SBIC TechNotes

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GUIDELINES FOR ISSUANCE OF DEBENTURE LEVERAGE COMMITMENTS TO PARTICIPATING SECURITIES SBICS

Introduction

This TechNote discusses the factors that SBA will consider in determining whether to issue a debenture leverage commitment to an SBIC that already has Participating Securities ("PS") leverage and/or a PS leverage commitment. The TechNote also describes some of the possible effects of debenture leverage on the operations of a PS fund.

SBA anticipates that SBICs with PS leverage and/or commitments may seek debenture commitments to make up for leverage shortfalls that occur under the following circumstances: (1) Because of funding limitations, the SBIC received PS commitments for less than the full amount of leverage contemplated in its business plan, or (2) the SBIC received PS commitments that expired or will expire without being fully drawn.

General Considerations

Aggregate amount of leverage: SBA will not approve a debenture leverage commitment that would allow an SBIC to be more highly leveraged in the aggregate than was contemplated in its approved business plan. For example, if an SBIC's business plan was predicated on two tiers of leverage, SBA will not approve a debenture commitment that represents a full or partial third tier.

Adherence to business plan: SBA will generally consider debenture leverage to be appropriate for a Participating Securities SBIC only if it does not change the SBIC's business plan or the overall composition of its investment portfolio. For example, a PS licensee might appropriately use debenture leverage under circumstances such as the following (in all cases, subject to SBA's normal credit review standards and the SBIC's submission of a debt service plan satisfactory to SBA (see the "Specific Considerations" section of this Technote):

- To make a follow-on investment in a portfolio company that is performing well, allowing the SBIC to maintain its ownership percentage in the company through a final round of venture financing prior to a liquidity event.
- For an SBIC with a later-stage equity investment strategy, to invest in preferred stock of a cash flow-positive company that will pay regular cash dividends.
- To pay fund expenses.

SBA is unlikely to approve a debenture commitment that essentially facilitates a change in an SBIC's business plan. SBA will presume a change in business plan if the commitment sought is large relative to the licensee's existing PS commitment, would be used to make a substantial number of new investments of a different type than originally planned, and/or would represent more than half a tier of leverage (50% of Regulatory Capital). SBA may consider such commitments on a case by case basis, but only in conjunction with an extensive review of the proposed business plan revisions as well as management's qualifications with respect to making debenture-compatible investments. In SBA's discretion, commitment requests smaller than half a tier may also require such review. Licensees contemplating a debenture commitment request under any of the circumstances described in this paragraph should contact their SBA analyst for further instructions.

Timing: SBA will consider a debenture leverage commitment for a Participating Securities SBIC only after its portfolio has developed to the point where a meaningful evaluation of its progress can take place. At a minimum, an SBIC must have three years of operating history, beginning with the date of its first investment, and must have drawn half of its total PS leverage commitment before seeking a debenture commitment.

Specific Considerations

SBIC's financial and regulatory performance: As in the case of any application for leverage, a PS SBIC seeking a debenture commitment must satisfy the requirements of 13 CFR 107.1120 and be in good financial and regulatory standing. All debenture commitment applications will undergo SBA's normal credit review process, which includes such factors as the following:

- The SBIC's current capital impairment percentage (CIP) must not exceed its maximum allowable CIP.
- The SBIC must not have any unresolved major regulatory violations. A major violation is an item that is identified in the examination report as a "finding" rather than as an "other matter."
- The SBIC must not be subject to either "Intensive" or "Enhanced" oversight, per SBA's risk assessment model.

If any of the above conditions exist, it is highly unlikely that SBA will approve a commitment for leverage.

Permitted investments: SBA will not require that SBICs invest debenture leverage proceeds only in securities that provide current income; licensees may also make investments in the form of either equity or deferred-interest debt, or draw leverage to pay fund expenses. However, as part of SBA's review, an SBIC must present a debt service plan and pro forma financial statements that provide for coverage of the required semi-annual payment of interest and additional charges.

Debt service plan: The required debt service plan must be realistic in light of the SBIC's overall business plan and portfolio composition. Other than leverage draws, the SBIC can use any available source of liquidity (including sale of portfolio securities and private partners' capital contributions) to provide the necessary coverage. SBA recognizes that leverage commitments can be drawn over a four to five year time period and that the SBIC may not know, at the time of application, exactly how it will make use of leverage proceeds or the exact sources of liquidity needed to pay interest and charges. However, the SBIC must provide as accurate and detailed an assessment as possible of the following:

- Follow-on financings to be funded with debenture leverage, including specific portfolio companies, dollar amounts, anticipated timing, planned investment structure (particularly current and deferred income features), and amount/timing of liquidity prospects.
- Any new investments to be funded with debenture leverage, including specific companies if known, dollar amounts, anticipated timing, types of portfolio concerns (stage and industry) and how they fit into the SBIC's business plan, anticipated investment structure (particularly current and deferred income features), and estimated holding period.
- Fund expenses to be paid with debenture leverage, including anticipated dollar amounts and timing.
- Liquidity to be available for debt service from all sources, including current income and/or disposition proceeds from existing portfolio companies, private partners' capital contributions, waiver/deferral of management fees, etc.

SBICs may be asked to update their debt service plan information at the time of a draw request.

Pro forma financial statements: SBICs must provide pro forma financial statements (income statement, balance sheet, and cash flow statement) for the fund as a whole, covering the period of time that leverage is projected to remain outstanding. All assumptions underlying the pro forma financials must be stated. SBICs should submit the financials in both paper copy and electronically in Microsoft Excel.

Potential Effects of Debenture Leverage on the Operations of PS SBICs

Before seeking a debenture commitment, licensees should be fully aware of the potential risks and added complexities of having both PS and debenture leverage. The discussion in this section highlights some of these issues but it does not address every possible issue that may arise; SBICs are in the best position to understand their own individual circumstances and should do their own research before proceeding.

Payment of interest and additional charges: Unlike the PS program, debenture interest and charges are payable semi-annually (see exception for "LMI debentures" below). Failure to make a payment when due is an event of default under 13 CFR 107.1810. **If the default is not cured, SBA has the authority to repurchase all outstanding debenture and participating securities leverage and transfer the SBIC to the Office of Liquidation.** Please refer to 13 CFR 107.1800 through 107.1820 for an understanding of the remedies available to SBA in the event of noncompliance with the terms of debenture or participating securities leverage.

Debenture prepayment penalties: Unlike participating securities, debentures can be prepaid only in whole, not in part. Furthermore, during the first five years after issuance, debentures are subject to a prepayment penalty (5 percent in the first year, declining by 1 percentage point per year thereafter).

Distributions: For SBICs with both PS and debenture leverage outstanding, the distribution rules for participating securities control (see 13 CFR 107.1540 through 107.1580). In particular, these regulations require all outstanding PS leverage to be redeemed before any prepayment of debenture leverage. The PS distribution rules create the risk that an SBIC could still have debenture leverage outstanding while the current pay investments it originally made with the debenture proceeds no longer exist.

Capital impairment: One of the factors involved in determining an SBIC's maximum allowable capital impairment percentage (CIP) is the percentage of Equity Capital Investments (at cost) in its portfolio. A typical PS SBIC has at least 67% of its portfolio in Equity Capital Investments and thereby has a maximum allowable CIP of 50% to 70% depending on its ratio of outstanding leverage to leverageable capital. If the use of debenture leverage should result in a portfolio consisting of less than 67% Equity Capital Investments, the maximum allowable CIP will decrease. SBICs should review the table in 13 CFR 107.1830(c)(2) to understand the variables that affect the maximum allowable CIP.

LMI debentures: For certain types of investments in qualifying "low or moderate income" areas, the LMI debenture provides SBICs with a financing option that does not immediately require current payment of interest and charges. The LMI debenture is a deferred interest debenture that is issued at a discount and requires no payments of interest or SBA annual charges for the first five years. LMI debentures are available in both 5 and 10 year maturities. An SBIC that has a debenture leverage commitment in place can request a draw in the form of either a regular or, if eligible, an LMI debenture. Because the LMI debenture is issued at a discount, the cash proceeds received will be less than face value. For example, an SBIC might issue an LMI debenture with a face value of $1 million but receive only $700,000 in cash. The full face value, however, is deducted from the SBIC's debenture commitment and is counted against its maximum leverage eligibility. Licensees interested in the LMI debenture should review the definitions of the terms "LMI Investment", "LMI Enterprise" and "LMI Zone" in 13 CFR 107.50, and the explanatory material available at http://www.sba.gov/INV/textonly/lmiweb.html.

ATTACHMENT 1 - TEMPLATE FOR SUPPLEMENTARY DEBT SERVICE PLAN INFORMATION FOR DEBENTURE COMMITMENT REQUEST BY PARTICIPATING SECURITY SMALL BUSINESS INVESTMENT COMPANIES (SBICS)

This information is supplemental to the debenture commitment request and will be used by the analyst to help ascertain how the SBIC intends to service and repay the debenture.

Name of SBIC	
License Number	

Amount of Debenture Commitment Requested ($):

ANTICIPATED USAGE OF DEBENTURE LEVERAGE

	Estimated Total Amounts ($)	Est. Number
+ Follow-On Financings		
+ New Investments		
+ Fund Expenses		

(a) Detailed Explanation on Usage of Debenture Leverage for Follow-On Financings

For each current portfolio company you anticipate funding with Debenture Leverage, identify estimated dollar amounts, anticipated timing, planned investment structure (particularly current and deferred income features), and amount/timing of liquidity prospects, using the following format.

Company Name	Est. Investment Amount ($)	Anticipated Timeframe of Investment	Planned Investment Structure	Estimated Amount/Timing of Liquidity Prospects

(b) Detailed Explanation on Usage of Debenture Leverage for New Investments

If you intend to make investments into companies not currently in your investment portfolio, for each investment you intend to make using debenture leverage, provide the following information:

Anticipated breakdown by Stage & Industry	Est. Number of Companies	Est. Investment Amount ($)	Anticipated Timeframe of Investment(s)	Planned Investment Structure(s)	Estimated Holding Period(s)

Describe how the anticipated new investments fit into your business plan.

ANTICIPATED DEBT SERVICE PLAN FOR DEBENTURE LEVERAGE

Describe all sources to be used to service debt, including current income and/or disposition proceeds from existing portfolio companies, private partners' capital contributions, waiver/deferral of management fees, etc.

PRO FORMAS

Provide pro forma financial statements (income statement, balance sheet, and cash flow statement) for the fund as a whole, covering the period of time that debenture leverage is projected to remain outstanding. All assumptions underlying the pro forma financials must be stated. SBICs should submit the financials in both paper copy and electronically in Microsoft Excel.