here before this got started.

By any measure, these past 30 years have been a time of incredible expansion for our industry. During this period, there has also been a huge broadening of possible investment vehicles that get defined as private equity.

Today, broadly defined private equity includes a wide spectrum of possible investments ranging from angel and earliest-stage start-

ups through and including international multibillion dollar buyouts. Yet while the industry has expanded dramatically, it remains fundamentally granular. And what I mean by that is that there exists an immense matrix of possible investment strategies that a private equity group might choose to execute, and these strategies are described across multiple dimensions—size of the company, stage of the company, the industry, the geography, to name just a few.

Competition for the available limited partner dollars, the private equity part of the SBIC program, encouraged general partners to identify niches in which they feel they can compete most successfully. I can only see this trend towards specialization continuing. And it has always been true that successful execution of a private equity group's business strategy requires an underlying match of its human and financial capital to the needs of its chosen niche.

So what do these things have to do with the Participating Securities program? In my experience, it was conspicuous to those of us using SBA debentures that there was a problem when we wanted to invest in situations characterized by high risk, high growth, and potentially high returns, i.e., venture or growth companies.

There was a fundamental mismatch between our sources of funds and our uses of those funds. At one level it made little sense for us to borrow money to make an equity investment in a company. But did we make those investments anyway? Yes, we did, but in less than optimal ways.

In my opinion, a Participating Securities program was intended to provide a better match between the nature of the funds provided to the SBIC and the realistic demand of the businesses into which the SBIC would invest.

So is there still a need today for this kind of program? Absolutely. If anything, the increasing specialization of our business suggests an even greater need.

From my experience, SBICs fill important pieces of the private equity matrix. They tend to be more geographically focused in regions underserved by other sources. Because we have learned how to prosper from other than the public markets, we are more comfortable with smaller businesses and with businesses and industries, or niches, of a size that typically does not represent IPO potential. And, once in an investment, SBIC principals often add value in somewhat different ways than traditional VCs.

Could traditional venture funds and larger buyout groups make these kinds of investments? Yes. And from time to time they do, but only when it is easy for them to do so. It is just not time- or dollar-efficient for them to aggressively make the kinds of investments that an SBIC is formed to make.

Regarding how the program might be more effective going forward, I would like to make a couple of observations. First, I believe it is absolutely critical that there be a match between private equity fund sources of capital and its uses as seen in the investments it intends to make. If you expect the SBIC managers to make relatively high-risk, low-liquidity, long-term but potentially high-return, i.e., equity type investments, then the SBA dollars that might be used should be patient, long-term, and risk-tolerant.

In any company situation seeking funds from a diverse set of players—and when you have the SBA limited partners and general partners, that is a pretty diverse group—there are pricing and term issues. To be successful, all parties to a transaction must feel there is a fair and reasonable sharing of risks and rewards, and that there are reasonable oversight and controls consistent with the players' position in the transaction.

Chairman MANZULLO. You have got a red light there. How are you doing?

Mr. O'CONNELL. All right. I will just finish. Let me talk to two things.

I think it is important that a pool of private equity investments at the SBA be properly diversified across both character and time, and I think that the money must be patient. And in order to be patient, that requires those with largely portfolio management issues, and those are best met by having a staff of professionals that I think requires a commitment to the SBA itself.

Chairman MANZULLO. Thank you very much.

[Mr. O'Connell's statement may be found in the appendix.]

Chairman MANZULLO. I have the first question here to ask of our Deputy Administrator. From the documents I have seen generated by the SBA, it appears the SBA was aware of problems with the Participating Securities program as far back as the summer of 2003, but it submitted a proposal to modify the program to the House and Senate Small Business Committees.

Furthermore, the SBA was aware that the Inspector General had issued a report in May of 2004 concerning problems with the Participating Securities program. Nevertheless, the SBA licensed more than 30 new Participating Securities SBICs in September of 2004.

My question is if the program was such a problem, why did the SBA license and, in fact, work overtime to do so many new Participating Securities SBICs?

Mr. GUZMAN-FOURNIER. I appreciate the question.

The Agency basically made a determination to continue to operate the program through the period of the authorization. There was a decision made that we had a statutory obligation to carry out the program. We intend to fulfill our obligations with the outstanding commitments, but we need to continue to monitor the risks with this money that we have already committed.

Chairman MANZULLO. The problem is that your J-curve, or your turnaround, is 5 years, and you had come to the conclusion an entire year before this thing was a black hole, and yet—I mean, it is not cheap to set up a participating securities SBIC. It is a tremendous amount of money in attorneys' fees and accounting fees, et cetera. It seems inconsistent.

You have a statutory obligation to continue the program now, but you have decided that you do not want to. It just does not make sense that in September of last year, what, 6 months ago, you gave the nod to 30 new companies, SBICs, to go ahead and start new programs.

Mr. GUZMAN-FOURNIER. Part of the problem was that we also had—the industry noticed that the program was going to be terminated, and we had a lot of private investors' capital interest, as this

chart shows. If you are making 1.9 times your money in profits, you would really be interested in participating in such a program.

Chairman MANZULLO. But you fueled that. You could have said, "Look, it is going to be our intent to zero this thing out."

Mr. GUZMAN-FOURNIER. We had a lot of debate about that internally in the Agency, and the decision was made we had to fulfill our obligation.

Chairman MANZULLO. But at that time you knew you wanted to terminate the program; isn't that correct.

Mr. GUZMAN-FOURNIER. As I said, we had a lot of private interest in the program.

Chairman MANZULLO. That does not answer the question. The question is, at the time that you authorized and licensed 30 new participating security SBICs, you knew at that time that you wanted to eliminate the program.

Mr. GUZMAN-FOURNIER. Actually, we knew at the time that the program was not going to continue, and we knew that that was the main reason we were going to be getting a lot of demand for our leverage. Again, this was an Agency decision.

Chairman MANZULLO. I do not care if it was an Agency decision or not. You still have not given me the reason why at a time when you knew that you—when a decision had been made to end the program, nevertheless you told 30 new SBICs to go ahead and start new programs.

Mr. GUZMAN-FOURNIER. And we have commitments until fiscal year 2008 for those. They will have money for the next 5 years, and we intend to fulfill our obligation to them. But they are going to have their 5-year cycle, so we are not shutting them down. When we made the decision that we were going to fund them, we said we are funding you with alongside commitments, and those are 5-year commitments.

Chairman MANZULLO. Were they aware of the fact they were going to have one shot at it and that was it.

Mr. GUZMAN-FOURNIER. I believe they did, because if the program was going to be—pretty much everybody at that time within licensing was, and we were, internally letting funds know that this was pretty much termination of a program. So I think so.

I think people knew. Most of the funds applying knew.

Chairman MANZULLO. Were you at the SBA at the time in September of 2004?

Mr. GUZMAN-FOURNIER. I was.

Chairman MANZULLO. Okay. Thank you.

Ms. Velazquez.

Ms. VELAZQUEZ. Thank you.

Mr. Guzman, the lack of availability of venture capital for minority women and veteran entrepreneurs is near crisis level. Overall it is estimated that minority entrepreneurs receive 3 percent of all venture capital investment and women get only 2 percent.

What is the SBA going to do to increase veterans', minorities', and women's access to this form of capital?

Mr. GUZMAN-FOURNIER. We have a debenture program, and we also have something called the LMI debenture, which is part of the debenture program, and that is focusing more on the lower- and middle-income areas of the United States. The key difference with

that debenture is that whereas with the normal debenture, you have to repay interest back to us semiannually, on the LMI debenture, you get a 5-year period. It is a zero coupon bond.

Ms. VELAZQUEZ. But, sir, answering my question, I am telling you that only 3 percent of all venture capital is going to minorities. Apparently, what you are doing is not working. So what is it that you are going to do to make it work?

Mr. GUZMAN-FOURNIER. We have been trying. Within the past 2 years, we have had an initiative within the SBIC to try to reach out to more minorities and women fund managers, which I think is the critical thing you are mentioning here. You want to have fund managers that know their communities so that this money can spread to different areas that are not being served, as you said.

But I think—and let me just speak based on fact here. Unfortunately, the LMI debenture, we have not had a lot of interest in that debenture from the current funds.

Ms. VELAZQUEZ. Does that mean that you are going to support the new market venture capital program?

Mr. GUZMAN-FOURNIER. That program, it still has—we did not see a lot of interest in that program when it was created. In fact, we had fewer applicants than—

Ms. VELAZQUEZ. So what you are trying to tell me is that the SBA is not going to support the new market venture capital and that you are going to try to get rid of that program, too?

Mr. GUZMAN-FOURNIER. No, I am not saying that.

That program has commitments from us, as well as the regular SBIC; and we are going to commit to fulfilling that obligation as well. Up until the time those commitments expire, we will be funding those companies.

Ms. VELAZQUEZ. How long did it take for the administration, SBA in this case, to issue the regulations on the new market venture capital?

Mr. GUZMAN-FOURNIER. I would need to get back to you on that.

Ms. VELAZQUEZ. Two years? So it showed a lack of interest and leadership coming from the administration to support the program.

Sir, the SBA is responsible for managing the SBIC program so that it is implemented in a prudent manner. However, SBA took back and let many SBICs flounder, losing much of their leverage extended. Why did SBA not intervene sooner in so many of the cases where it was evident that the SBA was highly likely to take a major loss?

Mr. GUZMAN-FOURNIER. That is a good question. We have venture capital, as was said in this panel, has a long-term view of things. So we have what is called a forbearance in our program. And what that means is for a fund that is a vintage year 1994 fund that started operating in that year, you give them between 4 and 5 years of operations without us intervening. Even if they are capital impaired, we give them a forbearance time because there might be a possibility, as was said here, that some companies are going to exit or come to fruition with the funds.

So the way we look at it—and I am going to be up front about this—we do not disagree that we could have done somewhat more at some periods, but if you think about who are the funds in liquidation that we have currently, they are mostly 1994 through

1998 funds. We were not here at that time. Those funds, 75 percent of the funds in liquidation currently are from those years.

When you get to your job and you see that you have some failed funds from those years, there is not much you can do about it.

Ms. VELAZQUEZ. I do not have much time, but you clearly admit the poor mismanagement of the program on the part of the administration.

Thank you, Mr. Chairman.

Chairman MANZULLO. Mrs. Moore, do you have any questions.

Ms. MOORE. Well, thank you, Mr. Chairman, and thank you ranking member. I feel very privileged to be here this afternoon, and I have enjoyed both panels.

I guess the question that I have is for Mr. Guzman-Fournier, because the rest of the second panel seems to believe that you have indeed succeeded.

You say that the program is structurally flawed. Is it possibly structurally flawed because you are not patient? You talked about a 5-year window, and we know that that is not a big enough window for venture capital.

You also complained about the distribution of profits to investors. Well, according to the testimony we have had here today, we have had millions, billions of dollars of angel investors come to the table because of this program. And if in fact our goal—and of course, 75, 80 percent of the businesses in our country are small businesses so that if we want to continue to be globally competitive, if we want to continue to encourage investors here on our shores to invest, how can we do it without this instrument?

All of the structural flaws that you have talked about tend to reflect on a lack of patience, which all of our other witnesses have talked about as being absolutely necessary.

Also, the investment in seed capital in early ventures will be severely hampered if, in fact, we close down the SBIC program. And, of course, we have heard from our other witnesses that there would be a geographic mismatch if you were to pull out. In other words, only those businesses that were willing to locate on the coasts would be able to attract private venture.

So I am wondering about that old saying that you should not throw the baby out with the bathwater. Is it not possible to structure our investments for longer terms and really see the benefit of investing in our economy, so that we do not continue to be the highest debtor Nation in the world?

And please excuse my voice. I am just kind of sick today, but this was so important that I thought I should come.

Mr. GUZMAN-FOURNIER. Thank you. Thank you for the question.

Let me talk a little on the not being patient enough. In fact, as I mentioned to Ranking Member Velazquez, we have probably erred more on the side of being too patient in this program. When the program started, the deal was made that we were not going to receive up-front profits in the same way as private investors, but that on the back end, which is when a fund failed, we could take action and get some of those creditor rights to move on funds.

Part of the reason why we have the $1.3 billion in the cash flow right now is because we had a lot of failures in the program of funds, that we had to repurchase their securities. And as I men-

tioned, 75 percent of those come from 1994 through 1998, their beginning years. And we are already into 2005, so it has been a while; and we have given funds time to prove if exits are going to come. But we have also some regulatory ways that we need to comply with the regulation.

We have a forbearance period. And once a forbearance period ends is when we need to move and take some action. We do it—I mean, we have discussions with management. We bring people for portfolio management meetings, and we have discussions to find out if this portfolio is going anywhere, if their companies have any chance of succeeding. And if not, then we move.

I agree with you that—I did not come here to say that there is not a need for equity investing. What we are saying is that the structure of this program is flawed, and it is so flawed that we are experiencing huge amounts of losses because of the way it is structured; and that is our main point today.

Chairman MANZULLO. We will have time for another round. Did you have a short follow-up? Go ahead.

Ms. MOORE. Thank you, Mr. Chairman.

I guess if we are experiencing losses on paper through SBIC, are we not recouping those investments by the economic impact of creating all the jobs and creating the businesses that are reflected here? Is that not part of the balance sheet—I mean, a governmental program should not operate like a private firm—that what you are calling losses are actually investments?

I mean, all these companies, obviously, do not succeed, but are you not experiencing losses because you have in fact generated thousands of jobs and created businesses, and you basically have subsidized the growth of our economy?

Mr. GUZMAN-FOURNIER. I wish I could come here today and tell you that this program has been a success, but from a financial standpoint it has not been a success, and the taxpayer has got the burden of $1.3 billion now in liquidation and potentially more. We have projections of $2.7 million in losses right now.

Ms. MOORE. Can I direct the question to someone else on the panel?

Chairman MANZULLO. You are over time. Let me go to Ms. Bordallo, and then we will have time to come back. Thank you.

Ms. BORDALLO. Thank you very much, Mr. Chairman. I will make mine very quick.

I want to thank you and Ranking Member Velazquez for holding this hearing. I also thank the witnesses.

In reading some of the testimonies, it seems we are all in a consensus that the SBIC program is important to small businesses and the economic growth, but because of the erosion of small businesses across the Nation and because of foreign competition, it seems to me that this is a program that should be maintained. If it is flawed, we should fix it. And I would like to continue working with the committee to see that we fix this program.

Certainly, we cannot allow our small businesses just to go out there and try to work their way up. This is a tough business right now. And all we hear at this Committee on Small Business with our hearings is one small entrepreneur after another saying how they have gone broke, they have had to close family businesses. So

we need to give them programs that will assist them and help them get on their feet and continue to grow.

So, Mr. Chairman, I support the program, and if it is broken, let us fix it.

Chairman MANZULLO. Thank you.

Congressman Akin.

Mr. AKIN. I do not really have any questions at this time, Mr. Chairman.

Chairman MANZULLO. I want to get back to Dr. Blaydon.

Just as you got to the bubble, the time bubble burst. Do you want to pick up at that point?

And anybody else who wants to add about the bubble just feel free to jump in.

Mr. BLAYDON. Thank you, Mr. Chairman.

What I was going to say is that the bubble hit everybody; it hit SBICs; it hit private venture capital firms. And the private venture capital firms of vintage year 1999, if one of those funds breaks even, returns its capital, it is going to be in the top tenth percentile of all funds.

Most of those funds from 1999 vintage year are going to lose money. The same is true of the 1999 vintage year of the SBICs. However, the difference is that the funds that have resources that are able to go in and try to work out their portfolios are, in fact, going to be the ones that are at least going to get back to break-even, and a lot of those funds are doing that. Those are funds that typically have been around for several years before, have reasonably large pools of capital to invest in restructuring and working out in restructuring their portfolios.

The people who are going to lose are the people who had funds that were out of money and cannot invest in restructuring those portfolios that suffered in the down economy. There are going to be those who are not willing to go forward. Those are largely the corporate venturers who, when they saw the downturn, also, you might say, panicked and pulled out. People are going to make money off of their portfolios because others are going to come in and take over those companies. They are going to restructure them; they are going to put more capital into it.

What it appears is going on with the SBIC is that the SBIC—apropos of the question of patience, the SBIC sees 5 years in a program, a vintage year, late 1990s, that is not doing well, and if they do not permit them to continue to invest, to restructure them, they are almost assuring that these companies may well fail, cannot be restructured; and the government, as well as the companies and the private investors, are going to lose money.

Chairman MANZULLO. Anybody else want to comment.

Red? Go ahead.

Mr. CLARK. The Federal Government is using the SBIC program not only to encourage innovation and encourage small business development; they are discussing—we are discussing the program today as a failed investment vehicle. If you are going to invest money in the venture capital industry, I think it is fair to ask the question, Why are you doing so with a different set of rules?

If you take a look at the rates of investment from the private sector in the institutional venture capital industry over the last 10

years, remove the bubble and what you see is a steady, increasing trend of investment. It has gone from $8 billion to $22 billion, $23 billion over the last 10 years. If you track the performance of those funds, when you cut the bubble out, what you find is that there are—the industry as a whole is making an acceptable rate of return.

And what you also find is that the way the returns come in varies a great deal from firm to firm, but more often than not you get very large returns on a very small number of investments; you get average returns on a modest number of investments; and you break even or lose money on a handful of investments. Your existing program cuts off the upside.

You cannot participate in the upside the way that it is structured right now. You have changed the rules. If you change the rules, it does not matter how much money you pour in. If you cannot win, you cannot win. You have rigged the game in the way the program has been put together right now.

So if there is an awareness that you can take away from this hearing, it is not that you cannot invest money and show an acceptable rate of return, it is not that you cannot invest money and encourage innovation and encourage new business development; it is that if you change the rules and you make it a loser, you are going to lose.

Chairman MANZULLO. One rule is that I am out of time.

Ms. Velazquez.

Ms. VELAZQUEZ. Mr. O'Connell, we have clearly indicated today that the greatest shortage for capital is for early- stage companies, correct?

Mr. O'CONNELL. Yes, ma'am.

Ms. VELAZQUEZ. The participating securities programs investment in start-ups has declined from 50 percent in the 1990s to 30 percent today. Do you think the SBIC will continue to shy away from start-ups, just as traditional venture capital has done?

Mr. O'CONNELL. I have always looked at the venture business as a business, and our goal is to take capital from whatever source, and to effectively deploy it and generate capital gains, and to do that by creating companies or expanding companies that are worthy of investment.

Those dollars ebb and flow. And, at times, earliest-stage companies are always the hardest thing to fund, and they are sometimes less attractive than later-stage things.

We react to the sources of capital that are available to us. And if the limited partners, who are a primary source, whether they are pension funds or institutional investors, or whoever they might be, if they are risk averse, then we tend to do investments that reflect their risk aversion as well. I think those things ebb and flow.

So what you have seen is, the bubble spooked everybody. Looking at my industry, I felt at one point that I had become a dinosaur, because the way that investments were made reflected an aggressiveness that was inconsistent with the due diligence and the patience we needed during the bubble. And I think we paid for that exuberance that we had.

Ms. VELAZQUEZ. But given the fact that there is an abundance of late-stage funding, but a lack of early-stage funding for start-up,

do you think it would be appropriate to tailor the SBIC program so that it really serves more start-ups?

Mr. O'CONNELL. I think that what I was trying to say is that we, as the marketplace, will flow to the opportunity. And if, in fact, we have capital available—and I think that is what the SBIC program has done historically, the participating preferred program has done historically is, it has encouraged general partners, who have a specialty, and who want to invest in a region or a stage of company, as you are suggesting, that is out of favor, it does that.

I think if you encourage that kind of investment, you will get that result.

Ms. VELAZQUEZ. Okay.

I would like to ask this question of every witness, with the exception of the administration, because I know the answer.

Do you believe there is a need for the government to continue to play a role in making venture capital available? Yes or no?

Mr. O'CONNELL. Yes.

Mr. CLARK. Yes.

Mr. REDDING. Yes, I do.

Ms. PRESTON. Absolutely.

Mr. BLAYDON. Definitely.

Ms. VELAZQUEZ. Thank you.

Ms. Preston, do you believe the Federal Government, specifically SBA, should help in strengthening the angel investment community, such as by providing leverage to angel networks?

Ms. PRESTON. Absolutely, there is no question about it. There are a number of different ways to provide advantages to angel investing, and to support the entire process of angel investing. Whether or not they ever walk up into and fill that funding gap is a complete unknown, and nothing that we should have as an assurance of a bet on that. Because I think that is a long shot of looking at angel investors filling up to $5 million.

Ms. VELAZQUEZ. And I know some States are experimenting with angel investment tax credits.

Ms. PRESTON. We have 18 States that currently have tax credits for angel investors.

Ms. VELAZQUEZ. And do you think that has been helpful in stimulating investment?

Ms. PRESTON. It has been helpful. But still when we look at the statistics, and even when we have done it through the Angel Capital Associations, surveyed our own members, the average investment by the groups themselves, not just individuals, has been between $100,000 and $500,000. So I think we do have a definitive issue still that the SBIC needs to address.

Ms. VELAZQUEZ. Thank you.

Mr. Blaydon, do you believe the participating securities program would be better implemented as a grant program; that is, if the funds were invested with no intention of repayment to the Federal Government?

Mr. BLAYDON. That certainly would remove many of the conflicts that are going on here, Ms. Velazquez. But I think, as some of my other colleagues mentioned here too, there is the possibility of designing the program also so that when the risks are shared appro-

priately with the rewards, that the program can succeed and be a self-funding program going forward into the future.

A grant program would absolutely assure that it would not be a question of how the risk is going to play out in the future, but I do think the program can be restructured in a way, with appropriate risk sharing and profit sharing, it could be self-funding over the long term.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman MANZULLO. Thank you.

I have an idea. We have a lot of brainpower here with all six of you. Would you all be willing to stick around after the hearing to sort of jam and put out some ideas on how to fix the program? Would that be okay with you?

Mr. GUZMAN-FOURNIER. For how long would that be?

Chairman MANZULLO. As long as you can stay. If it is a half-hour, that would be sufficient. Or have somebody here in your stead.

Mr. GUZMAN-FOURNIER. We have always said that we are willing to listen and to work with the committee. The question is the timing here.

Chairman MANZULLO. Well, if you cannot stay, Tee can stay. We will commit him. Is that okay with you, Tee?

Mr. ROWE. Anything you say, sir.

Chairman MANZULLO. Okay, thank you, appreciate that. And we can work with your plane schedules. But I just thought that since we want to get this thing fixed, why not take advantage of a very informal situation afterwards.

I have noticed, coming from a background of somebody who spends most of his time in Congress working on manufacturing issues, you are partners with Andrew Kalnow, are you not, at Alpha? You helped them start?

Or you did, Mark?

Mr. REDDING. Alpha Capital is a member of the investor group in Banner Service Corporation.

Chairman MANZULLO. Okay. Andrew Kalnow has a very interesting background. I met him when his family stepped in the breach when National Machinery from Tiffin, Ohio, went into Chapter 11. And National Machinery was the last, or is the last, coal-forming machine tool company in the United States. It is important because that machine tool makes bullets, and it went under. The Pentagon did not know about it.

I find it very interesting that Mr. Redding and Dr. Clark, both of you have this manufacturing background. I know the answer to it. But could you lay out before us the extra difficult time that manufacturers have in getting venture capital? What is it about the nature of manufacturing that makes it extra difficult?

Mr. REDDING. I think in my case, Congressman, when we did this transaction, the Banner business was in decline, like many, and the debt financing that was available was very restrictive and nervous. Equity investment continues to be an important part of any of these transactions; and the suggestion that the debenture program is a substitute, I think, is incorrect.

Manufacturing is a difficult business, thought to be going overseas, and not particularly attractive to many people who make

these decisions. Those of us who have been in it all our lives see it differently.

Mr. CLARK. In addition to having a bad public profile as an investment opportunity, just as an industry, the U.S. manufacturing industry is generally very capital intensive, very mature, and it tends towards being resistant to change. The people that are driven into the industry by available venture capital are agents of change. They are the antithesis of the way the industry works.

So while the investment community tends to resist the manufacturing community as an investment opportunity because of those issues, in fact, it is a necessary marriage. And what we are beginning to see is that there are a limited number of firms that are looking at specific dealings inside the manufacturing community. They see a tremendous opportunity for change and profitability, and they are beginning to back those. But they have to really be exceptional opportunities right now because of the negative profile the industry has.

Chairman MANZULLO. We had a situation in Rockford, when Ingersoll Milling Machine burst into—I guess that is the word—into several different areas. The cutting tool division was sold to an Israeli company. The milling machine company, the one that makes the seven-axis machines that wrap stealth material on aircraft, ended up in Chapter 11. And the stalking horse was a Canadian company, but the successful bidder was an Italian company, Camozzi Brothers.

Phil James came out of retirement, lives in Rhode Island, and tried to save the company, that division. He went to 10 banks and joint venture capital companies—I do not think he went to an SBIC—but he could not find anybody interested.

So he went to the Chinese to a company called Dalian, which is a wholly state-owned Chinese company, who bought the Ingersoll production line in Rockford where they manufacture machine tools and export them back to China. Now, you figure that one out. But what it showed is the fact that it was just desperation looking for that type of capital.

Now, when we reauthorized the SBA, we made it so that the 504 program could go up to $4 million for the purpose of infusing more money into the manufacturing sector. And I just bring that out because it is so difficult, if not impossible, to get that money into the hands of the manufacturing sector.

Mrs. Moore, did you have any further questions over there?

Ms. MOORE. Thank you, Mr. Chairman. I was particularly interested in a couple of people's testimony, and I just want to thank Mark Redding for all the work he did in Wisconsin. Franklin, Wisconsin, literally is across the street from my district.

And I also wanted to revisit some statements that were made by Ms. Preston regarding angel investors. I tried to look through your testimony here to see if I could glean the answer, and of course, I cannot.

And I also wanted to ask Dr. Clark about the economies that we have realized. You talked about the fuel efficiency and a number of others—increases in sales, and reducing our reliance on fossil fuels, and lead paint, and other things. I was very interested in that.

But first, Ms. Preston, I wanted you to explain the $22 million of new angel investors that have come in. It is not clear to me whether in 2004 that was because of SBIC's involvement.

Ms. PRESTON. Their estimation is being made by the Center for Venture Research at the University of New Hampshire, which has been doing research on angel investors for a number of years. And for 2004, the estimation was that angel investors invested $22.5 billion into entrepreneurial ventures, primarily at the early stage in the United States. And that was into an approximate 48,000 different ventures. So that is where the number comes from.

We estimate there are approximately 225,000 active angel investors in the United States at this time. That is a very small number compared to who has the ability to be angel investors. But, again, they are primarily at the very early seed-stage investing and understand the need, as you pointed out, of the patience of dollars.

And an expectation, as an angel investor myself, and others who are angel investors, is that we do not expect to see necessarily a return on our investment for 7 to 10 years because we understand that we are investing at that earliest stage, but at an incredibly vital stage of a company's development because there is no other source of financing if we lose the SBICs.

Ms. MOORE. So you were really just comparing the patience and the productivity of those investments in contrast with the impatience of the SBIC program?

Ms. PRESTON. That is exactly right.

Ms. MOORE. I also am very excited about the economies, and I believe it was Dr. Clark. Could you please share a little bit more about that, how we have reduced our reliance on a billion dollars in gasoline? I want to hear more about that.

Mr. CLARK. The technology that we have developed allows the companies that stamp metal to use thinner, stronger, lighter metals in order to manufacture anything that is made out of stamped steel, stamped aluminum, stamped titanium.

In the U.S. auto and truck market, we are currently deploying technologies. We have not fully penetrated the market, but we are deploying technologies that allow the auto industry to essentially reduce the weight of its parts, frame and body parts, by somewhere in the area of 10 to 20 Percent.

What that means is that for the weight of a car, if you have a 2,000- or 3,000-pound car, body and frame, you can cut, let us say, 300 to 400 to 500 pounds of weight out of that frame by using these new, advanced steels. Industry does not know how to form them. We have given them a technology that allows them to form them with fewer defects and make the parts faster.

When you calculate the impact of the reduced weight on the vehicles, that is where the fuel savings come from. The numbers I gave you were numbers that were calculated by DOE, based on full deployment of the technology.

We are just beginning to write up what we call the ″hockey stick″ right now in deployment of the technology within Chrysler, to a lesser extent within Ford; and we are just beginning to work on GM, and then we are working in the supply chain.

So as we continue to deploy, and if other technologies come along and do the job better than we do in specific circumstances, we will

see reduced fuel demand and improved vehicle mileage per vehicle because the cars are lighter. We can push them with less energy. So that is where that figure came from.

Ms. MOORE. And that would be impossible without venture capital?

Mr. CLARK. I guarantee you this technology never would have hit the street if we did not have the backing of the venture capital, first, angels and then the institutional venture funds backed by SBIC. We would not be here.

Ms. MOORE. Thank you very much. I think that is the wave of the future.

Thank you, Mr. Chairman, for your indulgence.

Chairman MANZULLO. Well, thank you for those excellent questions. I want to thank all of you; and we will come down there in a minute and sit down and chat with you informally.

Again, thank you for coming here, especially those of you who have come in from long distances. This hearing is adjourned.

[Whereupon, at 3:55 p.m., the committee was adjourned.]

House Committee on Small Business

Private Equity for Small Firms: The Importance of the Participating Securities Program

April 13, 2005

Prepared Remarks of Chairman Donald Manzullo (IL-16), Chairman
U.S. House Small Business Committee

Good morning and welcome to this hearing on a very important topic for small businesses around the country – access to capital.

A key part of economic security is creating the environment for entrepreneurs to take risks in starting or growing businesses, thereby creating jobs. The question becomes what should the federal government do to foster a better economic climate for small businesses to grow?

This Committee can play a key role in achieving economic security by ensuring that the federal government and America's small businesses work together in a sound partnership to spur growth in the economy.

In February, this committee held its first hearing of the 109th Congress to go over SBA's budget and key programs within that budget. One of the topics dealt with Small Business Investment Companies (SBICs); specifically, the participating securities program.

At that hearing, it was noted by SBA's own analysis that participating securities funds licensed between the years of 1994 through 2000 have performed as well as non-SBIC venture funds of the same vintage years that CalPERS (California Public Employees' Retirement System) invested in. Over $2.5 billion in leverage was invested in the three years, 1998 to 2000, immediately before the collapse of the economy. I asked Administrator Barreto how much of the losses in the program can be attributed to the recession. He said, "I would be happy to go back and research this for you." I expect the SBA to answer that question today.

I also asked him if he would be willing to commit to working towards a solution of this problem; to which he replied, "Absolutely."

I want to congratulate the Administrator and his team for following through on a commitment to find a solution to this thorny problem in the participating securities program. I will let our witnesses get into the details of how significant the program is for start-up and early stage funding.

The SBA Inspector General's report from May 2004 states, "Over the last 10 to 15 years, the General Accounting Office (GAO) and the Office of Inspector General (OIG) have found that SBA's policy of allowing extensive time for financially troubled SBICs to attempt rehabilitation has allowed SBIC assets to decrease and reduced SBA's potential for recovery. SBA's policy of allowing capitally impaired SBICs to charge significant management fees and the way SBA applies distributable gains from SBICs also contribute to program losses. The standard operating procedure (SOP) for the SBIC program has not been revised since March 1989 and existing guidance does not provide a systematic approach for estimating the level of financial risk, ensuring the implementation of restrictive operations, transferring capitally impaired SBICs to liquidation status, or liquidating SBICs receiving participating securities."

The report goes on to state, that the "structure of the SBIC funding process for participating securities and the quality of SBA oversight have contributed significantly to the losses in the SBIC program in recent years."

Some believe the notion that if it's a good business plan, then someone will fund it. As our witnesses will attest, this is simply not true. According to the Council on Competitiveness National Innovation Initiative Report dated December 2004, "[f]or those ideas that are pursued commercially, only seven out of every 1,000 business plans receive funding."

Mr. Steve Vivian, board member of the National Association of Small Business Investment Companies, testified at our hearing on the budget back in February that the "Participating Securities program accounts for roughly half of all SBIC investment dollars and, since inception in 1994, has infused nearly $9 billion into U.S. small businesses." In fact, he goes on to note that "thirty-five percent of that $9 billion, or over $3 billion, went into small and growing U.S. manufacturing companies."

I can tell you that these are investments would not have been made by traditional venture capitalists or banks. But for the equity participation of the SBA, these jobs, products, revenues, and taxes would likely not exist.

Listen to these quotes:

- "SBIC financings work to fill the gap in private equity markets, especially at the earliest stages of a company's growth."
- "By encouraging private risk-taking, the program is capable of supporting thousands of entrepreneurs through the slow economic period, with the prospect of growing leading-edge businesses out of the down cycle."

These comments didn't come from a trade association or industry guru, but from the SBA's special report on the SBIC program dated June 2002. SBA's report goes on to highlight that:

- SBIC financings represented 64% of Seed Financings during FY 1994 – 2002

- SBIC Portfolio Companies in FY 2002
    - **Created Jobs**: 73,000
    - **Sustained Jobs**: 176,309
    - **Total Jobs Supported**: 1.1 million
- Revenues in SBIC Portfolio Companies FY 2002 were $14.8 billion
- SBICs generated **$6 billion in taxes** in FY 2002
- Between FY 1994 and 2002, SBICs provided 65% of financing dollars to non-technology and life sciences, as compared to the overall venture industry with only 9% of all venture financing dollars in that category.

The SBA feels pressure to say the program doesn't work at all, as evidenced by the losses sustained. SBA must take some responsibility for how the program currently works. Again, from the IG report, "capitally impaired participating securities SBICs that have been transferred to liquidation are not being liquidated [by the SBA]. To improve the program's ability to limit risk and prevent major avoidable program losses, officials should pursue legislative reforms and act in a timely manner in dealing with and liquidating capitally impaired SBICs."

We're not going to solve all the problems today. Nevertheless, my hope is that the SBA will take an open and honest look at the program and recognize its necessity. It is an accepted fact that there are structural problems in the program; but I believe it can be fixed between willing participants. I am willing. Industry is willing. And, according to Mr. Barreto's previous testimony, the Administration is willing.

One final quote from the SBA report: "Our mission is to improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital…which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply…."

In light of SBA's own words as to the positive aspects of the participating securities program, they have an obligation to work with industry to resolve this problem.

I now turn to the Ranking Member for her comments.

Statement
Of
Senator James M. Talent

Before The
United States House of Representatives
Committee on Small Business

April 13, 2005

Chairman Manzullo, Representative Velazquez, other members of the Committee,

Thank you for the courtesy you have shown in allowing me to make an opening statement regarding what I believe to be one of the most important of all the small business programs created by Congress: SBA's Participating Security SBIC program. I feel very strongly about this program and the important role it plays in the fabric of small business financing.

Of the $8.9 billion in Participating Security investments since the programs inception in Fiscal Year 1994, approximately $135 million has been invested in Missouri. Those investments netted an estimated 3,750 jobs and over $641 million in portfolio company revenue within my State.

Here is a Missouri example – Between 1998 and 2001, two SBICs invested $13.2 million in Build-A-Bear Workshop a St. Louis, Missouri, based company. Build-A-Bear Workshop is a retail and internet business that provides a place for people of all ages to make and name their own unique bear or other stuffed creation. The first store opened in St. Louis in 1997 and as of January 2005 the company operated 170 stores in 40 states and Canada. With the opening of its international store in Sheffield, England in the fall of 2003 and the addition of international stores in Japan, Denmark, and Australia in 2004, Build-A-Bear Workshop has become the global leader in the teddy bear business. The SBIC program allowed Build-A-Bear Workshop to go from a company of 30 employees when the initial investment was made to one with more than 4,000 employees today and they were named the Retail Innovator of the Year for 2001 by The National Retail Federation.

None of this could have occurred had it not been for the more than $7 million in SBIC Investment Build-A-Bear Workshop has received. With that being said, let me turn to the Administration's Fiscal Year 2006 budget proposal.

I realize that the government is incurring losses in the program at this time. Some of those losses are directly related to the recent recession and some are related to structural flaws in the program that can and should be fixed. They should be fixed because the program works. It works in my state of Missouri and it works across the country.

We should not lose sight of the goal articulated in the enabling legislation: "to stimulate and supplement the flow of private equity capital . . . which is not available in adequate supply." The need is still there and we should not eliminate a program that uniquely fills that need simply because we did not get the structure right the first time. I know the industry is more than willing to meet the Administration half way to come up with a zero subsidy rate solution. I hope that the Administration, particularly those at OMB, is of a like mind. If we all work collaboratively and use reasonable performance assumptions in designing a new structure, I am confident the Participating Security program can be revived and continue to do what it does best: support small business growth and job creation across the country. I am willing to do my part to help achieve that goal. I hope the Administration and others involved in the process within the Administration will do the same.

Again Chairman Manzullo, thank you for the opportunity to make this statement. I look forward to working with you and the committee in the coming months as you try to develop a solution that will revive the Participating Security SBIC program.

STATEMENT
OF

ADMINISTRATOR HECTOR V. BARRETO
U.S. SMALL BUSINESS ADMINISTRATION

HEARING
ON
EQUITY INVESTMENT IN SMALL BUSINESS
Committee on Small Business
U.S. House of Representatives
April 13, 2005

Mr. Chairman, Ranking Member Velázquez, Members of the Committee, I appreciate the opportunity to offer testimony on the Small Business Investment Company (SBIC) Participating Securities (PS) program to outline the program's flaws and the negative impact this program is having now, and is projected to have over the next 5 years.

Estimated losses for this program top $2.7 billion and are expected to increase. I know the Committee shares the President's goal of a fiscally responsible government and understand why we cannot continue operating a program that leaves the taxpayers "holding the bag."

Current estimates project losses of over $2.7 billion on the more than $6 billion disbursed through FY 2004. As of the end of FY 2004, 29% of SBICs licensed prior to FY 2001 (41 of the 141 SBICs) that issued participating securities, had failed, while only less than 5% (6 SBICs) had repaid all committed funds from the Federal Government. Of those that had failed, 75% (33 SBICs) were given funding between 1994 and 1998, when the economy and the venture capital industry were growing rapidly.

While the downturn in the stock market that began in 2000 was a factor in the losses of the PS program, the major factors were variance in fund performance and the structure of the participating securities instrument. Let me address each of these issues separately.

First of all, it typically takes about five years before fund performance can be analyzed due to what is known in the industry as the "J-curve". The "J-curve" takes into account the fact that venture funds typically experience losses for the first few years due to operational costs and some investment write-downs and don not start to distribute cash to investors for several years. Because of this "J-curve" effect, the SBIC regulations allow for a four, and in some cases five, year forbearance period from the date of first issuance of the participating securities, during which participating securities SBICs are allowed to operate with a higher level of capital impairment. By the time the forbearance period ends, SBICs are expected to have overcome the early losses suggested by the "J-curve" and the capital impairment threshold is lowered substantially.

That means on participating securities that were first issued in FY 1995, it was not until around FY 2000 when the forbearance periods began to expire for a number of

SBICs. As SBICs became capitally impaired and passed their forbearance periods, the SBA began to take the necessary actions in FY 2001 on repurchasing the participating securities used to make government equity investments in SBICs in order to mitigate further losses. Despite three years of liquidating failed SBICs, the program's cash balance at the end of FY 2004 was almost negative $1.3 billion.

Secondly, the majority of SBICs did not perform up to expectations. Of the 49 SBICs that have generated a total net profit of $279 million for SBA, four SBICs provided over 50% of this amount. As the statute provides an effective cap of less than 10% in profit participation, this small amount of profit participation from a very few funds must cover the losses from the larger number of underperforming funds.

Unfortunately, even a fund that has generated some profit does not necessarily pay off all of its SBA-backed participating security. Of the SBIC funds that made distributions to the private investors greater than or equal to their investments (Paid-in Capital), less than a quarter (or six SBICs) had fully repaid their participating securities as of the end of FY 2004. This indicates a serious fundamental problem with the participating securities funding instrument as the taxpayer will need to make up the repayment shortfall.

Let's look at the instrument. The Participating Securities program allows a fund to secure government-backed funding of two times what private investors contribute, with a term of 10 years. In the SBA's debenture program, the SBIC would be required to pay the interest associated with the government-backed instrument, the debenture. Conversely, in the Participating Securities program, the SBA makes these interest payments and is only repaid out of the "profits," if any, of the fund. Annual fees on outstanding leverage are also paid only out of the profits of the fund.

Therefore, if a fund is never profitable, neither prioritized interest payments nor annual fees will be repaid to the government. This is important, as there are currently several SBICs that are neither financially impaired nor profitable; therefore, SBA may ultimately lose these advanced interest payments. In some cases, an SBIC's outstanding prioritized interest payments actually exceed the participating security amount.

However, advancing prioritized payments (deferring interest) is not the only flaw in the instrument. The statutory distribution formula also has flaws that limit SBA's ability to recover taxpayer funds. SBA typically contributes two thirds of the capital of an SBIC through the participating securities instrument but receives less than 10% of the profits, if any, of the fund. Moreover, Participating Securities SBICs distribute cash based on fairly complex rules; however in simple terms, the order of distribution is prioritized payments (or interest), profits, then redemption of equity capital.

Among the problems with these rules are the following: 1) Profits are paid before redemption of the participating security. This means that the taxpayers are repaid only if there is money left over after private investors receive their profits. 2) Optional "tax" distributions that are not required to be based on any private investor's actual tax liability, allow the SBIC the ability to provide even more of the overall distribution to the private investor at the expense of the taxpayer. 3) When SBA has less than or equal to 50% of

the capital in a fund, it gets only its profit participation (typically less than 10%) and no repayment of interest or pay-down of the participating security. In essence, the distribution formula allows the SBICs to minimize distributions to the SBA, and maximize profit to the private investors.

For example, prior to the downturn in the stock market and venture industry, there was a distribution exceeding $207 million from a single SBIC. Because the SBA's equity position in the fund was only 49.5% (under 50%), the SBA received less than $18 million. The remainder ($189 million) went to the private investors, over five times their initial $30 million investment. While this distribution by itself is disconcerting, the SBA's equity position in the fund was under 50% only because a short while before this transaction, the SBIC had made a previous distribution which lowered SBA's holding from 56% to 49.5%. If the SBIC had made both these distributions at one time, SBA's share would have been substantially higher and would have repaid the full amount of the participating security plus a profit distribution for SBA.

In order to understand the effect of the program rules on the performance of the program, the SBA looked at its SBIC funds on a vintage year basis. For vintage years 1994-1998, the SBA estimates that the private investors on a pooled (cumulative) basis received returns (distributions) of approximately 1.9 times the capital they paid into the fund. In contrast, the SBA received returns of barely half of all the capital and interest payments the SBA made. Unfortunately, based on current net asset values in the funds, it is anticipated that the SBA will neither be profitable nor break even for these better performing vintage years. The SBA believes that this problem is related to the participating securities instrument itself.

In looking at the SBICs in liquidation status, it is noteworthy that several of the funds are well-known names. Three such funds are expected to leave SBA with an estimated liability of $190 million. These are failures of funds managed by people with significant venture capital experience and long track records. While good fund managers will have poor performing venture funds from time to time, it does lead to questions as to whether there are aspects of the Participating Security SBIC program that have worked to the detriment of the taxpayers.

This is why it is the Administration's position that, while the Participating Securities program has in the past provided benefits to small businesses, the cost to taxpayers and the structure of the current program cannot be supported.

The important issue that the Administration is now addressing is, "how do we manage this program in order to minimize losses?" Currently, Participating Securities SBICs have $4.9 billion in outstanding PS investments and $5.7 billion in unfunded PS commitments. If present trends continue SBA and the taxpayers stand to lose more than the already estimated $2.7 billion.

SBA is reviewing its processes and reporting mechanisms to provide management with greater insight into its portfolio and the associated risks. The recently released financial performance report was only a first step into gaining greater insight into the SBIC program portfolio.

Considering the current results of the Participating Securities program, there is a question as to whether the Government should be involved in venture capital outside of the SBIC Debentures program. This is a valid question and one we should ask regardless of the performance of the program. To help identify the value of the SBIC and other SBA financial assistance programs, the SBA has executed a contract with the Urban Institute, an independent, non-partisan research organization, to help answer this question.

One factor that should be considered is whether there exists enough funding in the private equity market that the Government doesn't need to be involved.

The most recent report from the Center for Venture Research at the University of New Hampshire's Whittemore School of Business and Economics shows that angel investing has increased 24% from 2003 to 2004. Roughly 48,000 ventures received angel financing totaling $22.5 billion in 2004, an amount greater than the amount invested by institutional venture capital firms in 2004.

The report also shows that angel investing is becoming a more popular investment activity. In 2004 roughly 225,000 individuals made angel investments, and minorities now represent 3.6% of angel investors, and make up 5.4% of firms that seek angel investments.

Furthermore, while angel investing is growing, venture capital money is still being left un-invested according to new survey from Dow Jones/Venture One. Venture capital funds still have nearly $53 billion to invest, much of it earmarked for new portfolio companies. These funds have been raised since 1999 and largely result from the fundraising boom of 2000. In that year, large amounts were raised but could not be profitably invested after the stock market downturn. This "overhang" is good news for new businesses. As funds begin to invest these dollars, the potential for investment in new portfolio companies and small business improves.

Finally, I want to say that SBA's role in venture capital is not ended. We continue to support and encourage the SBIC Debenture program. While it focuses on later stage financing as opposed to equity based seed funding, it nevertheless produces significant and impressive results without the fiscal difficulties inherent in the participating securities program.

Thank you again for the opportunity to submit testimony.

TUCK SCHOOL OF BUSINESS AT DARTMOUTH

CENTER FOR
PRIVATE EQUITY
AND ENTREPRENEURSHIP

Statement
Of
Colin C. Blaydon

Director
Center for Private Equity and Entrepreneurship

Dean Emeritus
Buchanan Professor of Management
Tuck School of Business at Dartmouth College

Before The
Congress of the United States
House of Representatives
Committee on Small Business

April 13, 2005

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Mr. Chairman and members of the Committee:

It is a distinct pleasure to testify at this hearing regarding the importance of the Participating Securities Program.

By way of background, I am the Director of the Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth College in Hanover, New Hampshire. I am also Dean Emeritus and Professor of Management at Tuck. I serve on boards of advisors and boards of directors of private equity investment funds and growth companies. Previously, I served as Dean of the Tuck School from 1983 to 1990 and 1994 to 1995. I also held teaching and administrative positions at Harvard University and Duke University. In addition, I served in the government as Deputy Associate Director in the Office of Management and Budget as well as Staff Assistant in the Office of the Secretary of Defense while in the Army. My full curriculum vitae is enclosed in the appendix section of my written testimony.

The Center for Private Equity and Entrepreneurship was founded in 1998 to study best practices in the capital markets of the entrepreneurial and private equity sectors as well as best practices in founding, growing and restructuring businesses. My associate Fred Wainwright, who is Executive Director of the center and serves as Assistant Adjunct Professor at the Tuck School, is in attendance at this hearing today and has been integrally involved in all of the research projects of the center. The center has an advisory board of over 30 individuals representing a broad cross section of leadership in the private equity industry. These include senior partners of some of the largest venture capital firms such as New Enterprise Associates (NEA) and leaders of key industry associations such as the National Venture Capital Association (NVCA) and the Institutional Limited Partners Association (ILPA).

Private equity can be defined as investment in private, non-public companies. As commonly known, venture capital has played an integral role in the growth of the US economy during the past 25 years. According to a report commissioned by the National Venture Capital Association, in 2003, venture backed companies employed more than 10 million American workers and generated $1.8 trillion in sales.[1] Today, hundreds of multi-billion dollar companies owe their success to small initial investments of patient and intelligent growth capital provided 5, 10, 15 or even 20 years ago by individual investors and professional venture capitalists. Companies such as Federal Express, Sun Microsystems, Apple Computer, Amgen and Staples owe their success in part to private equity financing, and by the way all of the companies I mentioned have received SBIC funding.

While in their early stages, fast growing companies have large needs for cash and are usually unprofitable for the first several years of their existence. Therefore they are not qualified to receive debt financing from banks. Equity financing is essential for growth and innovation in the US economy. The impact of equity investing is fundamental and long lasting.

[1] Venture Impact 2004: Venture Capital Benefits to the US Economy, p. 1

The center has been asked by the National Association of Small Business Investment Companies (NASBIC) to conduct a study to address the following topics:

- Assessment of the "equity gap" relative to investment size, industry and geographic concentration; and
- Assessment of the pattern of SBIC investment based on analysis of SBA data, relative to investment size and industry and geographic concentration.

We have only recently begun this study, with initial access to some data from the SBA. The results we will report today are only preliminary, and the center's analysis is not yet complete. We are seeking additional data to develop a more complete analysis. We will provide a formal and final report at a later date, but we would like to take this opportunity to discuss preliminary findings with you today.

In addition, it would be very helpful to hear from the distinguished members of this committee as to what are their key questions and concerns. My associates and I in the Tuck center will endeavor to produce a final report that addresses your concerns to the fullest possible extent.

Introduction

Many observers note the inefficient nature of the private capital markets for venture investment (e.g., Branscomb and Auerswald, 2002). Such inefficiencies have the potential to leave gaps in the access to capital for entrepreneurs. Our study looks at the pattern of private venture capital investing and compares this pattern to the investment pattern of SBICs in order to assess the gaps left by private capital and the extent to which SBICs address such gaps.

The Equity Gap

The "Equity Gap" can be broadly defined as the lack of capital to early stage companies with these characteristics:

- Requiring initial funding of less than $5 million
- Located away from the Silicon Valley, Boston, New York or Chicago areas
- Focused in industry sectors other than information technology, life sciences or financial services

My team and I at the center have reviewed over 40 business articles and academic papers describing some form of an equity gap or capital gap. A complete bibliography is listed in the appendix of this document. In addition, a search of scholarly journals produced 64 cites to papers addressing the "equity gap." The fact that so many authors of so many business media and academic backgrounds have written about this issue is an indication as to its importance.

In addition, according to data from the SBA, approximately 75% of total SBIC financing amounts were in the form of equity in 2002.[2]

The Financial Gap

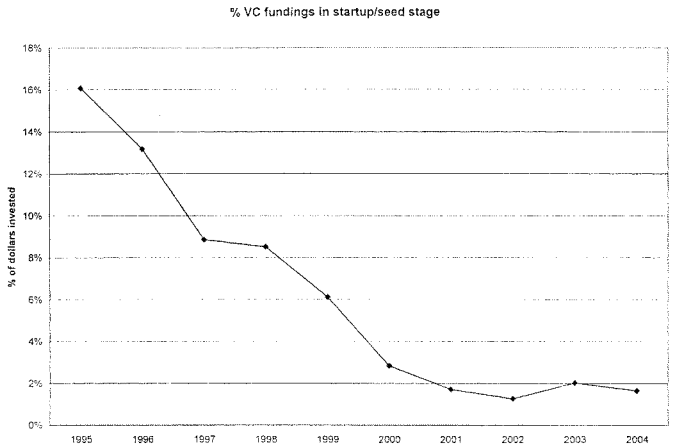
During the past decade, professional venture capitalists have been successful in raising successively larger and larger funds. Several funds manage over a billion dollars each. With such large funds, VCs have been increasingly reluctant to fund transactions below $5 million. According to Venture Economics, the average round of equity financing by VCs in 2002 was $7 million. In comparison, according to SBA data, the average equity financing round for SBICs was $1.1 million.

Early stage companies should receive relatively smaller amounts of capital because that is what is typically needed to finalize product development, test products, begin selling products, hire the first few employees and other such activities. This is appropriate because the company needs to prove itself in the marketplace and if the marketplace responds well, then subsequent larger financing rounds are required. A second financing round will be done at a higher valuation of the company and this allows the founders to retain a higher percentage of their company while taking in new capital. As a leading venture capitalist has stated in one of my classes, to best assure success, startups should establish a financing trajectory of steadily rising valuations while raising capital in phases.

Figure 1 shows that VCs, as an industry, have greatly reduced their relative emphasis on the earliest stages of investing. This is confirmed and detailed in a recent article by a venture capitalist entitled "The Vanishing Early Stage Fund" in the March 2005 issue of Venture Capital Journal, a leading industry publication. By contrast, historically SBICs in the 1990s made nearly 50% of their investments in startup or early stage investments. Although that percentage decreased post bubble, early stage investing still exceeds 30% for SBICs.[3] SBICs are providing a key service to innovation in the economy by providing appropriate amounts of capital to growing companies. (See below for Figure 1)

[2] SBA website (http://www.sba.gov/INV/stat), SBIC Program Statistical Package, Table 20
[3] SBA website (http://www.sba.gov/INV/stat), SBIC Program Statistical Package, Table 20

Figure 1



Source: Venture Economics / PWC Moneytree Survey

The Geographic Gap

Venture investing is local and regional. For a venture capitalist, it is much easier to monitor and manage an investment that is an hour's drive away than one that is a 3-hour plane ride away and academic research confirms this clustering behavior. Therefore, any effort toward regional economic development (at the state or county level) should include the establishment and support of relatively nearby sources of capital.

Evidence of the geographic capital gap can be found in the concentration of venture capital activity in California and Massachusetts. These two states, while making up only an estimated 14% of the United States population in 2002, took in almost 56% of all venture capital investment dollars that year. By comparison, according to SBA data, only 38% of SBIC equity investment dollars went to California and Massachusetts in 2002.

Some states receive remarkably little venture investment given the commercial and industrial activity in those states. Table 1 shows the number of companies that received a venture investment in certain states in 2002. (See below for Table 1)

Table 1

State	Number of Companies That Received Venture Investments in 2002	Number of INC 500 Companies in the State in 2002
Wyoming	0	1
Iowa	1	6
Montana	1	2
North Dakota	1	0
South Dakota	1	0
Nebraska	1	2
Kansas	2	1
Oklahoma	2	1
Arkansas	2	2
Louisiana	2	2
Hawaii	3	0
Maine	3	2
Vermont	3	0
Indiana	4	8
Kentucky	4	2
Nevada	4	2
Idaho	5	2
Mississippi	5	2
Total	**44**	**35**

Sources: Venture Economics and Inc. Magazine

Is it possible that the tens of thousands of university researchers, experienced entrepreneurs, talented technologists, and product innovators in those 18 states who sought to launch ventures deserved only 44 investments in 2002? Those 44 investments in those 18 states represented only 5% of the total number of venture investments made in one state: California (835 investments).

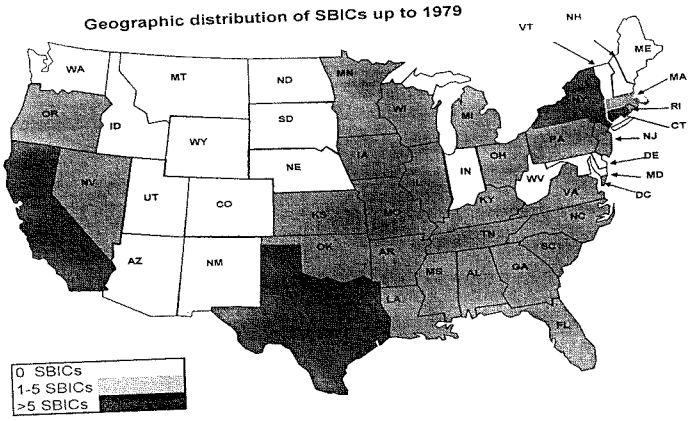
As shown in Table 1, if those 18 states produced 35 companies who were sufficiently successful to be selected for the Inc. 500 list of fastest growing companies in 2002, how many other startups and early stage companies might have received the equity capital they needed to expand and hire more employees?

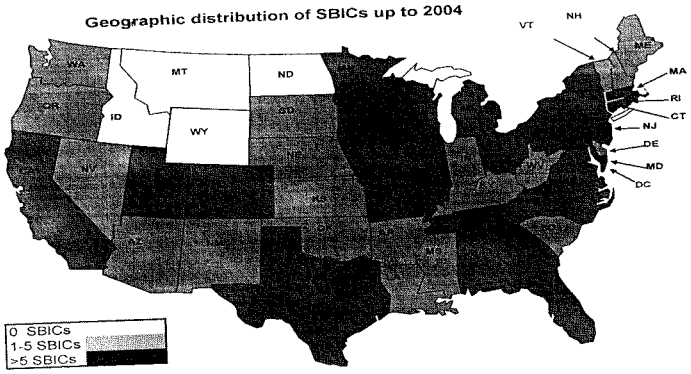
The absence of local and regional sources of equity financing has a powerful negative effect on potential entrepreneurs who choose to relocate to the coasts in order to access venture capital. Conversely, SBICs located in non-traditional VC regions attract entrepreneurs and encourage the formation of business ventures. Startups have a well known multiplier effect. As companies grow they hire talent from both within and outside an area. This allows attorneys, accountants and technical service providers to expand. Then if the growth companies are bought by larger corporations this will allow some wealthy ex-employees to start their own ventures, which will produce new

innovations and generate even more jobs. In time vibrant entrepreneurial ecosystems can develop.

As Figure 2 shows, the SBIC program has developed in a way that provides a greater geographic diversity in venture capital investment. The geographic distribution of SBICs has increased substantially. (See below for Figure 2)

Figure 2

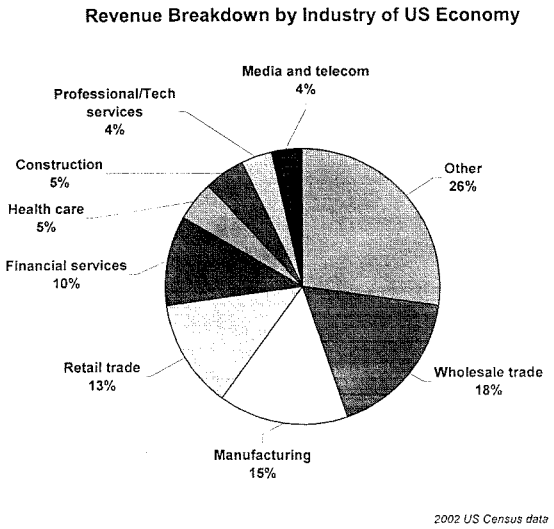

Geographic distribution of SBICs up to 1979
VT
NH
ME
MA
RI
CT
NJ
DE
MD
DC
WA
MT
ND
MN
OR
ID
SD
WI
MI
WY
NE
IA
NV
UT
CO
IN
OH
PA
WV
VA
KY
KS
MO
NC
TN
SC
OK
AR
AZ
NM
MS
AL
GA
LA
FL
0 SBICs
1-5 SBICs
>5 SBICs


Geographic distribution of SBICs up to 2004
VT
NH
ME
MA
RI
CT
NJ
DE
MD
DC
WA
MT
ND
OR
ID
SD
WY
NV
NM
0 SBICs
1-5 SBICs
>5 SBICs

The Sector Gap

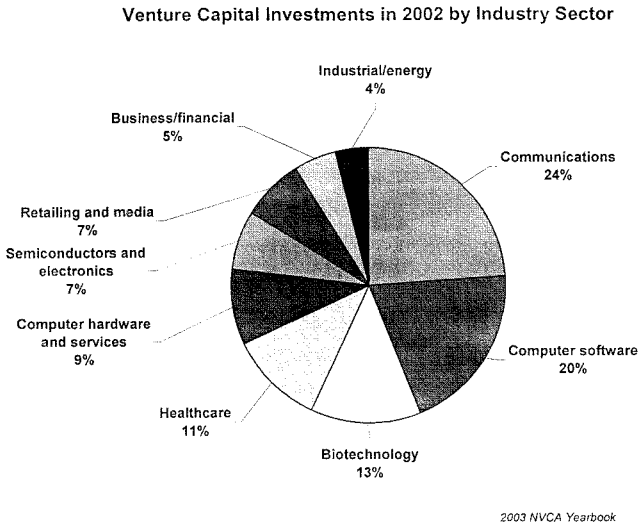
The chart in Figure 3 shows the distribution of sectors in the economy according to revenue produced in 2002, as derived from the latest census:

Figure 3



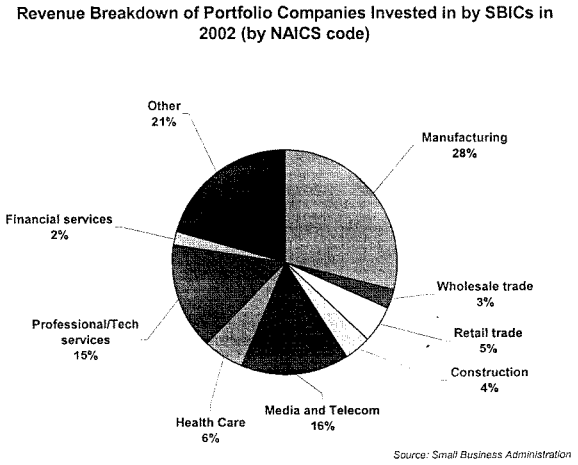
The two following charts (Figures 4 and 5) show the distribution of investments by venture capitalists in general and specifically by SBICs. (See below for Figures 4 and 5)

Figure 4



**NVCA only provides sector analysis by dollars invested rather than by revenues of portfolio companies.*

Figure 5



As can be noted, venture capitalists focus on communications, software, biotechnology and healthcare sectors (68% of dollars invested). This makes intuitive sense because these sectors tend to require relatively larger amounts of capital for research and development and product regulatory approval.

In comparison, SBICs invest equity in a more comprehensive breadth of sectors which more closely matches the sectors of the economy. For example, manufacturing represented 28% of SBIC portfolio companies by revenue. The SBA's own SBIC Fiscal Year 2002 Special Report confirms the sector gap.[4] If SBICs were to cease investing equity then the US economy would suffer from a lack of innovation in a number of critical sectors, such as manufacturing, professional technical services, and trade.

While it is outside the scope of this report, business and academic articles mention that minority and women entrepreneurs are underserved, therefore representing a possible "Diversity Gap." The SBA has chosen not to provide data that would allow the center to study this issue in further depth.

Conclusions

In summary, an apparent equity gap exists by stage, by geography, and across industry sectors. Although relatively small compared to overall venture capital, SBIC investment patterns provide a counterbalance to this distribution. Given the well known and documented inefficiencies in the capital markets for venture investing, the SBIC program does fill in some of the gaps created by those inefficiencies. It is important to note that capital alone is not the only aspect of a robust solution to the issue of economic development. Intelligent and experienced individuals must be carefully selected to manage capital investments and to provide significant ongoing advice to entrepreneurs and company managers who receive equity funding so that value is built and maximized at the most efficient pace.

Thank you very much for your consideration of this important program. I look forward to your comments, questions and feedback during and after this session.

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[4] *Small Business Investment Company Program Fiscal Year 2002 Special Report*, SBA, June 2002, p. 32

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Statement
of
Susan L. Preston

Before The
United States House of Representatives
Committee on Small Business

April 13, 2005

Chairman Manzullo, Ranking Member Velázquez and Members of the Committee:

A. Introduction

Thank you for inviting me to testify regarding the Administration's FY 2006 budget proposal for the Small Business Investment Company (SBIC) program. To provide context for my testimony, I provide a brief summary of my background and expertise and attach a more complete resume for the Committee's information. My testimony reflects my expertise and knowledge of the private equity market, in particular angel investing.

For approximately 5 years, I have been an Entrepreneur-in-Residence (E-in-R) with the Ewing Marion Kauffman Foundation, an internationally recognized foundation dedicated to the advancement of entrepreneurship in the United States. One of the most critical issues for entrepreneurs is the availability of financing for creation, development and growth of a business venture. As an E-in-R for Kauffman Foundation and in several other capacities, I have focused much of my professional efforts on the subject of angel financing of entrepreneurial ventures: understanding that economically vibrant communities are created through the support of entrepreneurial endeavors.

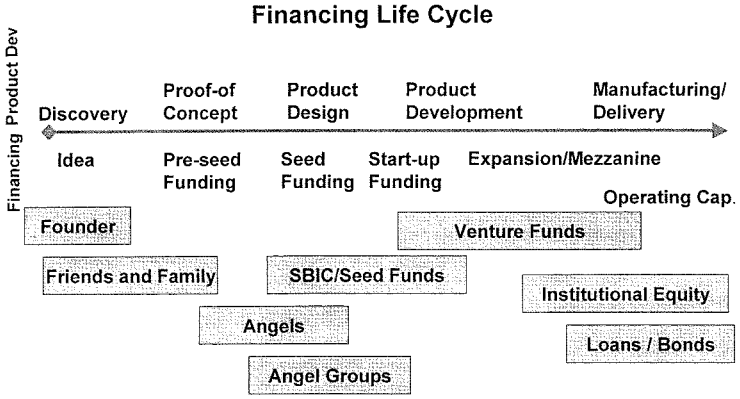
My activities specifically relating to angel investing are numerous and broad-reaching including:

1. Author of "*Angel Investment Groups, Networks and Funds: A Guidebook to Developing the Right Angel Organization for Your Community*", a comprehensive guidebook on the establishment and operation of angel investment groups.
2. Contributing author to *"State of the Art: An Executive Briefing on the Cutting-Edge Practices in American Angel Investing"*.
3. Author of numerous articles on private equity financing, particularly angel investing and angel organizations.
4. Member of the Advisory Board, Treasurer and one of the founding members of Angel Capital Association (ACA), a professional alliance of angel organizations.
5. Frequent speaker and instructor on private equity financing, including at: ACA North American Summits, State Science and Technology Institute (SSTI) conferences, National Association for Seed and Venture Funds (NASVF) annual conferences, Organization for Economic Cooperation and Development (OECD) double ministerial conferences, Governors' Conference on Economic Development, Industry Canada, State of Wisconsin and many others.
6. Profiled in Inc. Magazine and other local and national publications on angel investing, private equity financing and women's entrepreneurship.
7. Founder of Seraph Capital Forum, an all-women's angel investment group in the Seattle, Washington area.
8. Co-chair for two consecutive years for the Early Stage Investment Forum, the premier investment event in the Pacific Northwest

B. The Funding Gap

The development of any entrepreneurial venture requires funding at various stages of development. As Graph 1 below depicts, the source of funding varies with development of a company's product or services.

Graph 1:
Financing Life Cycle



As will be discussed in this testimony and supported by facts from MoneyTree™Survey, National Venture Capital Association, Center for Venture Research, Dow Jones Venture One and other sources, venture capital is no longer a realistic source of financing for the critical seed and start-up phases of a company's development – creating a funding gap for which entrepreneurs must seek other sources of funding. Historically, the funding gap between investments made by friends and family and the point at which companies could obtain venture capital financing was between $500,000 and $2 million in invested capital. However, with venture capitalists moving further up the funding chain with fewer and fewer investments early in a company's development, a second funding gap has emerged between $2 million and $5 million.[1] Table 1 illustrates these funding gaps:

TABLE 1

Stage	Pre-Seed	Seed/Start-Up		Early	Later
Source	Founders, Friends and Family	Individual Angels	**Funding Gaps:** **1. Between $500,000 and $2,000,000;** **2. Between $2,000,000 and $5,000,000**	Venture Funds	
Investment	$25,000 to $100,000	$100,000 to $500,000		$2,000,000/$5,000,000 and up	

[1] Source: Sohl and Sommer, *Angel Investment Activity: Bracing for the Downdraft,* 2002 Babson Conference

MoneyTree™Survey[2] statistics amplify the loss of venture capital in the seed/start-up stage of entrepreneurial company development. In fact, as shown in Table 2 below, in the last 6 years, the amount invested in the seed/start-up stage by venture capitalists has decreased by nearly 90%, and the percentage of funding dollars has decreased by 72%.

TABLE 2
VC Seed and Start-Up Financings[3,4]

1999	$3.3 billion	809 deals
	6.1%*	14.4%**
2000	$3.0 billion	672 deals
	2.9%	8.3%
2001	$767 million	251 deals
	1.9%	5.4%
2002	$352 million	155 deals
	1.7%	5.1%
2003	$385 million	193 deals
	2.0%	6.1%
2004	$346 million	171 deals
	1.7%	5.9%

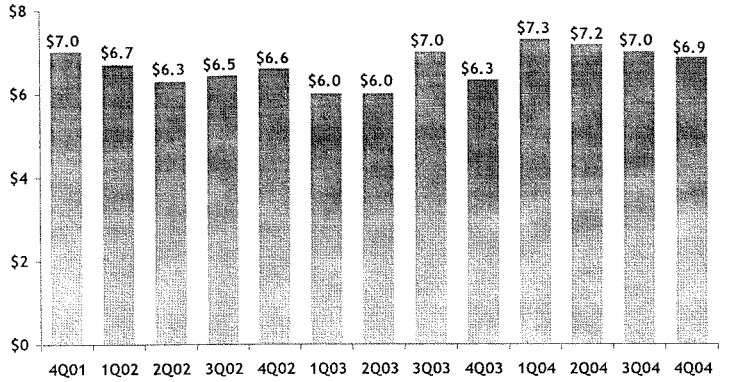
*Percentage of total dollars invested by venture capitalists in seed/start-up ventures
**Percentage of total deals by venture capitalists in seed/stat-up ventures

The reasons for this alarming and precipitous drop in funding are multi-faceted. First, since the bust, venture capitalists have been re-investing in their portfolio companies, rather than new investments. Second, because of the size of venture capital funds, often several hundred million dollars, it is not cost-effective for venture capitalists to go through the often arduous task of due diligence and then ongoing investment stewardship for a $2 to $5 million deal, than the historical median investment of $6 to $7.5 million.

Graph 2 below shows the median amount invested by venture capitalist in each round of financing. Clearly, few companies require $7 million in the seed/start-up phase of development.

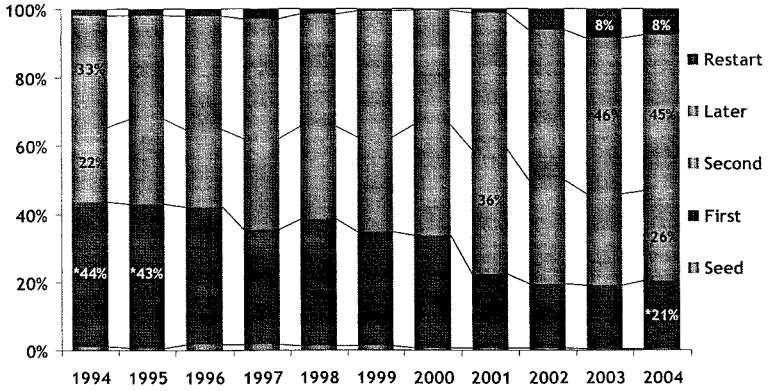
[2] PricewaterhouseCoopers/Thomson Venture Economics/National Venture Capital Association
[3] Source: MoneyTree™Survey
[4] Definition of "seed/start-up" under MoneyTree™Survey: "The initial stage. The company has a concept or product under development, but is probably not fully operational. Usually in existence less than 18 months. "

Graph 2[5]
Median Amount Invested Per Venture Capital Financing Round



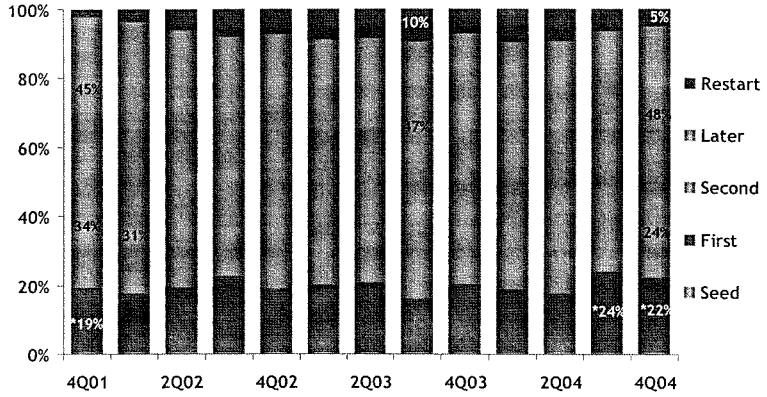
Finally, investing in later stage companies provides venture capitalists with operational history, evidence of market acceptance and sales performance information, theoretically reducing the investment risk. Graphs 3 and 4 below show venture capitalists' strong preference for later stage investments, both in terms of total dollars invested and number of investments.

Graph 3[6]
Most Venture Capital Dollars Directed at 2nd & Later Rounds



[5] Source: Dow Jones VentureOne/Ernst &Young
[6] Source: Dow Jones VentureOne/Ernst &Young

Graph 4[7]
Venture Capital Allocation to Later Rounds Continues



C. Angel Investments

Angel investors have proven themselves to be an integral part of the capital market, particularly for funding seed/start-up companies. The term "angel" originated in the early 1900s and referred to investors who made risky investments to support Broadway theatrical productions. Today, the term "angel" refers to high net worth individuals, or "accredited investors," who typically invest in and support start-up companies in their early stages of growth. In addition to the value provided by early funding, angel investors are typically experienced professionals who can offer wisdom and guidance to the entrepreneur and who have the patience to allow time for normal company maturation. With few exceptions, angels invest on a regional basis, being interested in personal relationships with companies and employees, as well as in giving back to their communities.

In the financial world today, angel investors are a critical and essential part of a healthy economy. Experts estimate that, on a cumulative basis, the level of investments made by angels over the last 30 years has been double that of investments made by venture capitalists.[8] The Center for Venture Research at the Whittmore School of Business and Economics at the University of New Hampshire estimates that angel **investments for 2004 were approximately $22.5 billion in 48,000 deals**, compared to $18.1 billion in 42,000 deals in 2003, representing a 24% increase in deals. These investments were made by an estimated 225,000 active angel investors. The majority of the 48,000 deals in 2004 were in the seed/start-up phase of entrepreneurial company development.

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[7] Source: Dow Jones VentureOne/Ernst &Young

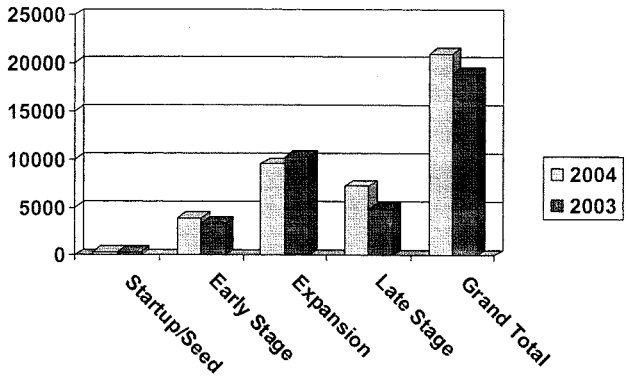
[8] According to statistics published by the National Venture Capital Association and the Center for Venture Research, University of New Hampshire

Therefore, angel investors can be defined as individuals who:

- Provide early-stage investment dollars
- Typically invest smaller dollar amounts per investment, with average investments of $25,000 to $250,000 per deal
- Invest their own wealth, with a clear expectation of financial reward
- Make their own investment decisions, in contrast to venture capital funds which are a passive investment process for the limited partners
- Provide valuable mentor or advisor services to companies as many are successful entrepreneurs with wisdom and expertise to offer the entrepreneur
- Have a sense of community involvement and social responsibility
- Have a tolerance for loss of entire investment
- Help fill part of the funding gap left by venture capitalists

In contrast, **venture capitalists invested less than angels in 2004 in dollars and in considerably fewer deals: $20.9 billion in 2,876 deals**. (Venture capitalists invested $18.9 billion in 2003.) Graph 5 below further emphasizes previously stated statistics and reflects the focus of venture capitalists on late stage company development rather than seed/start-up, with the 2004 increase in venture capital investments largely due to late stage investments, an increase to $7.2 billion in 2004 from $4.9 billion in 2003.

Graph 5
Venture Capital Investments by Stage of Development[9]
($s in Millions)



MoneyTree™Survey defines the various stages of investment as:

1. Seed/Start-Up Stage: The initial stage. The company has a concept or product under development, but is probably not fully operational. Usually in existence less than 18 months.
2. Early Stage: The company has a product or service in testing or pilot production. In some cases, the product may be commercially available. May or may not be generating revenues. Usually in business less than three years.

[9] Source: MoneyTree™Survey

3. Expansion Stage: Product or service is in production and commercially available. The company demonstrates significant revenue growth, but may or may not be showing a profit. Usually in business more than three years.
4. Later Stage: Product or service is widely available. Company is generating on-going revenue; probably positive cash flow. More likely to be, but not necessarily profitable. May include spin-outs of operating divisions of existing private companies and established private companies.

The combination of late stage investment focus, sizable investment amount median and reinvestment into portfolio companies should convince anyone that venture capitalists are not a realistic source of funding for the corner-stone of innovation and creativity in the United States: the entrepreneurial venture.

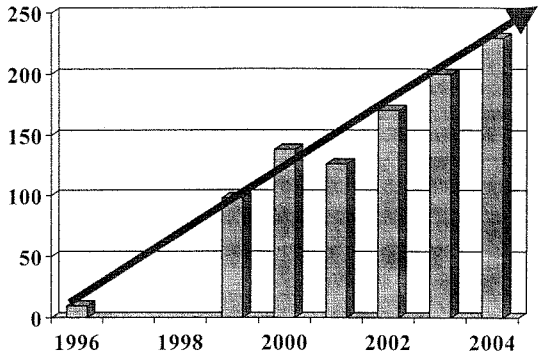
D. Angel Organizations

As stated earlier, Kauffman Foundation's mission is advancement of entrepreneurship in the United States. The founder understood the vital importance of entrepreneurs to the creation of healthy, vibrant economies. Unfortunately, one of the fundamental issues for entrepreneurs is the availability of adequate financing, particularly at the critical seed/start-up stages of company development. In recognition of this issue, Kauffman Foundation has focused much attention and resources in developing programs to support the availability of funding for young entrepreneurial ventures, most recently in support and promotion of angel investing and angel organizations.

An important part of the definition that separates angel groups from other investment vehicles is the active participation of angel group members in the investment of their own capital. From this definition of active investment of one's own capital, an angel group is then a group of angel investors investing through a member-directed investment process. The actual investment direction process may vary considerably, but all members have input either through their individual decision to invest or as a member of the group to invest part of the group's fund. Angel organizations can be everything from an informal group of individuals who conduct cooperative due diligence to a group with paid management and committed investment funds. Angel investment groups provide several advantages for individual angel investors including: 1. Quality deal flow; 2. Greater investment clout from combined dollars; 3. Opportunity to bridge the funding gap; 4. Collective due diligence; 5. Formal and informal investment education; and, of course, 6. Group social benefits.

Because of these advantages, we have seen a definitive increase in the establishment of angel investment groups in the United States. Graph 7 below depicts this recent extraordinary rise in angel organizations:

Graph 7[10]
Growth of Angel Organizations



Approximately three years ago, I, along with others at Kauffman Foundation became involved in what were initially small, semi-formal, meetings of representatives of angel groups. The attendees' strong expression of interest for a more formal, structured mechanism for angel organizations to meet and share best practices, information and experiences, led to Kauffman Foundation creating Angel Capital Association (ACA), a professional alliance of angel organizations. ACA is still a program of Kauffman Foundation, but will soon file for independent corporate recognition and will be seeking independent 501(c)(3) and 501(c)(6) status. The primary objective of the 501(c)(3) entity will be to conduct research on the angel investing market and educate individuals and the public on angel investing and angel organizations. The 501(c)(6) will be the angel organization trade association, with commensurate member and public benefits.

The recognition of the importance of angel investing is reflected in the estimated amounts invested by angel investors in 2004, $22.5 billion, as well as in the remarkable success of ACA. ACA began accepting group membership in March 2004 and at the time of the second North American ACA Summit in April 2005, 85 angel groups had been accepted for membership, including provisional groups (forming angel groups). This second ACA Summit attracted approximately 150 attendees with a keen and focused interest in furthering understanding angel investing and angel organizations.

All indications point toward continued growth and success for ACA. One of the important reasons for this anticipated positive future is the nascent character of angel investing – so new many are still hesitant to refer to angel investing as an actual industry. As such, the "terms and conditions" of angel investing are far from set. Just a few years ago, angel investors were considered unsophisticated, often taking common stock in return for their investment, failing to conduct adequate due diligence and investing at highly inflated valuations. Through several recent angel investing educational programs, as well as through the valuable angel group summits, angels are becoming "professionals" at investing.

[10] Source: Center for Venture Research

But as with the development of any industry, numerous variables exist in investment models and organizational structures, which raise issues of sustainability. Angel investing and angel organizations as an investment vehicle can be equated to the venture capital industry 25 years ago. Currently, several legal and operational structures exist for angel groups, with no certainty of which model will provide positive return on investment (ROI) or if these factors even affect ROI. Additionally, the angel industry has differing opinions on fundamental terms and establishment of professional standards. Therefore, the continued presence of angel investing as a vital part of supporting the growth of entrepreneurial companies particularly at the seed/start-up stage will depend on several variables. As yet, no one has created a crystal ball which will assure the future of angel capital as an adequate and effective resource for the funding gap. Nor should any intelligent economy rely on one source to meet these critical economic needs, just as companies would not single source a crucial part of the product.

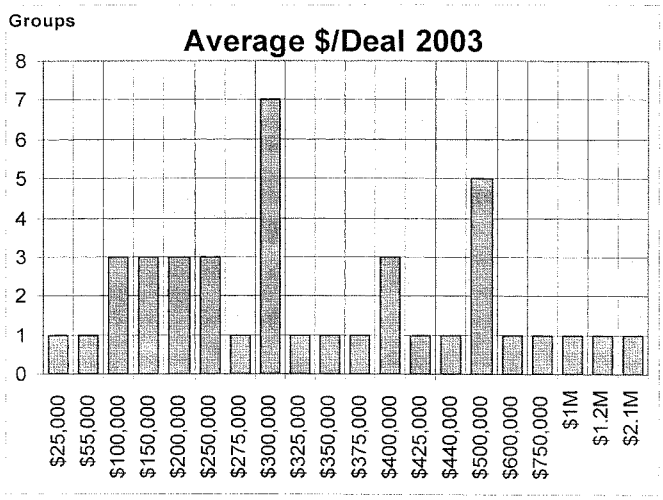
In addition to those issues being discussed and addressed through the ACA, equally important to angel investing, in any form, include critical factors as the availability of follow-on financing, patience in return on investments, an understanding of cyclic and often unpredictable nature of the investment industry and education of existing and potential angel investors. These factors emphasize the nascent qualities of angel investing and the importance of diversified financial resources.

E. Funding Gap Still Exists

One of the most critical issues for angel investors is the availability of follow-on funding. Some angel groups are beginning to reserve funds for follow-on round needs; however, few entrepreneurial funding needs can be met by angel investors alone, even through angel groups. This is particularly true for the second funding gap - $2 million to $5 million – left by the venture capitalists essentially abandoning seed/start-up funding rounds. As such, another source of funding must be available for this funding gap, specifically the SBIC program.

Even in these early stages of development, ACA has already conducted research on its member angel organizations. One particularly interesting and important statistic for the current discussion related to the continued funding of the SBIC program, is the average investment size of ACA group members. Graph 8 below shows the results of a recent survey of ACA angel group members, showing that the average investment amount per round for a group is between $100,000 and $500.000.

Graph 8



By these statistics, an individual angel group cannot meet the larger early stage investment needs of entrepreneurial companies, particularly the larger $2 to $5 million funding gap. Angel groups are only beginning to discuss deal collaborations or syndications and the likelihood of collaborations occurring and to what degree is uncertain at this time. This uncertainty is amplified by the fact that angels typically invest within their own community and most angel groups still leave investment decisions up to individual members. This combination of factors makes reliance on angels to fill the funding gap a risky bet and currently a long shot at best.

Because angel investing is a new industry, the ability to create substantial funding leverage is still developing. Therefore, to rely on angel investors and angel groups to fill the funding gap of $2 to $5 million is short-sighted and unrealistic and the numbers bear out this statement. Without the SBIC program, entrepreneurial ventures have lost an essential and critical component of early stage financing.

F. Policy Implications

One of the most troublesome consequences of the loss of the SBIC program is the further widening of the chasm between the middle and upper class. Without a vital funding source at the early stages of a company's development, only those with the financial capability to self-fund entrepreneurial endeavors, the upper class, will have the ability to drive a company through these initial stages of growth. Lower and middle class entrepreneurs with innovative products and creative business models will not have the financial resources to start businesses or grow to a point of possible sustainability. This is especially true for minority and women entrepreneurs.

G. Conclusion

Early stage investing must be patient money as the time period for realizing a return can often be several years. In addition, we have recently gone through an economic depression, partly due to unrealistic and poorly thought-through investments, which has resulted in significant losses. Therefore, any recent losses incurred by the SBIC program are similar to those experienced by all other participants in the investment community, including venture capitalists and angel investors. Despite these recent losses, the number of angel organizations continues to grow as does the amount of angel investing. Angels understand that we must continue to support entrepreneurial endeavors and strong returns can be achieved through these investments. This is no different than the economic cycles every investment segment experiences at some point in its lifespan. But if investors abandon each segment during a downturn, we would have few investment options today.

Far more good ideas exist than dollars to fund them and we must continue to support all sources of funding that enable the support of aspiring entrepreneurs at each stage of development from idea to viable company. As the Kauffman Foundation recognizes, entrepreneurs are the key to local and national economic wealth.

Testimony of Mark A. Redding Before The House Committee on Small Business

April 13, 2005

Chairman Manzullo, Ranking Member Velázquez, and Members of the Committee:

I appreciate the invitation to testify at the hearing of the Committee on Small Business of the United States House of Representatives. This hearing, to address the challenges facing small businesses needing equity because of the shutdown in the Participating Securities Program, is of great importance to me. My name is Mark A. Redding. I am currently the Chief Executive Officer of Banner Service Corporation in Carol Stream, Illinois. Banner is a manufacturing company with about sixty employees engaged in the precision processing sector of the steel bar industry. While small in comparison to the total steel industry, Banner is a leader in its chosen field of precision centerless bar grinding. We service the needs of the machining, automobile, metal service center, and selected original equipment, industries.

My professional background, since 1974, has been in the metal products industry. For the past thirty years I have worked exclusively in the machining, grinding, foundry, and machinery making industries. From an entry level position as a production control analyst, on to plant management, sales management, Chief Operating Officer, Group Vice President, and eventually twice a Chief Executive Officer, I have been engaged in both large and small firms. I have had the opportunity to be in a private ownership position in three of those firms. Most recently I was able to lead the effort that resulted in the purchase of Banner Service Corporation from its founding family, some forty-plus years after its original inception. Two licensed SBIC private equity firms, Prism Capital and Alpha Capital Partners joined with me to make that purchase and subsequent revitalization of Banner Service Corporation possible.

To more fully understand the importance of these issues, I would like to more fully describe Banner. To know this business, its history, past success, decline, and recent revitalization is, in my opinion, of great relevance to the subjects being discussed in this hearing. Banner was formed by the Jack Sneeden family in 1961. In the beginning it was mostly a small, metal distributor focused upon serving small metal bar users. Over a period of many years, Banner transformed itself from metal bar distributor to a turnkey provider of precision straightened, ground, and polished bar products. During the course of its history it expanded many times, added additional equipment and created new jobs. In the mid to late nineties, it eventually outgrew its facility and began to look for a new home. In cooperation with a Chicago-area real estate developer, it was able to secure a new building that was designed specifically for its intended business. In late 1997, as the U.S. economy blossomed, Banner relocated to this 74,000 square foot facility, ideal for its functionality, but at a significantly higher cost. Many new efficiencies were realized as a result of this expenditure and Banner was blessed with business that resulted in sales revenue of over $26,000,000 in 1997. However, there would be trouble ahead for Banner and its new scale. Much of that growth was based upon making bars to be further manufactured into component parts for office products such as computer printers. From the late 1990's until the early 2000's, most of the demand

for these bars evaporated as the office products sector moved offshore. In addition, the recession of this period impacted many other sectors of Banner's traditional clients and the result was a serious decline in Banner's revenues. By mid-2003, at the time I came upon Banner, its sales revenue had declined to an annualized pace of less than 17 million dollars. This was considerably less than what it would take to support its new facility. The then owner considered many options to deal with these conditions. Eventually, liquidation studies were conducted with the possible intent of simply ceasing to operate. Fortunately for the company and its employees, the ultimate result was a sale of the business to our group, led by me but heavily supported by Prism Capital and Alpha Capital Partners. Portions of the funds from Prism and Alpha used to support this purchase were provided by the Participating Securities Program.

The transaction to buy Banner from the Sneeden family occurred over the approximate time frame of May 2003 to September 2003. The early part of that period saw me working on dual fronts to negotiate with Mr. Sneeden on the terms of the sale, while also attempting to raise equity capital to anchor the financial structure and consummate the purchase. Armed with a Letter of Intent signed by Sneeden, the seller, I searched the financial community to attract equity investors to combine with capital of my own. The private equity investors are well established and well known in the Chicago market. I contacted firms such as Wynnchurch Capital Ltd., Cambridge Capital Partners, P.S. Capital Partners LLC, Cedar Creek Partners, LLC, High Street Capital, Tangram Partners, Inc. and others. However there was a very low level of interest in participating in this transaction. That low level of interest was in spite of my promise to not only invest my own personal capital in the venture, but also my full-time leadership as Chief Executive Officer. While I believe my considerable related experience was valued, the market for deals of this nature and size was very limited—limited because of the lingering recession, because of the reluctance of banks to extend debt financing, and because of the small size of the deal. It is commonly acknowledged in the traditional private equity community that small transactions are nearly as much cost and trouble as large ones, yet have considerably less upside. By June of 2003, I had found little solid support among equity investors for the Banner transaction and my window of opportunity described by my letter of intent was closing. It was at that time that I was fortunate enough to contact Steve Vivian of Prism Capital Mr. Vivian showed initial interest in the opportunity and frequently visited the company with me. He learned, firsthand, what the conditions at the company were. After developing more specific interest, we both met with Andrew Kalnow of Alpha Capital Partners to enlist his support and interest in joining with us. After careful and considerable investigation, Alpha Capital committed to investing equity capital to get this small but worthy transaction completed.

On September 3, 2003, the closing of sale occurred. What happened thereafter was and remains a wonderful success story. I would like to detail that success and offer my opinions as to why it has unfolded that way. During what remained, post closing, of the 2003 calendar year, Banner was able to make a profit and have a positive cash flow. Due to a firm financial structure, anchored by our SBIC equity investors, we had the time to carefully reposition the business and its intent. During the full year that followed

(2004) Banner was able to survive and thrive in an improving steel industry marketplace. By year end of 2004 Banner was able to regrow its sales revenue back to over $24,000,000 and more than double its free cash flow. We met every one of our debt financing repayments, increased our employment, added new products, and invested new money in new equipment. By year end Banner had purchased and installed a Twin Grip centerless grinding production line that cost in excess of $600,000. That investment arrived just in time to serve a strong 2005 demand for Banner's product and service offering. That investment provided work for machine riggers, electricians, plumbers, truck drivers, and others. Four new permanent jobs have resulted.

Further, this transaction, supported by SBICs Prism and Alpha, has created a new "class" of ownership at Banner. As part of the investor agreements developed by Prism, Alpha, and myself, four long-term employees of Banner became eligible to participate in Banner Holding Company's Management Common Unit Plan. This included one gentleman in excess of sixty years of age and one woman over fifty-five years of age. This plan also provides for future key members of Banner's management team to qualify for ownership if their contribution to Banner's future success warrants it.

In summary, as a result of the new ownership cooperation between Alpha, Prism and me, new life has been given to Banner Service Corporation. However, it is my opinion that much of the foundation underlying this success was the Participating Securities program and its cooperation with the small business community through SBIC licensees like Prism and Alpha.

Could it have happened without that specific source of equity capital? Perhaps, but when you consider the real alternatives, at that time, I doubt it. Let me explain why.

The Banner business was in decline, as I have already stated. The debt financing available without substantial equity investment was restrictive, nervous, and in short supply. A very basic tenet here is that equity investment was and continues to be a must for these transactions. Could there have been an alternative equity source to the SBIC licensed private equity? Perhaps, but unlikely. Traditional private equity does not seem to "like" small, basic manufacturing. In fact, it often does not like the Midwest as a region for reasons that are sometimes one and the same. Traditional equity investors often do not want this kind of small deal size or have the appetite for equity amounts needed to prevent the risk of excessive leverage. The desire for too much leverage would likely have prevented the Banner transaction from getting the debt financing required, especially when considering the lending environment at that time, the economic conditions and the company's recent decline. Prism and Alpha were prepared to commit sufficient equity capital to offset severe lender covenants that could have come into being if Banner had not been able to turn itself around quickly. What about so-called "angel" investors or high net worth individual investors? Perhaps, but undesirable to me due to future dependability and long term motives and purpose. The benefits of equity investment supported by the Participating Security Program were many when applied to the Banner transaction: patient, knowledgeable investors such as Prism and Alpha, the constancy of purpose of their SBIC license and use of that

equity capital, and the focus on small business deal size. It is my conclusion that the Banner story would be very different without the Participating Security Program. We will never know for sure. However, we do know that because of it, a viable small business, formerly in decline, is back growing, spending capital on business expansion, increasing employment, and regenerating itself after 44 years in business. Furthermore, that regeneration is in a responsive, niche business that will not be outsourced overseas. The nature of Banner's business model does not lend itself to long distance supply routes or long lead times. As a result of the equity financing provided by the Participating Security Program through Prism and Alpha, Banner has attracted strong senior management comprised not only of myself, but others we have been able to attract. It is further supported by an experienced Board of Directors where members of both Prism and Alpha serve. Together we plan further acquisitions in an industry many others do not care about or trouble themselves with. With help from the SBIC Participating Security Program, there could be many more stories like Banner. I sincerely hope there will be. Please consider us and those other small businesses when you consider the future of the Participating Securities program.

Thank you. It has been a privilege to participate in this process.

TESTIMONY BEFORE THE HOUSE SMALL BUSINESS COMMITTEE
APRIL 13, 2005
SBIC INVESTMENT AND US SMALL BUSINESS DEVELOPMENT
DR REDMOND CLARK, PRESIDENT
METALFORMING CONTROLS CORPORATION

My name is Redmond Clark. I am a resident of the State of Illinois, and I am president of Metalforming Controls Corporation, which is a venture-funded startup firm serving the metal stamping and die-making industries in North America. Our company sells a stamping press control system that allows metal forming operations to make stamped metal parts faster with fewer defects and less wear on the production line. Perhaps more importantly, our technology allows less expensive forming of high strength, lightweight steel that will reduce the weight of cars and trucks. That reduction in weight will not compromise the safety of the passengers, but it will reduce the fuel requirements of the US vehicle fleet. In doing so, our equipment will help to reduce the US dependency on foreign oil suppliers. Using US Department of Energy calculations, this technology could help to reduce US oil and gasoline consumption by almost one billion gallons of fuel annually.

Before I was the president of Metalforming Controls, I was president and CEO of the TDJ Group, which was and is a specialty chemicals manufacturer located in the Chicago area. This company has been an industry leader in the development, manufacture and sale of chemicals used to safely remove and detoxify lead paint from steel and masonry surfaces throughout North America. Lead paint is a significant threat to health of our children and the cleanliness of our drinking water. To date, company technologies have been used to clean more than 100,000,000 million square feet of lead painted surfaces, including such structures as the Seattle Space Needle, The Indianapolis 500 Speedway, the launch platforms for the Space Shuttle, and the hulls of the Trident Missile Submarine Fleet. In addition, this company has detoxified and/or recycled almost 1,000,000 tons of industrial hazardous waste.

I am here before your committee today to discuss the viability of the SBIC Program, and I am here to advise the committee as to whether the program should be funded in the upcoming federal budget for the 2007 fiscal year. Why is my testimony relevant to that issue? Simply put, those two companies that I managed would not be here today if SBIC funding had not provided the startup and/or turnaround capital required to make those companies successful. SBIC-backed funds provided a material portion of the money used during both company startups, and those funds attracted the rest of the investment dollars that got each company up, running and profitable.

THE CAPITAL LANDSCAPE FOR STARTUPS

I have spent the past 22 years working in the startup and growth company environment. During that period, I have raised almost $50,000,000 in capital invested into the businesses that I managed. During those 25 years, I have personally seen three trends that should be noted by this committee: institutional and private venture capital has

increased dramatically, capital availability has clustered on either end of the investment spectrum (Seed, Later Stage), and capital sources are clustered on the coasts.

As investors recognized the opportunities in venture investment, there was a steady increase in the dollars allocated for investment in growth companies (See Table 1).

Table 1: The Growth of Institutional Venture Investment in the US

	VC Investment ($ Billions)	Seed Investment ($Billions)	Seed Investment Percentage
1995	8.2	1.3	16.1
1996	11.5	1.5	13.2
1997	14.9	1.3	8.9
1998	21.4	1.8	8.5
1999	54.6	3.3	6.1
2000	105.9	3	2.8
2001	41	0.7	1.7
2002	21.6	0.3	1.3
2003	18.9	0.4	2
2004	20.9	0.3	1.7

Source: National Association of Seed and Venture Funds

In the past decade, venture fund investment has almost tripled in size to more than $20 Billion. With that kind of growth, it would appear that the venture capital community would eventually catch up with any demands for startup and growth capital. Unfortunately, a second industry trend ran in parallel with the growth in capital investment: the venture capital industry invested larger amounts of those dollars in later stage companies. The reasons behind the trend include lower risk, shorter investment timeframes, and limited high quality investment managers. Whatever the cause, the effects are obvious: the absolute dollars invested in early stage companies fell by more than 75% while total investment expanded by 250%. Early stage companies are having more trouble finding funds necessary to support startup activities.

Angel capital has received a lot of attention as a partial solution to this growing problem. Private investors have allocated meaningful amounts of money to support the startup effort, but even though the numbers of angel investors and angel organizations have grown dramatically, and estimates of the dollars available for investment exceed those of the venture capital community, there is still a hole in the availability of early stage capital. Historically, angel capital may cover early startup costs, but these angels typically do not have the ability and the willingness to follow-through with concentrated additional investment that precedes venture fund or bank investment.

This creates a funding gap for growing ventures in need of debt and/or equity investment. This is a space that has been occupied by a number of first stage funds, including SBIC-backed venture funds.

The third trend worth noting is the location of capital sources. As outlined in Table 2, the vast majority of venture funding is found on the west coast and in the Northeastern US.

Table 2: Geographic Sources of Venture Capital in the US: 1994 - 2004

STATE	NO OF DEALS	$ INVESTED ($Billions)	% OF TOTAL VENTURE INVEST.
CA	14381	133	41.8
MA	4175	33	10.4
IL	872	7	2.2
MO	235	2	0.7
TN	275	2	0.6
IN	101	0.6	0.3
KY	93	0.5	0.3
KS	76	0.5	0.1
NE	29	0.2	0.1
MI	28	0.3	0.1
AK	26	0.1	0.1

Source: National Association of Seed and Venture Funds

This table indicates that more than 50% of the venture investment over the last decade occurred in two coastal states: CA and MA. This table also shows that there are large areas of the US where venture capital is very hard to find.

CHALLENGES IN RAISING STARTUP CAPITAL

I have raised venture capital and angel capital on the east coast and in the Midwest. In the last two venture-funded companies I managed, these companies attempted to raise approximately $1,000,000 - $2,000,000 each in order to cover startup and growth related expenses. In the first case – The TDJ Group, a 1989 chemical management startup – we received our first backing from Moreamerica, a Cedar Rapids, Iowa SBIC fund formed in 1959. No first stage money was found in Chicago, Minneapolis or St Louis. Through the support of Moreamerica and an Iowa-based, state-run venture fund, the additional funding requirements for the company were ultimately obtained from a small, east coast fund. Without the capital and support of the SBIC organization, the TDJ Group would not have existed.

My most recent company – Metaldforming Controls – sought $2,000,000 from venture investors in the greater Chicago area. The bulk of the funding necessary to start the company came from AAVIN Venture Fund in Cedar Rapids, Iowa. This fund is also an SBIC-backed investment fund. Through their leadership, we were able to bring in money from the State of Illinois and a new angel fund that started operations during the first year of our own operations. When a second round of funding was required to grow the business, the SBIC-backed fund continued in a leadership role, while the angels declined further investment.

Without SBIC investment, these companies would not have survived. Although they are not huge, they have generated more than $50,000,000 in sales, millions in taxable profits, more than $10,000,000 in payroll and income taxes, and directly or indirectly employed

more than 50 people. Those companies detoxified and/or or recycled almost 1,000,000 tons of industrial or toxic waste. Those companies are making significant headway in reducing oil consumption and greenhouse gas emissions. Without SBIC involvement, these numbers would be zero.

CONCLUDING THOUGHTS

If my experience is a guide, I can offer the following thoughts about SBIC-backed investment funds;

- The SBIC supports a national availability of venture capital. Those funds are available to competent investment fund managers in any state.
- A significant number of SBIC – backed funds seem to be biased towards seed and first stage investment, with median investments in the $500,000 to $1,500,000 range, roughly double that of the angel community. That figure does not include follow-on investments by those funds. This covers a large portion of the funding gap referenced in this testimony
- SBIC investment in small to medium sized funds ($10 – 25 Million dollars) exceeds $800,000,000 annually (Source, SBIC 2003 report), which is a major fraction of the seed/first stage dollars invested by the entire venture capital industry each year.
- SBIC – backed funds are found in all 50 states
- Their geographic diversity often places licensees in markets where capital availability is a critical limit to the success of startups. If I may offer an analogy, the professional baseball leagues do not find all of their talent in a handful of states. The same is true for entrepreneurs and the businesses they run. The SBIC has made my companies a reality in spite of the locations of the businesses.
- The entire venture capital community has passed through periods of better and worse performance, because that industry is subject to business cycles too. The total investment in the venture capital industry is still increasing, even after the effects of the industry bust after the bubble. Recent SBIC performance is not necessarily a guide to future performance, as long as the program works to fund competent managers and business concepts.

We are beginning to understand how important small companies are to the strength of the US economy. We already know that unavailable risk capital is a significant limit to growth for most startup firms, and we know that well run SBIC licensees can provide that capital to promising startups. It would seem imprudent to cut back or terminate such a program, especially as we see global competition in almost every corner of our economy. Thoughtful investment of SBIC venture capital during business evolution fuels technology change, economic growth and competitive advantage.

Testimony of Daniel W. O'Connell before the House Small Business Committee
April 13, 2005

Chairman Manzullo, Ranking Member Velazquez, and Members of the Committee

Thank you very much for this opportunity to testify at the hearing of the Committee on Small Business of the United States House of Representatives regarding the importance of the participating securities program. My name is Daniel W. O'Connell. I am currently the director of the Stanley C. Golder Center for Private Equity studies in the College of Business at the University of Illinois at Urbana-Champaign. This Center, through a combination of education, research and outreach initiatives, focuses on the issues, roles and impact that the private equity community has in supporting new and growing businesses, as well as in the recapitalization and restructuring of existing enterprises.

More than thirty years ago, I was introduced to the venture capital industry when, as a summer intern in 1973 at the then First National Bank of Chicago, I was asked explore whether or not the Trust Department should be involved in the venture capital industry, and if so, how. In my subsequent white paper, I argued that it should, and presented a strategy by which it might proceed. After graduation in 1974, I returned to the Trust Department, and, eventually, served as the venture capital asset class manager executing the strategy I had recommended. During the five years of my leadership, our team made more than fifty investments into both venture capital funds and individual companies. In 1984 I left First Chicago to co-found Alpha Capital, which was one of the first licensed partnership-form SBIC's. My partner and I formed Alpha in order to take advantage of an opportunity we perceived to serve the needs of small and early stage companies in the Midwest. During my time with Alpha, I was a NASBIC governor, and in the early 1990's, I had the honor to serve on a committee whose work ultimately led to the creation of the participating securities program. In 1993 I left Alpha to join Allstate's private equity unit, a group which, I believe, at the time of my arrival was the largest venture capital pool between the coasts. Upon Allstate's departure from the private equity business at the end of 1999, I joined Capital for Business, an SBIC focusing on buyouts and expansion financings of primarily smaller Midwest-based manufacturing businesses. Over the years, I have been all around the venture table, acting at various times as a general partner, a limited partner and an investor in a wide range of private equity situations.

These past thirty years have been a time of incredible expansion for our industry. Dollars under management, dollars invested, companies created, number and types of limited partner investors, number of investment professionals, and the size and character of supporting infrastructure have all grown dramatically.

During this period there has also been a huge broadening of investment strategies. At First Chicago we felt we were ahead of our time because we preferred to refer to what we did as the deployment of "risk" or "development" capital, not just "venture" capital. Today, private equity, broadly defined, includes a broad spectrum of possible investments, ranging from angel and earliest stage start ups through and including huge international multi-billion dollar buyouts.

Yet while the industry has expanded dramatically, it remains fundamentally "granular". That is, there exists a immense matrix of possible investment strategies described across multiple dimensions: size of investment, size of company, stage of company, industry, geography, level of ownership, character and degree of investor involvement, to name a few. And while the dollars under management have grown substantially, over the years many of these dollars have flowed into a relatively few, established private equity groups. The resulting competition for the remaining available dollars encourages general partners to identify niches in which they feel they can compete more successfully. I can only see this trend toward specialization continuing. The best private equity managers recognize that they are in a business. As such, they identify an attractive and defensible opportunity, create a strategy and plan, and assemble a team and the resources to capture the opportunity. It was, and still is, true that successful execution of a private equity group's business strategy requires an underlying match of its human and financial capital to the needs of its chosen niche.

Over these years we have endured several venture cycles in which I have seen it, at one end, incredibly difficult for good investors to raise money and, at the other, incredibly tempting to compromise one's discipline and strengths in order to make investments in overheated, very challenging markets. Always, but especially in between these two extremes, there can be something almost magical that occurs when all the elements of a good investment come together to create, sustain or grow worthy businesses.

So what do these have to do with the participating securities program? In my experience at Alpha, it was conspicuous to those of us using SBA debentures that there was a problem when we wanted to invest in situations characterized by high risk, high growth and potentially high returns; i.e. venture or growth companies. From one perspective, it made little sense for an SBIC to **borrow** money – which implies some sort of reasonable expectations as to timing and probability of collection – to make an investment in a company that by its stage and character made such expectations unpredictable or unrealistic. Those companies required **equity**. There was a fundamental mismatch between our source of funds (SBA debentures) and our uses of those funds (equity investments). Did we make those investments anyway? Yes, we did, but in less than optimal ways. We tolerated more risks at the fund level; we acquired notes from our portfolio companies, and over funded the equity piece in a company investment in order to mitigate some of these risks. In my opinion, the participating securities program was intended to provide a better match between the nature of the funds (i.e. long-term, patient, equity-like dollars) provided to the SBIC and the realistic dynamics of the businesses into which the SBIC would invest.

So, is there still a need today for this kind of program? Absolutely. If anything, the increasing specialization of our business suggests an even greater need. From my experience, SBIC's fill important pieces of the private equity matrix. They tend to be more geographically focused, and in regions under served by other sources. Because they have learned how to prosper from exits other than the public market, they are more comfortable with smaller businesses, and with businesses in industries (like manufacturing) or niches of a size that typically do not represent IPO potential. And because SBIC's manage smaller pools of dollars, they tend to make smaller investments, on average. Once in an investment, SBIC principals often deal with value creation needs somewhat different than those of traditional vc's. For example, at CFB we felt a significant element that we brought to the table was our ability to take a small, owner operated business to the next level by developing in place management, judiciously adding to the team over time, and refining or putting into place the financial and managerial controls, processes and disciplines necessary for growth. Could and do traditional venture funds and the larger buyout groups make these kinds of investments? Yes, from time to time they do. But only when it is easy for them to do so. It is just not time or dollar efficient for them to aggressively make the kinds of investments that an SBIC was formed to do.

Regarding how the program might be more effective going forward, I wish I had more specific knowledge so I could make tighter suggestions. In any case, I would like to make a couple of observations. First, I believe it is absolutely critical that there be a match between a private equity fund's sources of capital and its uses as seen in the investments it intends to make. On any private equity fund's balance sheet, there is largely sweat equity brought to the table by the managing principals, risk capital (equity) from the fund's limited partners, and, if used, somewhere in between might appear dollars from the SBA. If you expect the SBIC managers to make relatively high risk, low liquidity, long term, but potentially high return, i.e. equity, type investments, then the SBA dollars that might be used should patient, long term, and risk tolerant.

In any company situation seeking funds from a diverse set of players, there are pricing and term issues. So it will be here. To be successful, all parties to the transaction must feel there is a fair and reasonable sharing of risks and rewards, and that there is reasonable oversight and controls consistent with a player's position in the transaction.

When I look at the SBA itself, my experience would suggest several things. First, because of the risks and illiquidity involved, it is essential that any pool of private equity investments be broadly diversified, both by character (industry, stage, etc.) and over time. Second, there is a need to be patient. Interim results – good or bad – can be very misleading in the private equity business. It is only when you have finally and completely exited an investment that you are able to determine its success. A rush to decision in the middle of the investment process nearly always results in suboptimization over the long run. Both of these issues are portfolio management challenges which are best met by having a staff of experienced professionals. And to build and keep such a staff, it would appear to me, requires a long term commitment to the SBA itself.

Finally, if we in the industry are going to ask for patience and flexibility from our backers, we must do everything we can to earn and sustain their trust. It is thus incumbent upon us to rigorously adhere to the highest management and ethical standards, and to accumulate and share appropriate information that shows the continuing value of our efforts.

In conclusion, thank you, again, for this opportunity to share my experience and thoughts. I truly believe that there is a continuing need for SBIC's that lever their private capital with equity-like SBA dollars. I also believe that the SBA has been a productive and valuable partner. And while there are certainly things that can and should be changed, the goal of having a program to support the creation and support of America's small businesses is worth the effort.

At this time I would be pleased to address any questions the Committee might have.

September 9, 2004

President George W. Bush
1600 Pennsylvania Avenue, NW
Washington, DC 20500

Dear Mr. President:

We have recently learned that there is now a debate within the Administration concerning the economic justification or "need" for SBA's Participating Security SBIC program. NVCA believes strongly that this program fills a void which non-SBIC venture funds are unable to fill. We request that our views be taken into consideration when you formulate the Administration's final position on this issue.

NVCA is the only organization that represents the overall venture capital and private equity industries in the U.S. As such, we believe NVCA is uniquely qualified to address the "need" question relative to the SBIC program. As part of our mission we track the flows of venture capital throughout the country on an quarterly basis and publish our findings so that government and industry leaders can better understand and appreciate the critical role venture capital plays in U.S. job creation and economic growth. In addition, reports such as, "Venture Impact 2004," issued July 20, 2004 demonstrate that venture capital continues to play a critical role in encouraging growth of the U.S. economy and contributing to job growth and technical progress.

With that brief background, let me turn to the three reasons we believe there is a role that the SBIC program fills within the private equity universe for the Participating Security SBIC program:

1. First, Participating Security funds make equity investments in smaller increments than do the large majority of non-SBIC venture funds. This is of critical importance to very small companies, particularly those not in high-technology industries, which require equity financing rounds in the $1.0- to $5.0 million range. That range of investing is generally not attractive to major non-SBIC venture funds, but one that is critical to help grow the business to a level that will eventually attract the interest of non-SBIC funds.

2. Second, SBICs, including Participating Security funds, make investments in areas of the country that are generally not served by the large majority of non-SBIC venture funds. For example, companies in California and Massachusetts received 52% of all venture capital invested during the period FY 1994 – FY 2002. During the same period, SBIC's invested 71% of their capital in companies outside of California and Massachusetts. Since there is no way to tell in advance which small companies will grow to tomorrow's large public success stories or simply important regional employers, nurturing companies in all segments of the country is important.

3. Third, SBIC's support a much more diverse segment of small businesses than do non-SBIC venture funds. In recent years, non-SBIC funds have concentrated their

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investments in the NAIC fast growing critical sectors of "Communications & Computers" and "Life Sciences." In contrast, SBIC's have invested approximately 50% of their funds in NAIC sectors "Manufacturing" and "Consumer Related." While there is overlap, it is clear that the SBIC program addresses the capital needs of many small businesses that are in industry sectors generally not attractive to non-SBIC funds.

In conclusion, the Participating Security program is a small but important part of America's overall capital structure. We urge the Administration to support continuation of the program and to work with all the program's stakeholders to secure the legislation necessary to achieve that result.

Thank you for your consideration of our views. We are available at your convenience to discuss the points made above or to address other issues the Administration believes are relevant to make a final decision on the future of the Participating Security SBIC program.

Sincerely,

Mark Heesen
President

cc: Hector Barreto
Joshua Bolten
Daniel Heath
Hon. Donald Manzullo
Hon. Olympia Snowe