A study of song problems of small business investment companies, 1959 - 1965

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DEDICATION

This paper is dedicated to my parents, Mr. and Mrs. Obie Washington, whose love, inspiration, understanding, and efforts have made possible whatever I have accomplished.

I. W.
ACKNOWLEDGMENTS

The co-operation of the following persons who have read this paper, made constructive suggestions, and helped in numerous other ways is appreciated.

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CHAPTER I

INTRODUCTION

Historical background of Small Business Investment Act.--The Small Business Investment Act of 1958 evolved from a variety of bills introduced in both houses of Congress several years before 1958. It can be safely said that its principles and concepts had been seasoned by considerable committee and floor debate. Some of the momentum for legislation on behalf of small businesses was originated as early as 1950, when President Truman delivered a message to Congress which concluded that the financial institutions were not meeting the expansion needs of small business and that legislation was needed to fill the gap.1 After establishment of the Small Business Administration's loan program, government leaders were approached by several business associations, which argued for an additional program designed to make equity capital available to small business on better terms.

Partly on the basis of these arguments, Congress sponsored a series of public hearings throughout the country. In addition, a significant study was conducted by the Federal Reserve Board. The hearings and the study concurred in finding that small businesses played a large

and important role in the economy; that industrial concentration and the rising complexity of operations—legal and tax—tend to jeopardize the vitality of small business; and in particular, that the mainstream of institutional and public financing within the country was directed toward the financing of large corporations.²

With these findings in hand, two legislators, Wright Patman (D., Texas) in the House of Representatives and John Sparkman (D., Alabama) in the Senate started their fight for legislation. To compensate for the risks and headaches involved, they persuaded Congress to authorize the new kind of investment company.³ The Small Business Investment Act of 1958 (Public Law 85-699) was signed into law on August 21, 1958, less than seven years ago. The text, explanations, and provisions of the law cover a 17-page government publication. Some of the important points under the Act and some Small Business Administration regulations will be given in this paper. Other legal points will be mentioned throughout the study.

Small Business Investment Act.—The Small Business Investment Act of 1958 represents the most significant piece of legislation dealing with the economically important and politically sensitive issue of small business in many a year.⁴ Enactment of the law was aimed at stimulating and supplementing the flow of private equity capital to smaller firms

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²Ibid.


which frequently encounter difficulties in obtaining needed funds from conventional lending sources. The Act, which is administered by the Small Business Administration, establishes procedures for federal licensing of small business investment companies whose function is to provide capital and management services to fledgling enterprises. The following paragraphs will set forth some provisions and regulations of the Act.

A small business investment company must have a minimum paid-in capital and surplus of $300,000 and, to supplement funds provided by its stockholders, it may borrow up to four times its capital and surplus. Moreover, upon certification that the company is unable to borrow needed operating funds from private sources, the Small Business Administration may lend it up to 50 per cent of the firm's paid-in capital and surplus or $4,000,000, whichever is less.\(^5\)

The small business investment company can aid the small businessman in these ways: making long-term loans, purchasing convertible debentures or equity-type securities and providing management counseling services.\(^6\) Under the Small Business Administration’s provisions, the capital needy business must meet these tests: it must be privately owned and operated, it cannot be dominant in its field of operation, and it may have total assets not exceeding $5 million and average annual earnings after taxes over a three-year period of no more than $150,000.\(^7\)


\(^6\) Ibid., p. 51.

\(^7\) "SBIC—New Investment Force," op. cit., p. 28.
Essentially, the backbone of the law is embodied in the special tax concessions which permit write-off of capital losses against ordinary income and the conversion of any current dividend income into capital gains through complete corporate tax exemptions and allowance for full retention and reinvestment of such earnings. Interest income is normally taxed but may also be retained.  

Since 1958, the original Small Business Investment Act has undergone three major revisions—one in each of the succeeding Congresses. These revisions will be discussed later in detail. The changes in the law afford concrete evidence of the continuing interest of the Congress in the small business investment company program. All of the ins and outs of the law are by no means covered by points mentioned in the preceding paragraphs, but they do serve as a brief summary for introductory purposes.

Statement of problem.—A burst of new interest in small business financing problems developed throughout the country in the wake of Congress' enactment of the Small Business Investment Act of 1958. The business community's reactions to the Act were swift and pronounced. A flood of articles appeared in the business and financial press generally acclaiming the bill as opening new avenues for small business financing and magical capital gains for investors. While many responses were openly enthusiastic, others ranged from mildly cautionary to outright condemnation. This is an index of the community's interest in

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8Small Business Investment Act, op. cit., p. 52.

the bill in these early stages of its functioning. From inception the small business investment industry and the Act itself have been the subjects of much discussion as to their adequacy. The new industry has had its share of problems and growing pains as it has attempted to establish itself among other financial institutions as a source of funds for small business and as an investment outlet. Specifically, some problems have been: getting sound management for the investment companies, complying with legal requirements, making safe and flexible investments, finding a market for public companies' securities, and maintaining a favorable public image.

Purpose of study.—This study will attempt to identify and provide insight into the nature and significance of some problems of small business investment companies from 1959 to 1965. Also, steps taken by the companies and government to alleviate problems will be pointed out. In general a growth study of some problems of small business investment companies will be presented.

Limitations and definitions.—The time span covered in the study will be from 1959, the year in which the first small business investment company was licensed, until 1965 or the period in which this author can acquire the latest available information on the subject. This study will not necessarily be presented in yearly sequence in all cases because some of the problems experienced in 1959 still prevail and others cover more than one year. In this study the abbreviations (SBIC) and (SBA) mean Small Business Investment Company and Small Business Administration, respectively. The term "small business" shall have the same meaning as in the Small Business Investment Act.
Significance of study.—The author feels that the information contained in this study can be useful to persons desirous of operating an SBIC and to interested students of business. An understanding of the growth problems of a new institution can be helpful for future operations.

Method of procedure.—An attempt will be made to review the nature of SBIC's so as to gain insight into their problems and practices. Primary research sources are business and financial periodicals. Other sources include government publications, books, case studies, and personal interviews.
CHAPTER II

MANAGING AN SBIC

At least three distinct species of SBIC's have developed. The Harvard Business Review refers to them as the "Pro Bono Publico," the "Collateral Advantage," and the "Profit Motive" types. The Pro Bono Publico company would measure its success in terms of community growth, additional jobs created, and higher per capita income. A second SBIC is the kind organized for the purpose of securing collateral advantages for its owners. The majority are organized by banks as substantially wholly owned affiliates. The "profit motive" or venturing SBIC has attracted the bulk of attention which has been directed toward the Small Business Investment Act. They are essentially concerned with making capital gains.¹

Regardless of the type of SBIC's organized, they require essentially the same breed of managers. Arthur Wiesenberger, author and investment expert, had this comment on managing an SBIC.

Successful operation of an SBIC requires an unusual brand of management ability to cope not only with the financial problems of the SBIC itself but also with specific and often esoteric problems of individual portfolio companies.²


Finding men who possess this unusual brand of management is a prerequisite for successful operation of an SBIC. Good management is most important and good management is worth paying a premium for. Efficient and ethical management of SBIC's is a problem that has plagued the SBIC industry since inception.

Wendell Barnes, head of the SBA in 1958, in telling the American Management Association how the SBA planned to administer the Small Business Investment Act pointed out good management as an ingredient of success. He stated that his agency intended to make certain that the companies have the best possible management talent available. Successful operation involves more than the obtaining of funds from the government or other sources. It involves also an extensive knowledge of finance and the management of financial institutions, plus a knowledge of business and business administration with all its ramifications.\(^3\) A good many SBIC's have been and are being run by businessmen with long records of success in big enterprises but some have been operated by lesser men. Many SBIC's have been set up by obscure businessmen who operate on the local level. In such cases the ability of management is unknown.\(^4\)

Since it was a relatively simple matter to establish a company with access to government credit, "get rich quick" operators—some of whom had little experience in the intricacies of investing—entered the field. Some were interested in the leverage potential in an SBIC which

\(^3\)Wendell B. Barnes, "How the SBA Will Administer the Small Business Investment Act," Commercial and Financial Chronicle, December 18, 1958, p. 3.

could borrow several times the amount of its own capital and surplus. From the backgrounds of the officers and directors of some SBIC's, it would also appear that it has been popular to use big name directors as "window dressing." In these companies the big names were very active in other major businesses and actually devoted very little of their time and energy to making a success of the companies which they served as officers and directors.5

Perhaps the most serious flaw of all was a fact that seemed to have eluded the SBIC founders and the well-intentioned politicians who sponsored the program—namely, that investing is a difficult and intricate field at best and that the problem of finding suitable investment opportunities would be greatly intensified by a proliferation of SBIC's.6

Alan Harris, an area coordinator of the SBIC program for the SBA, stated that the minimum capital requirement of only $300,000 has allowed some persons to start SBIC's who are incompetent as investment managers. Many were looking for get rich quick ventures. He also stated that some operators are still too conservative in a business where one must be willing to take a risk with venture capital. Mr. Harris cited the instance of a Birmingham operator turning in his license. The president of the company said that the company had sufficient funds but the officers found out that they were in the wrong field. They were afraid to invest the money.7

7Interview with Alan Harris, SBA's Area Coordinator of SBIC Program, Region V, June 9, 1965, Atlanta, Georgia.
Among SBIC managements and stockholders, patience must certainly be a virtue. Investors who are used to thinking of capital gains in terms of six-month periods will have to adjust their sights to upwards of four or five years holding duration. Much longer investment experience undoubtedly occurs. "We plan to invest in growth situations; taking capital gains after three years" was a characteristic and oversimplified sentiment frequently seen before certain investment facts of life became more widely known.8

Ordinarily the small firm is initiated by an ambitious specialist, an investor, an engineer, a sales manager, or a production expert. As the firm grows, the need for capable executives in all the functional fields of management becomes as urgent as its requirements of additional capital. The SBIC must supply both factors to its clients to enable them to succeed as well as protect its investment. Hence it must maintain a staff of management experts who can help the client in planning, organizing, staffing, and controlling his operations.9

The SBIC industry claimed that the government's restriction on granting stock options to key employees hindered them from attracting and retaining highly qualified professional personnel. They felt that stock option plans had become commonplace in the United States' corporate life because they provided strong incentive to key employees to do their best to increase the earning power of the business they served. The industry felt that they should not be handicapped in competition with

8 Donham, op. cit., p. 98.

other institutions by an inability to offer stock options. They felt that stock options were desirable inducements to the maintenance of a high caliber staff by an SBIC.\textsuperscript{10} The government has given in to the industry's demand and now allows the granting of stock options to key company employees. At least one SBA official feels that the demand for stock options was unreasonable. He feels that since the key employees of an SBIC are usually the owners of the company, they do not need to be granted stock options.\textsuperscript{11}

Government officials are concerned about the unethical management of some companies. Abuses have not been widespread but it only takes a few publicized instances to help tarnish the public image of SBIC. In 1963, officers of the Midwest Capital Corporation were indicted for allegedly embezzling the company's funds. This was the first such action involving an SBIC.\textsuperscript{12} In Cleveland, SBA officials stumbled across the sobering news that a "wheeler-dealer" had skipped town with $300,000 of Cosmopolitan's funds. Down South, the head of the First Louisiana Investment Corporation was accused of reporting a fictitious $47,000 loan.\textsuperscript{13}

The SBA does not allow ill-conceived loans and "self dealing" transactions in which the SBIC directors approve loans to companies.

\textsuperscript{10}Ibid.

\textsuperscript{11}Interview with Alan Harris, SBA Area Coordinator, June 9, 1965.


\textsuperscript{13}L. A. Armour, "Businessmen's Risks: Prospects Are Brightening for the SBIC's," \textit{Barron's}, XXXIV, April 6, 1964, p. 3.
which they control. In 1964 the Securities and Exchange Commission filed a civil suit charging James J. Ling with profiting from personal transactions in the stock of Tamar Electronics Industries, to the alleged detriment of Electro-Science Investors, an SBIC of which Mr. Ling was an officer and director.\footnote{SBIC's Getting Off the Ground?, op. cit., p. 7.}

There have been some plus factors in the management of SBIC's. One successful company, San Diego's Electronics Capital Corporation, has managed to get a combination of capital plus brains. It is one of the first and largest public owned SBIC's. They believe that a company should specialize in a field where they can offer expertise—in Electronics Capital's case—in the electronics industry. Like many SBIC's, Electronics Capital has backers who are well equipped for their jobs. More than most, the founders have gathered around them a talented assemblage of financial, legal, and electronics specialists. This type of management has paid off for Electronics Capital Corporation.\footnote{An SBIC Thrives on Electronics, Business Week, April 9, 1960, p. 49.}

Another well managed company is Growth Capital Corporation of Cleveland. They have a staff of over 15 persons including engineers, management consultants, attorneys, marketing specialists, CPA's, and credit investment analysts. With this staff they have been able to provide not only financial assistance but management counseling and direct aid in specified management fields.\footnote{James W. Howard, "SBIC's--Their Problems and Prospects," Burroughs Clearing House, XXXVII (October, 1962), 38.}
In July, 1964, in a dramatic step the SBA slapped a 90-day moratorium on issuing new licenses for SBIC's. The moratorium gave the SBA a chance to write stricter rules for licensing SBIC's. In 1964 the SBA announced a revised set of standards for new licensees. Now a company must have a full-time responsible officer in charge of operations who has had at least five years of experience in a commercial bank, investment bank, or a comparable organization. At least three stockholders who are not close relatives must be had. The company must maintain office hours open to the public. Most officers of bank affiliated SBIC's have the necessary background but they have found that experience in commercial loan departments of a bank does not provide sufficient background for SBIC management.17

Richard E. Kelley, an industry consultant and acknowledged authority on SBIC's, was appointed as deputy administrator of the SBIC program in 1963. He was responsible for the halting of new licenses and the writing of stricter rules. During the 90-day moratorium on issuing new licenses a major SBA problem was what to do with some SBIC's that were generally inactive. They had no plan to lift licenses from inactive SBIC's, the SBA wanted to find out which ones would just as soon quit the program. They have been encouraging new applicants for a license to buy out the inactive SBIC's, rather than start from scratch.18


According to SBA official Alan Harris, there has been a 25 per cent turnover of SBIC licenses. But in most cases the SBA has been successful in getting new applicants to buy the companies. He also stated that he believes that the stricter rules for granting new licenses has resulted in better SBIC management.¹⁹

¹⁹Interview with Alan Harris, SBA Area Coordinator, June 9, 1965.
CHAPTER III

PROVIDING ENOUGH FUNDS

The problem of SBIC's providing enough funds for small businesses can be looked at from many sides. There have been mixed reactions on the part of government officials concerning the performance of SBIC's in carrying out the purposes for which they were created. Some have been critical of the shortcomings of the SBIC's and the laws that govern them. Others have expressed satisfaction and optimism. The industry has complained about restrictive regulations and the difficulties in obtaining funds. While some critics have accused the SBIC's of hording funds, the SBIC's have claimed difficulties in finding suitable investments. The amount of money that SBIC's can invest in small businesses depends mainly on the amount of funds the SBIC's have on hand or have access to. The sources of funds for SBIC's have been the Small Business Administration, private capital of owners, bank funds for wholly owned SBIC bank subsidiary, banks that invest in privately owned companies, other institutional lenders, and the public. A separate chapter will be devoted to problems of public sale of SBIC stock.

Under the original Small Business Investment Act of 1958 an SBIC had to have a minimum paid-in capital and surplus of $300,000 with $150,000 required to be obtained from private sources and $150,000 could
be gotten from the SBA by selling them subordinated debentures. Moreover, upon certification that the SBIC is unable to borrow needed operating funds from private sources, the SBA may lend it up to 50 percent of the firm's paid-in capital and surplus including the amount provided by the SBA. A minimum capital SBIC with an initial investment of $150,000 could be potentially leveraged up to eleven times under the SBA rules.

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<td>$1,200,000</td>
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Potential loan from private sources: up to 4 times paid-in capital and surplus.

Loan by SBA at 50% of paid-in capital Matched by SBA

Stockholder's Equity Investment

Perhaps the most telling criticism that has been directed at SBIC's is that they are not fulfilling their purpose. A study by the

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1 Small Business Investment Act, op. cit., p. 53.

Denver Research Institute under the SBA Management Research Grant Program, for example, concluded that SBIC's generally are following overly conservative lending policies. They hoard cash until they find a deal so safe that a bank would lend money on it or a brokerage house handle an underwriting.\(^3\) A study by a Harvard professor and doctoral candidate concurred with the findings of the Denver Research Institute. Their findings said:

For good or for bad, SBIC's appear to be taking on some of the more conservative aspects of financial institutions in their efforts to operate efficiently and reduce risks. And these tendencies raise some question as to whether SBIC's are effectively accomplishing the task of helping to finance the long run capital needs of the United States' small business community.\(^4\)

Senator William Proxmire (D.-Wis.), chairman of a subcommittee of the Senate Banking and Currency Committee, has been an outspoken critic of the SBIC program. He stated that "the SBIC program has been of little help to the really small businesses." He was disturbed by the number of large loans being granted and felt that Congress should make it clear that these loans should go only to the truly small business which simply cannot secure funds elsewhere.\(^5\)

Within the broad definition of what constituted a small business there were apparently some differences of opinion as to what type of

\(^3\) Denver Research Institute, The Financial Gap—Real or Imaginary, August, 1965, p. 12.


small business the SBIC's were supposed to concentrate on financing. To some it seemed clear that Congress was mainly concerned about the small, one-man-managed business since it gave maximum leverage of government funds to the minimum capital SBIC's that by law could not make a single investment of more than $60,000 (20% of the $300,000 capital and surplus). The organizers of the larger SBIC's who went to the market and obtained large sums of money from private investors apparently had no such understanding. They began to make much larger investments in better established companies which were on their way to becoming major corporations.6

In 1961 Senator John Sparkman said that "the honeymoon is over on this program." He said that "it is not quite fair to characterize the program as a complete failure," but he added that "it has not had the success that we all visualized." Ninety SBIC's were organized in 1959 and had about $50 million in capital and surplus, $8.7 million of which had been supplied by the SBA. One third had been loaned out to small businesses. This was just a drop in the bucket, far below the most conservative projections. Officials at SBA were somewhat disappointed at this growth rate. But Duncan Read then in charge of the program looked upon SBIC's as a "hopeful experiment," saw "nothing wrong with the program," and was optimistic about its future.7

In contrast, a Business Week survey in 1960 showed that most of those actually operating the companies thought the program needed a good

6Hayes and Woods, op. cit., p. 11.
7"SBIC's Seek Changes to Survive," Business Week, April 9, 1960, p. 43.
overhaul. Their most frequent complaints were: difficulties in raising ample capital, coolness toward the SBIC's as a financial risk by the rest of the financial community, and the jungle of red tape that surrounded the program. If the program is to succeed for meritorious small concerns, they said, it must be reshuffled and strengthened.8

A study was made of eight publicly traded SBIC's that had been in business long enough to develop meaningful data. The majority of the information was based on reports of March 31, 1961. At the date of study, these companies had been in business an average of nine months. Some had invested as much as 80 per cent and some as little as 10 per cent of their funds in small businesses. The average investment was 40 per cent of total funds. The average period of time required for the investment of a $5 million or larger SBIC was projected to be two years.9 To further support the allegation that the SBIC's were hoarding funds, in 1963 the public owned companies had invested in only about 775 businesses and a great number of the borrowers were real estate ventures.10

To support the SBIC's, SBA official Alan Harris said that the SBIC's were doing their jobs but not as well as they would like. But he added that the SBIC's are doing a tremendous job considering that in 1965 the average age of SBIC's is 3½ years and it takes time to make full investment of funds. He cited that some small businesses are not

8Ibid.
10"SBIC's Short Lived Glamour," op. cit., p. 10.
interested in borrowing because of false tales of SBIC's charging too much interest and wanting to take over their businesses.\textsuperscript{11}

Wendell Barnes, SBA Administrator in 1958, immediately following the passage of the Small Business Investment Act observed that:

One of the essential ingredients of an investment company to be successful is the availability of funds in large amounts exceeding those mentioned in the Act as a minimum requirement. Access to additional funds will enable a company to provide additional capital or credit to a company which it sponsors.\textsuperscript{12}

These additional sources of funds have not materialized for the SBIC's. In 1960, 80 per cent of the SBIC's had put up only the minimum $300,000. A number of these already had fully committed themselves to borrowers--leaving them with no funds for the scores of new applicants.\textsuperscript{13}

In 1962, an SBIC operator said that when the industry is dependent upon obtaining financial resources from the Federal Government, the industry is beset with problems and restrictions of a political nature that limit their effectiveness.\textsuperscript{14}

To show the dependence of SBIC's on Federal funds, a study was made by Dr. S. J. Flink, a business professor at Rutgers University. His 1964 study revealed that bank affiliated SBIC's had practically no dependence on Federal funds. SBIC's that were not affiliated with banks obtained more than $110,000,000 from the SBA as part of their capital

\textsuperscript{11}Alan Harris Interview.

\textsuperscript{12}Barnes, \textit{op. cit.}, p. 4.

\textsuperscript{13}"SBIC's Seek Changes to Survive," \textit{op. cit.}, p. 44.

\textsuperscript{14}Stewart Devore, "Essential Role of SBIC's," \textit{Commercial and Financial Chronicle}, September 6, 1962, p. 3.
and more than $55,000,000 in loans. Bank affiliated companies drew less than $10,000,000 for capital and less than $3,000,000 in loans.\textsuperscript{15}

Those SBIC's with most of their funds already invested needed additional capital above Federal funds to finance future investments. The natural channel of the public equity market was closed to most SBIC's because of the stock crash in 1962. Banks, insurance companies, and pension plans failed to invest heavily in SBIC's.\textsuperscript{16} The government and the SBIC industry have taken steps to increase the availability of funds. The industry has taken merger steps and joint participation in investments. The government has made changes in the laws governing SBIC's.

In 1961 James Snyder, investment specialist and underwriter, advocated the merger of companies in SBIC portfolios. He said that Electronics Companies can be merged with other electronics companies to make stronger units and speed up the growth process. It may also be possible to make some consolidations within one's own portfolio "combining other product lines which fit, again all for the purpose of making a larger or stronger unit or a better unit." He suggested that this would improve the ultimate prospects for the company and help the SBIC work out of its warrant position. It was difficult for Mr. Snyder to see markets returning to their 1961 level.\textsuperscript{17}

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\textsuperscript{15}Presley, \textit{op. cit.}, p. 59.
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\begin{flushright}
\textsuperscript{16}Hayes and Woods, \textit{op. cit.}, p. 12.
\end{flushright}

\begin{flushright}
\textsuperscript{17}James E. Snyder, "Future SBIC Prospects," \textit{Commercial and Financial Chronicle}, August 23, 1962, p. 3.
\end{flushright}
Deputy SBA Administrator Richard Kelley recently openly encouraged the mergers among smaller SBIC's. The industry thus far has seen only one successful big merger. In 1962 Narragansett Capital Corporation acquired Empire Small Business Investment Company's $2.6 million in assets. But the merger route is difficult even for big companies to work out and hasn't been widely followed. Bon Ami Company, an industrial concern, talked merger with San Diego's South-Western Capital Corporation, but the deal fell through because of too many problems.18

There is difficulty in agreeing on terms, coupled with incompatibility of the portfolios of different SBIC's both in terms of industries represented and remote geographical locations. So, for many SBIC's, the interest in mergers may represent less an enthusiasm for expansion than a barometer of dissatisfaction with congressionally imposed size limitations and the unreliability of primary financing sources.19

SBIC men did not wait for Congress to act. They have taken big steps to assure that their investment capital doesn't run dry. They have introduced one important innovation—"syndicates" or "joint participation" by a group of SBIC's in financial ventures. Thomas Grant, Jr., president of the SBIC's national association in 1960, had this to say on joint ventures:

The trend is sure to continue. Participation in joint ventures is the big future of the SBIC program as it now stands. Virtually all companies are making


19Hayes and Woods, op. cit., p. 16.
plans for it. The SBIC's have turned to each other to make up for the failure of other institutions to invest heavily in them.20

A syndicate or joint venture works like this. An SBIC undercover an investment prospect which for any number of reasons, it does not want to attempt to handle alone. It therefore contacts other SBIC's with which it has developed working arrangements and offers them "pieces" of the business. If there is enough interest to provide the needed funds, an investment "package" is drawn up and the deal closed. Ordinarily the SBIC with the largest participation assumes the leadership in negotiations and often coordinates the supervision of the syndicate's interests once the investment has been made.21

A team of five SBIC's raised $275,000 for a land development project in Prince George County, Maryland, for construction. The contractor was unable to secure bank financing. He got help when SBIC's from Houston, Washington, Miami, Philadelphia, and Baltimore took part in the undertaking.22

SBIC's have also participated with banks in making loans. Hamilton National Bank of Chattanooga was approached by a Rome, Georgia, bank to participate in an operation involving $175,000. The Chattanooga bank, unable to put up a full share, brought in Tennessee Investors, an SBIC, which put up the balance of the needed funds.23

20"SBIC's Seek Changes to Survive," op. cit., p. 46.
22"SBIC's Seek Changes to Survive, op. cit., p. 46.
23"SBIC--The Banker's Friend," Mid-Continent Banker, February 1, 1961, p. 44.
There are certain problems which are inherent in syndicates. The most important ones are:

1. The frequent necessity of relying on the judgment of others in the assessment of investment opportunities.

2. The difficulty of bringing a group of venture capitalists to an agreement on the attractiveness of the investment.

3. The fact that group placements rob the individual SBIC of effective control over its share of the investment once the commitment of funds has been made.

4. Unless it can find someone willing to purchase its share, an individual SBIC which loses confidence in a business which it has committed funds through a syndicate is "locked in."²⁴

While joint participation has enabled the SBIC's to enlarge their commitments while keeping each SBIC under the 20 per cent per deal limit, it really didn't solve the essential difficulty—the shortage of cash.

That is why many SBIC's turned to the equity route of raising money which gave them relief for a while. This will be discussed fully in the next chapter.

Hayes and Woods concluded in their study that the use of syndicates has some important implications for the SBIC program. By bypassing the smallest borrowers which are least likely to have alternative sources of capital and instead concentrating on the larger more substantial business which in many cases does have alternative sources, these SBIC's are ignoring the very capital gap which they were created to serve.²⁵

Whereas Senator Proxmire was disturbed about the truly small business not receiving funds, Senator Sparkman believed that the crux of

²⁴Hayes and Woods, op. cit., p. 16.
the problem was in the "small SBIC." He said that "a good many SBIC's are just too little to exist." He believed that they needed a larger financial base. Further adding, he said that "the incentive is profit making and to succeed they need leverage." The potential leverage had never materialized for most SBIC's because there was no substantial source of funds where Federal funds left off. Suiting action to words, Senator John Sparkman in 1961 sponsored a bill that would raise the amount of money that the SBA could invest in an SBIC on a dollar for dollar basis with private capital from $150,000 to $300,000.26 Congress was more generous. Public Law 87-341, approved October 3, 1961, increased from $150,000 to $400,000 the amount of funds that the SBA might contribute to the capital of an SBIC. After further pressure for more funds, Congress passed Public Law 88-273 on February 28, 1964, further increasing the matching Government funds provision to $700,000.27

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CHAPTER IV

GOING PUBLIC

A swift rise, followed by the shakes, gloom, and a struggle for recovery—in four quick phrases—this is a capsule history of the almost seven year old small business investment company program. The phrases particularly describe the rise and fall of publicly held SBIC's.

The first major public offering of SBIC stock did not occur until June, 1959; and no further large public offering occurred until August, 1960. But from August until July, 1961, there were 11 underwritings of over $5 million and an equal number of smaller SBIC public issues. As of May, 1961, subscribed capital of SBIC's was reported to be $200 million. Of this amount, about $130 million had been supplied by public underwritings. Underwriting of SBIC stock had been very attractive to the investment banking people since the strong demand for shares began in September, 1960. Most of the underwritings were managed by the major New York investment bankers.¹

Electronics Capital Corporation, the first SBIC to go public, soared from an original offering price of 10 to 69. Franklin Corporation, organized by Long Island's Franklin Bank, shot from an initial price of

¹Rubel, op. cit., p. 37.
10 to 25. Both Boston Capital and Narragansett Corporation about doubled in value.²

The haste of investment firms to market shares of SBIC's was understandable. The investing public, throwing caution to the wind, was eager to bid up new issues of untried and unproven ventures.³ Investors eagerly bid up the prices of 50 odd SBIC's that raised their initial capital through public offerings such as Electronics Capital and Franklin Corporation. In the speculative aura of the early 1960's, SBIC's experienced luxuriant growth. By the end of 1961 a total of 443 had been licensed with combined capital of $432 million.⁴

In 1959 and 1960 SBIC's became glamorous in the mind of the public and private companies were conceived and founded. The public companies were underwritten to the strong public demand created from early SBIC profits. Many private companies were started under these same conditions hoping to become larger when investments began to season and show performance.⁵ Serving as an inducement to investors was the ruling under the Small Business Investment Act that allows investors to deduct all capital losses resulting from the sale of SBIC stock against ordinary income, while taxing profits at capital gain rates. The law

²"SBIC's Short Lived Glamour," op. cit., p. 10.
³Armour, op. cit., p. 4.
⁴"SBIC's Short Lived Glamour," op. cit., p. 10.
also permits SBIC earnings to be passed on to stockholders without a corporate income tax.6

Stanley M. Rubel, a financial expert who has followed closely the activities of SBIC's, made these predictions in 1961:

Market prices of SBIC shares are likely to be quite volatile. The businesses in which they have invested are subject to greater operating fluctuations than publicly traded companies. As public underwriting of companies in which SBIC's have invested is developed, the price of their stock is likely to increase considerably. Subsequent profit taking and uncertainty resulting from lack of information could force prices below a proper level.7

There are good reasons to count Mr. Rubel's predictions as being accurate. The bubble burst during the 1962 market break and SBIC stocks plummeted. In part the SBIC's had been a casualty of the new issue market. In return for providing long term capital to small and medium sized companies, SBIC's usually received convertible debentures or stock from these companies. The big portfolio profits in 1961 came from juicy capital gains—at least on paper—when SBIC-backed companies matured to the point where they could go public and their stock appreciated. But in 1962 these new issue stocks of small companies had become a drug on the market and paper profits melted away.8

Tax concessions granted to SBIC shareholders turned out to be very important. In October, 1962, Electronics Capital Corporation had come

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6Small Business Investment Act, op. cit., p. 52.
7Rubel, "SBIC Industry Grows and Grows," p. 60.
down to 11 from a lofty high of 69. It was one of the few SBIC's still selling above original price, though this was small comfort to those investors who had bought the stock at higher levels. Boston Capital and Franklin Corporation both came down to around 7, while Narragansett Capital plummeted to 4.9 The accompanying table shows how important the tax concessions turned out to be to SBIC shareholders in 1962.

<table>
<thead>
<tr>
<th>SBIC Corporation</th>
<th>Original Offering Price</th>
<th>Recent Price</th>
<th>Net Asset Value</th>
<th>Percentage Discount(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boston Capital</td>
<td>15</td>
<td>7</td>
<td>$13.24</td>
<td>47</td>
</tr>
<tr>
<td>Business Funds</td>
<td>11</td>
<td>6</td>
<td>10.27</td>
<td>42</td>
</tr>
<tr>
<td>Capital Southwest</td>
<td>11</td>
<td>5</td>
<td>9.96</td>
<td>50</td>
</tr>
<tr>
<td>Electronics Capital</td>
<td>10</td>
<td>11</td>
<td>12.48</td>
<td>12</td>
</tr>
<tr>
<td>Florida Capital</td>
<td>8</td>
<td>3(\frac{1}{2})</td>
<td>6.77</td>
<td>48</td>
</tr>
<tr>
<td>Franklin Corporation</td>
<td>10</td>
<td>7</td>
<td>8.96</td>
<td>22</td>
</tr>
<tr>
<td>Growth Capital</td>
<td>20</td>
<td>9</td>
<td>16.61</td>
<td>46</td>
</tr>
<tr>
<td>Midland Capital</td>
<td>12(\frac{1}{2})</td>
<td>7(\frac{1}{2})</td>
<td>11.65</td>
<td>36</td>
</tr>
<tr>
<td>Narragansett Capital</td>
<td>11</td>
<td>4</td>
<td>9.32</td>
<td>57</td>
</tr>
<tr>
<td>St. Louis Capital</td>
<td>10</td>
<td>9</td>
<td>8.96</td>
<td></td>
</tr>
<tr>
<td>Sierra Capital</td>
<td>10</td>
<td>5</td>
<td>9.17</td>
<td>45</td>
</tr>
<tr>
<td>SBIC of New York</td>
<td>20</td>
<td>10</td>
<td>18.00</td>
<td>44</td>
</tr>
<tr>
<td>Techno Funds</td>
<td>12(\frac{1}{2})</td>
<td>4</td>
<td>7.81</td>
<td>58</td>
</tr>
<tr>
<td>Texas Capital</td>
<td>6</td>
<td>4</td>
<td>6.32</td>
<td>37</td>
</tr>
</tbody>
</table>

\(^a\)Financial World, October 23, 1963, p. 60.

The reason for the market decline stemmed in part from the fact that SBIC's were distributed as "hot deal" vehicles because of their heavy concentration in electronics. Too many people were led to expect too much too soon. There was a brief flurry but when electronics stocks passed their peak, the SBIC's suffered proportionately with the decline in the market for the underlying securities. The market broke in May, 1962, and prices collapsed completely. Prices of the 47 publicly held SBIC's had been drifting steadily downward since the high water mark of their popularity in the spring of 1961. By the end of May, 1962, SBIC prices were 27 per cent below their April 30 average and down 66 per cent from the April, 1961, high. The average SBIC was now in fact selling at sharp discount from book value. The ratio of market price to book value had dropped to 69 per cent.

This abrupt fall from grace was part of the widespread disenchantment with glamour issues that set in following the 1962 break. But in the case of SBIC's, this sudden shift in sentiment worked a double hardship. For while the rude awakening precipitated the plunge in SBIC shares, it also dried up the flow of new flotations, a main channel by which SBIC's could obtain capital.

The optimists in the SBIC business, however, felt that all was not lost. They claimed that the market break brought one blessing:

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10Snyder, op. cit., p. 4.
12"SBIC's Short Lived Glamour," op. cit., p. 11.
Many top-notch companies that were seeking cash in the new issue market were then turning to the SBIC's.\textsuperscript{13} Even so the SBIC boom seemed over. Public confidence had been shaken. It would take time for the wounds to heal. For example, security declines from a high of 70 to a low of 8 or from a high of 60 to a low of 4, it takes a long time for this lesson to be unlearned. There were a lot of inexperienced investors in the market. They invested for many reasons but found out that the market was not a one-way street. It is their confidence in the real benefits of security ownership that must be built.\textsuperscript{14}

When the market broke in 1962, hopes of raising additional funds for public SBIC's were dashed to the ground. Only a select few private SBIC's were able to sell more stock in 1963. The SBIC name had become considerably tarnished through unfavorable articles in the financial press, although many of the articles were said to be unduly pessimistic and triggered by beleaguered security prices of the public companies. Early losses and the fact that most SBIC public issues were still selling below offering prices contributed to the bad image of the industry. Stanley Rubel has said that "the aspect of the problem that is so remarkable is that the industry is doing very little to combat the false impression carried by the public about SBIC's." He suggests that they have been poor public relations men, have failed to challenge news stories, and have not prognosticated on the public companies in projecting the future image of SBIC's.\textsuperscript{15}

\textsuperscript{13}"SBIC's Short Lived Glamour," \textit{op. cit.}, p. 11.

\textsuperscript{14}Snyder, \textit{op. cit.}, p. 3.

SBA Administrator Wendell Barnes said "that losses by some SBIC's, industry growing pains, impatient stockholders, and continued lack of understanding, combined with other market factors to drop SBIC shares to unrealistically low levels." He mentioned that this was an ideal situation for raiders with an eye toward gaining control of SBIC's and liquidating them for quick profits. The SBA has regulations to prevent the quick liquidation of an SBIC which has been taken over by a new management group—a group which would buy up shares to turn a quick profit and had no intentions of operating the company as an SBIC. But as the publicly owned SBIC's have lifted the percentage of their capital invested, the incentive to try for a takeover has dried up. Generally, in 1963, SBIC shares were still selling below net asset value but above cash value—and the raiders would have had to liquidate securities of uncertain value to make a profit.

One observer has compared the SBIC's with the insurance industry and predicts a similar outcome. In the 1950's, insurance stock lost favor because of changes in their tax status. As a result markets remained in the doldrums for nearly three years. Then investors generally discovered that value continued to build up in the insurance business. Suddenly the insurance stocks became popular again and immediately moved to new high levels and by and large have held their ground since.

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16 Barnes, op. cit.
17 "SBIC's Rocky Road Looms Ahead," op. cit., p. 68.
18 Snyder, op. cit., p. 4.
SBA official Allan Harris likened the SBIC's in their present state to the savings and loan associations in the 1940's. He agreed that the stock crash hurt a great deal. He believes that the stock of SBIC's was outrageously overpriced in 1960 and 1961 and that it fell too low when many became priced under the value of cash on hand. Very few companies attempt to go public today because there just is not any great demand for SBIC shares. In spite of this, Mr. Harris stated that he believes that "SBIC stock is one of the best to buy across the board, but taken individually there are some good and some bad."

Mr. Harris also believes that a "bad public image" is the main problem of SBIC's today. He too has been surprised at the laxity on the part of the SBIC's to improve their image to the public. To this problem, plans are underway now by the National Association of Small Business Investment Companies to hire public relations people to help dispel the industry's true image to the public.\(^{19}\)

March, 1965, proved to be a sterling month in the SBIC's steady climb back to "fame and fortune." The averages moved steadily upward to reach 7.2 by month end. This set a two-year record for the high point achieved by averages. Gains considerably outdistanced losses. Price leaders were Allied Capital, First Midwest, Growth Capital, Florida Capital, and Gulf Southwest. The Wall Street Journal reported that increasing interest in OTC shares and secondary issues by the small

\(^{19}\)Interview with Alan Harris, SBA Area Coordinator, June 9, 1965.
investor has brought a new stimulus to speculative investing. Averages of SBIC public held portfolio companies moved up 3 per cent in March, the third straight month of improvement. Their averages have improved 13 per cent since December, 1964. Once again new issue underwriting has become possible. During March, three SBIC portfolio companies were underwritten. All three showed increases in market value after the underwriting.20

A problem of getting SBIC and portfolio company stock on the market is acceptability by an underwriter. He looks at two sides of the situation, quality and saleability: Quality - is this worth doing? Do I want to be identified with it? and then saleability. If it has sufficient quality, will the market accept the security? Is this industry a popular industry? Once this point is reached, an underwriter will examine the growth rate, record of sales or earnings, dividends, company prospects, qualifications of management, and again the appeal of the industry. If the security is acceptable, it must be priced and then distributed. The last and most important element is the after market. The securities of course will fluctuate with the market but the issuer and the underwriter are not interested in seeing securities decline.21


21 Snyder, op. cit., p. 3.
CHAPTER V

PROVIDING FLEXIBILITY AND SAFETY IN INVESTMENTS

The Small Business Investment Act of 1958 made provisions for SBIC's to aid small businesses in three ways: making long-term loans, purchasing convertible debentures, and providing management counseling services. Under the original act the total amount which an SBIC could lend or invest in a single small business concern could not exceed 20 per cent of the combined capital and surplus of such investment company. ¹ SBIC's were created under the Act to provide the above mentioned services to small business. But SBIC operators are in the business to make profits and capital gains for their stockholders while providing financial assistance to small business. This chapter will discuss the struggle of SBIC's to make profitable investments while complying with SBA regulations and dealing with other adverse factors.

In making an investment in small businesses, the first step for an SBIC is to screen and investigate the applicants. In 1959 Paul Donham in a Harvard Business Review article said that "the screening problem alone will almost certainly block a number of SBIC's from realizing success." As part of the searching out program it is valuable to have detailed investigation criteria such as prerequisite profit margins,

¹Small Business Investment Act, op. cit., p. 15.
growth trends within the industry, and return on invested capital, combined so as to form an analyzer that will help direct the energies of the organization to industries and companies which offer the maximum opportunities for successful investments. Such is not developed overnight. Among the desirable investment characteristics often mentioned are:

1. Sound management (including management depth).
2. Part of a growth industry.
3. A competitive niche or advantage.
4. Development beyond the experimental or prototype stage.\(^2\)

James Snyder, an underwriter, said that "loans sought by small business are difficult to evaluate and costly to administer." But he added that an aggressive SBIC program for grooming and developing portfolio companies is a necessity. This is going to be the basis on which markets will ultimately recover. This does not mean "force feeding," there is nothing gained by trying to rush into an immature company. "If you do, your first effort may be your last."\(^3\)

Stewart Devore in an address before a meeting of the National Association of Small Business Investment Companies stated that in considering each investment the industry should consider whether the investment serves the purpose for which it was created. For instance, if an investment benefits only the SBIC and merely incidentally serves the small business, "it is not worth our support." "Each investment must attempt to achieve a significant benefit to a small business and by

\(^2\)Donham, op. cit., p. 99.
\(^3\)Snyder, op. cit., p. 4.
benefiting a small business, we can then derive a legitimate and purposeful profit." Mr. Devore stated that "to do otherwise will only weaken our standing as an industry and in the end bring disrepute upon us all." 4

Wendell Barnes, former SBA Administrator, believes that if an investment company has access to only a few financial opportunities, it is likely to have a distorted view of what is worthwhile and may suffer the consequences through poor investments. He cited the example of one successful company that examined over 2,700 applicants and selected less than 50 in which to invest funds. SBIC's must select their investment opportunities with care. 5

SBIC's have a problem of screening large numbers of applicants. An official in Colorado's largest SBIC said: "We look at an average of 100 firms per month; 20 of which may be manufacturers. Of these we may end up financing only one." 6 James Howard, president of Growth Capital, said that in a two-year period his staff looked at over 3,000 situations to arrive at an investment of 23. Of those a detailed investigation was made of 500. Each of these in turn was screened by his staff. In screening they looked for the following:

1. Profit history
2. Person check of management
3. Credit history
4. Cost data

4Devore, op. cit., p. 3.
5Barnes, op. cit., p. 3.
6Denver Research Institute, op. cit., p. 16.
5. Ability to make a profit at a given sales volume
6. Willingness of management to retain profits for growth
7. Ability to generate enough profit to pay back loan

John Mckittrick, treasurer of the Chase Manhattan Corporation, said that "in common with the rest of the industry we find that acceptable proposals constitute a very small percentage of those received, and out of a total of 500 proposals considered worth recording, we have made 10 loans." SBIC managers say that most small businesses approaching them for funds are not worth the trouble of "opening our doors."

A product with obvious advantages is easy to evaluate as is one that is obviously worthless. However, most products do not fall in either category—they are in a large gray area. It is expensive to investigate an applicant with any degree of thoroughness. This cost can run into several thousand dollars. Some SBIC's are inclined to skim off those firms having the most obvious growth potential. This procedure may sometimes unfairly eliminate a worthy firm, but this is a chance that some SBIC's take.

San Diego's Electronics Capital Corporation has not sat back and waited for investment chances. Its staff is constantly scouring the electronics industry looking for prospects. But they have made only a

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7Howard, op. cit., p. 38.
9"SBIC's Seek Changes to Survive," op. cit., p. 45.
10Denver Research Institute, op. cit., p. 15.
few investments and have turned down many more companies than they have accepted.  

Because of difficulties in finding suitable investments, some SBIC's have simply disbanded. Water Industries, for example, could put only 14 per cent of its $5.3 million capital to work. The company liquidated in 1963. St. Louis Capital, which had invested only $1 million of its $7.5 million assets, attempted a similar move but was stopped by insurgent stockholders.  

Affiliated term lenders are able to have lower investigating cost due to expertise in selected industries and lower administrative costs because there is little need for constant portfolio investment supervision.  

Herbert Silvermann, president of Talcott Incorporation, sees sound credit judgment as the end product of analysis of the most reliable experience data available. He suggested making joint audits of companies where SBIC's have mutual interest to provide the most dependable facts and figures on which credit judgment can be exercised. Notwithstanding the problems of a syndicate, they can pool talent when analyzing an investment opportunity. An SBIC with little or no familiarity in a particular industry can call upon another SBIC for help in analyzing an

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12"SBIC's Seek Changes to Survive," op. cit., p. 43.  
opportunity in which both are considering an investment. However, rather than relying on an analysis from an SBIC with untested judgment, many SBIC managers prefer to establish informal but continuing working arrangements with certain of their colleagues whose judgment they have come to respect. 15

To cut down on investment risk, some SBIC's have invested in specialized industries while others have been more diversified. Some SBIC's have been set up to help one particular industry or trade. So-Tex Investment Corporation of Alice, Texas, for one was formed to furnish loans to small independent grocers. The organizer is in the wholesale grocery business and has made several loans to grocery stores for modernization and the like. Frankford Grocery Small Business Investment Company, a wholly owned subsidiary of Frankford Grocery Company, a Philadelphia cooperative, has made loans totaling $122,000 to six grocers. 16

In Scranton, Pennsylvania, 46 stockholders—including 18 banks—formed the Keystone Small Business Investment Company in 1960 with the avowed purpose of supplementing existing industrial development programs in seven counties of Northeastern Pennsylvania. 17

The electronics industry and other industries associated with the "space age" have been focal points of SBIC investments. One of the most

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16"SBIC's Seek Changes to Survive," op. cit., p. 46.
17Ibid.
successful companies that has specialized in electronics is Electronics Capital Corporation of San Diego. They seek companies in specific areas of the electronics industry for which they see big growth. They are firm believers in SBIC's specializing in an industry in which they can offer expertise.\(^{18}\)

In 1963 critics noted that SBIC's had been turning to real estate and construction financing, in part to get capital gains independent of the stock market. According to S. M. Rubel and Company of Chicago, which has become the chronicler of SBIC activity, 20 per cent of the SBIC loans through December, 1962, were for real estate and construction. Rubel said that real estate type investments are considerably different than other types of small business financing. "It is conceivable that the initial concept of SBIC's did not envision undue concentration in the real estate field."\(^{19}\)

SBIC's with diverse portfolios also bend to the lure of real estate, to show profits while their longer term investments are maturing. A big chunk of SBIC money has been flowing into real estate development—a natural turn since the return on real estate often is quicker and the investment safer than, say, financing an electronics parts maker just starting out.\(^{20}\)

Policy on investment specialization came out of the review of SBIC's during the 90-day moratorium on issuing new licenses in 1964.

\(^{18}\)"An SBIC Thrives on Electronics," op. cit., p. 53.

\(^{19}\)"SBIC's Rocky Road Looms Ahead," op. cit., p. 68.

\(^{20}\)"A Freeze on Forming New SBIC's," op. cit., p. 36.
The government encourages specialization to some degree in order for an SBIC to offer expertise in a particular industry. But the SBA has ruled that an SBIC may invest no more than one third of its funds in real estate.21

Dr. S. J. Flink concluded in a study for the American Banker's Association that bank affiliated SBIC's can exert a strong influence on the SBIC industry as a whole. They have most nearly approached the intentions of the Congress when the Small Business Investment Act was passed. They have refrained from high interest real estate loans, a major area of activity for many non-bank affiliated SBIC's in the minimum capital bracket.22

The original Small Business Investment Act allowed SBIC's to provide funds for small business by making long term loans and buying convertible debentures. Interest charges for long-term loans are subject to negotiation between the company and the SBIC, but must comply with legal rates in the different states. The loan maturity would be subject to negotiation also, but may not be for less than 5 years or more than 20 years. An SBIC generally could not invest more than 20 per cent of its paid-in capital and surplus in a single small business firm.23

The general consensus of the SBIC industry was that SBIC's should not be restricted to the purchase of convertible debentures and

21 Ibid.
22 Presley, op. cit., p. 58.
23 Small Business Investment Act, op. cit., p. 15.
straight loans. They wanted to be able to buy common stock warrants also.

The Harvard Business Review in 1959 attacked the critics who attacked the sole use of convertible debentures as an investment medium. The small businessman could shop for SBIC financing just as he might shop for a mortgage, and the convertible debenture would allow him to go from door to door receiving roughly the same quotations without being thoroughly dazzled by financial footwork. Law makers argued that there is flexibility in convertible debentures. For instance, there is no provision against making prior contractual agreements that call for virtually instantaneous conversion of debentures into stock, an opening that allows an SBIC to invest on an equity basis even though pricing formally in terms of convertible debentures.

In spite of the arguments for the sole use of convertible debentures, on June 11, 1960, the law was amended to permit SBIC's to use any investment medium, including direct common stock purchases, debentures with warrants, notes, stock options and the like. The resultant flexibility from the new law has had a considerable effect on the operation of SBIC's. Equity type securities are prime attractions for most SBIC's. Their primary interest is in concerns offering good growth possibilities, and thus the possibility of being able to sell their equity interest at capital gain rates at some future time. Such SBIC's are not as interested

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in high interest rates as they are in increasing the value of their equity interest. Pure equity securities can be very advantageous to small business concerns since they obtain their funds, strengthen their balance sheets, lock in the SBIC, and yet have no interest obligation to meet. This is true if SBIC's buy common or preferred stock. For this reason many SBIC's appear to still favor the debenture with detachable warrants since it permits the SBIC to provide for normal amortization and even complete pay off without affecting the amount of equity that can be purchased.  

SBIC's are obviously engaged in high risk financing. They advance capital for relatively long periods of time to enterprises which are relatively small in their fields, and their claims upon the assets of their clients are subordinated to those of commercial banks and other creditors. The SBIC is really an equity partner of its clients. It is true that the law provides some attractive tax advantages to SBIC's and their stockholders to induce them to take an equity position. However, the SBIC industry thought that the government should do more to equip them with the high risk-taking capacity they needed.  

The most urgent requirement was to permit an SBIC to accumulate from its earnings before taxes an adequate reserve against losses. The case for permitting an SBIC to accumulate a reserve appeared to be strong in view of its great exposure to risk. Such a provision in the tax laws would, in effect, make the Federal Government share in the

26 Howard, op. cit., p. 39.  
27 Snyder, op. cit., p. 3.
risks of losses by SBIC's. By creating a buffer against the impairment of capital it would make the SBIC a more attractive financing institution.28

The Internal Revenue Service gave the SBIC's the lift they wanted by letting them set up a bad debt reserve equal to 10 per cent of outstanding loans. But while setting up reserves, SBIC's show lower earnings which dent dividends. Midland Capital Corporation, for one, passed its 1965 dividend. Midland put $525,000 into its new loss reserve and this ate up most of the year's earnings.29

In 1961, it was felt that the profitability of SBIC's would increase as they became fully invested. The funds not invested with small businesses were generally placed in low yielding government obligations or certificates of deposit. Legal and investigation expenses are greater in the initial years of the fund than subsequently. Salaries and other expenses do not increase substantially except perhaps in proportion to the growth of the fund.30

The least successful SBIC's have been those of minimum capitalization. Those of this size that try to operate face many difficulties. Those that don't achieve growth in the first few years usually fail. The SBA now recognizes that SBIC's should be larger to operate profitably and effectively and has encouraged formation of larger companies.31

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28Ibid.
29Armour, op. cit., p. 4.
30Rubel, op. cit., p. 38.
31Stanley Rubel, "Let's Take a Fresh Look at SBIC's," p. 41.
For the year ending March 31, 1963, the larger SBIC's earned about 2 per cent before application of loss reserves. The small ones broke even. Since the industry was still new and continuing to build its loss reserves, write offs during 1962 were about 2 per cent of new worth for large and small companies. In 1964 few SBIC's had paid income taxes. They expect most of their profit from capital gains rather than interest income on long-term loans.32

The SBIC industry looked upon the 20 per cent restriction on the amount that could be invested in a single SBIC as unrealistic. The industry had pressured for a change since inception. The regulation prevented an SBIC from investing an unlimited amount of money in a company that offered great growth possibilities. Finally in February, 1964, Public Law 88-273 eliminated the restriction. Herman Goodman of the $10 million Franklin Corporation said "We can now start thinking about going into some good size deals, the bigger the deal, the bigger our potential profit."33

In trying to make investments that are safe, flexible and profitable, SBIC's still must face an investment fact of life. In spite of the help given by government, all SBIC's must contend with the formidable factor of adverse selection. By definition, the investments open to SBIC's are usually confined to risk situations unable to raise capital through more conventional channels. This indeed was the intent of the

32Ibid.
33Armour, op. cit., p. 5.
enabling legislation. Whether legislative intent and investor objective can be satisfactorily married in SBIC's is still not totally known. It is still too early to tell if capital gains will materialize in sufficient amounts to justify risks.
CHAPTER VI

SUMMARY AND CONCLUSIONS

The Small Business Investment Act was passed in 1958. It authorized the establishment of small business investment companies to provide long term credit and equity capital for small business concerns. The Act was passed as a result of findings that pointed out a "financial gap" in small business financing. Commercial banks and the SBA provided short term and intermediate credit to small business but above this, there was no substantial source of long term financing.

The SBIC's have experienced many problems major and minor while trying to establish themselves as major financial institutions. The SBIC's, Congress, and SBA have taken steps to alleviate some of the industry's problems. After a slow start in 1959, SBIC's experienced a meteoric rise in 1960 and 1961, and an abrupt fall in 1962. Since 1962 the industry has been struggling to regain public favor. They are currently showing signs of recovery.

SBIC's have gotten a great deal of publicity since their inception and much of it has been adverse. By playing up insignificant SBIC abuses, problems, and shortcomings, the financial press has helped to give SBIC's a bad public image. Problems and shortcomings should have been expected in the new industry involved in the intricate field of
investments. This is not the first Federal sponsored program to be beset with problems and disappointments. While the Congress and SBA have been critical of SBIC's, they have had shortcomings on their own part by having unrealistic restrictions and too much "red tape" in the program.

In some cases the SBIC industry has been too critical and demanding of government. As for government regulations, it is true that they are difficult to live with at times. But they also have provided very important buttresses for SBIC's against the possible forfeiture of the integrity of an entire institutional complex due to the activities of a fringe element. In the absence of government surveillance, SBIC's doubtless would have been forced to organize an association to perform essentially the same functions as are now being accomplished by the government. Judging from the magnitude of initial interest in the prospect of using government money against a thin equity base, many more inept SBIC's might have been formed were they not confronted with legislative considerations, most of which require planning, paper work, and determination of specific operating policies. It could be said that the government is like a parent; it gave birth to the new type of investment company and therefore has the right and duty to regulate until the new entity is matured enough to operate on its own.

On the question of SBIC's providing enough funds for small business, the SBIC is not oriented toward all small businesses any more than the private investor is. Therefore, the proprietor, the inventor with an undeveloped idea, and the small manufacturer seeking research funds are still likely to find capital hard to come by. SBIC's are not in business to lose money. SBIC's were created by Congress to provide long term
funds for small business, but SBIC operators are interested in making profits while doing this. Therefore, a lot of small businesses are going to be left out if the SBIC finds them to be unprofitable ventures. Under our capitalistic system, an individual has the right to own and operate a private enterprise but he also has the right to fail.

A firm that is too small for public or institutional financing and too large for the private funds of insiders, but possesses business-like management and that is in a growth industry will find that it may locate funds in an SBIC on a much more convenient basis than previously had been the case.

The SBIC industry will probably be dependent on government financing for at least ten more years. It will be at least that time before a substantial number of companies' investments will have matured and capital gains realized.
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