



VOLCKER SCHMOLCKER

Why a Sputnik-era investment incentive is back in vogue at banks of all sizes

BY SHANE KITE

A decade of waning interest in small business investment companies is quickly reversing course among banks big and small.

One reason is that SBICs – essentially pooled investment funds that can get matching money from the Small Business Administration – are exempt from the restrictions on equity investments imposed by the Volcker Rule, as well as the Bank Holding Company Act.

Such regulations are particularly burdensome for banks at a time when they are eager to get close to innovative technology startups that could disrupt how business gets done.

If a bank wants more than a small equity stake in a company that offers financial services – say, a mobile payments provider – the only practical approach now is to form a SBIC and invest through it, several bankers and lawyers say. The regulatory hassle makes trying to invest in any other way all but impossible.

But the Volcker Rule workaround is hardly the only impetus for the sudden surge in the popularity of SBICs. The potential for outsize returns in a low-interest rate environment, the chance to spur economic growth and job creation, and the bonus of Community Reinvestment Act credit are all part of the lure.

So is the opportunity to connect with promising middle market businesses, any of which might become a lucrative bank customer, says Tim Rafalovich, a senior vice president at Wells Fargo who oversees its investments in SBICs.

"Each SBIC invests in roughly 25 companies," Rafalovich says. "Every one of those 25 companies needs somebody to handle their insurance, deposits, their foreign exchange. So we stand a better chance of getting that business if we're invested in these funds that engage with these companies first."

The relationships can expand well beyond

Alex Nabaum

the basics. One of Wells Fargo's SBIC investments supplied senior debt funding to R360, a Houston-based oilfield waste disposal company. Later, the private equity firm Blue Sage Capital tapped Wells Fargo as an adviser on the 2012 sale of R360 for $1.34 billion. Then, Wells Fargo provided a term loan facility to the acquirer, Waste Connections, to finance the purchase.

SBICs can act like divining rods for banks' corporate lending efforts. Instead of finding potable water though, SBIC fund managers find revenue streams for banks in the form of the double-digit interest payments from corporate borrowers.

The SBA, which oversees the SBIC program, does not track the number of participating banks or the amount they invest. But those familiar with the sector say activity from banks is on the rise. Some are returning to SBICs after years away. Others who have been active all along say they are increasing their investments.

At least one big bank is creating its own SBIC so it can make strategic equity investments in startups that it views as being disruptive to the banking sector. The bank – which asked not to be named because its SBA approval is pending – wants to get more intimately involved with fintech innovators that threaten traditional banks' revenue from services like payments.

Several other banks also say they're turning to SBICs, primarily to avoid restrictive regulations. The pending Volcker Rule in the Dodd-Frank Act seeks to limit a bank's investment in private equity and venture funds to no more than 3% of each fund. It also says a bank's total ownership in all such private funds must not exceed 3% of the bank's total Tier 1 capital. (The rule is slated to take effect in July 2015.) Another complicating factor is the Bank Holding Company Act, which prohibits acquiring more than 5% of the voting shares of a nonbank company that engages in activities closely related to banking.

None of these restrictions apply to bank investments through SBICs, however. An exception on SBICs was written directly into the Volcker Rule to keep banks unshackled from lending to small businesses.

Though banks still have a cap on how much money they can put into SBICs, it's less onerous than the other regulatory limits; a bank can invest up to 5% of all of its capital and surplus.

"There has been great interest by banks since the Volcker Rule came into existence of returning to SBICs," says Michael B. Staebler, a partner at Pepper Hamilton. He has helped set up more than 210 SBICs over the past four decades and says several banks have taken steps in recent months to start their own SBICs, including a regional bank that is new to these types of investments.


Heilbronner

MONEY IN:

How SBICs Get Started

Besides banks, investors in SBICs often include insurance companies, endowments, pension funds, family offices, wealthy individuals, hedge funds and private equity firms.

Fund managers, called general partners, first get SBA approval to operate an SBIC, then raise money from the investors. The SBA usually then kicks in two to three times the amount of the private capital raised.

Most SBICs lend money at double-digit, "mezzanine" rates to small companies that couldn't otherwise raise capital to grow their businesses. These borrowers often lack the assets or collateral to qualify for a traditional bank loan at lower rates. Or they may be too new to provide the operations and revenue history that banks require. However, their cash flow is strong enough to repay the mezzanine lenders.

Precisely this type of SBIC money helped fund the early growth of what are now marquee brands, including Apple, Costco, FedEx, Intel, Outback Steakhouse and Staples.

Congress fast-tracked SBICs into existence in 1958, to turbocharge American invention. The legislation came 10 months after the Soviets launched Sputnik, beating the United States into space. SBICs were among the nation's major responses to the "Sputnik moment," meant to catch the country up technologically to its Cold War counterpart. They became the preferred vehicle around which many of the first venture capital and private equity investors organized their funds.

The SBA allows SBICs to invest in small businesses that have tangible net worth of less than $18 million. The businesses also must have an average of $6 million in net income over the previous two years at the time of investment. SBIC investors usually focus on investments in the lower middle market, a tier roughly defined as including firms with $5 million to $50 million in revenue.

SBICs can raise as much money from investors as they want, but the maximum amount that the government will provide in matching dollars is $150 million for a single fund and $225 million for multiple funds. A bill awaiting a Senate vote would raise the latter cap to $350 million.

The government money comes from the SBA in the form of debentures, which essentially are unsecured loans, but with super-low interest rates pegged to the 10-year Treasury note. The rate was 2.81% at press time.

In general, borrowers are paying SBICs a rate of about 12% lately, though it has ranged up to 18% at times.

The attractive spread helps fuel SBIC returns – minus the fees that the SBA collects and the expense of running the fund and raising private capital. SBICs also make money when they take equity in a business that increases in value.

Besides the income they provide, SBICs automatically earn CRA credit, which is an attractive benefit for banks.

"Banks see SBIC investing as doubly positive," says Mark A. Kromkowski, a partner at the law firm McGuireWoods. "Not only are SBICs exempt from the Volcker Rule, but they also count as qualified

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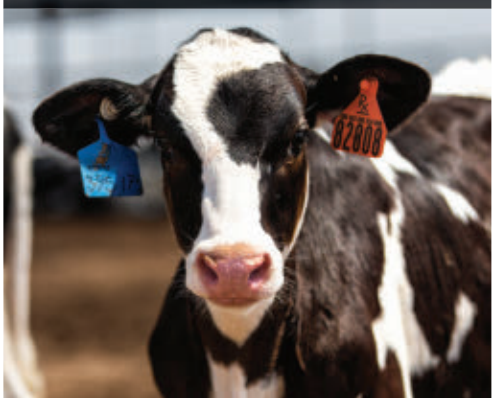
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CRA investments. And frankly, the returns on SBIC investments are significantly greater than any other CRA-type of investment."

With Kromkowski's help, the $13 billion-asset FNB Corp. in Hermitage, Pa., spun off its merchant banking arm in September to create a $175 million SBIC called FNB Capital Partners.

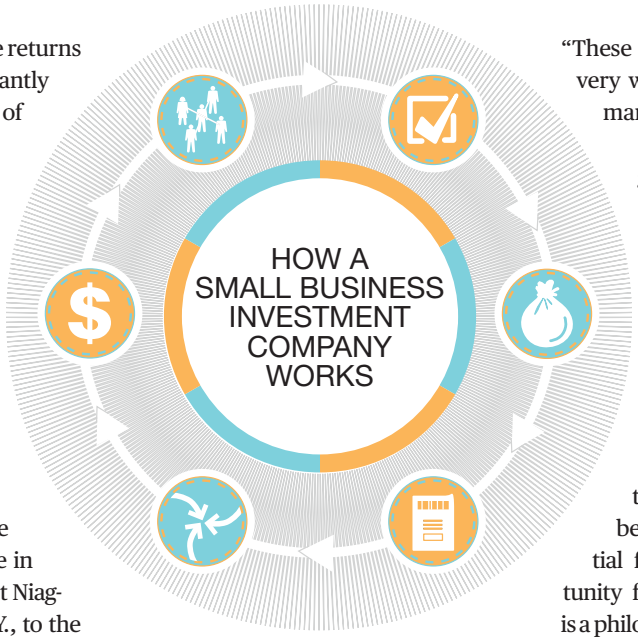
Five other banking companies also contributed to the fund, with the stated goal of investing in small businesses in a manner in which they would be unfettered by Volcker. They range in size from the $38 billion-asset First Niagara Financial Corp. in Buffalo, N.Y., to the $422 million-asset Farmers & Merchants Bancorp of Western Pennsylvania in Kittanning, Pa.

By November, the SBIC had its first investment, in Phoenix Rehabilitation and Health Services, of Indiana, Pa. The mezzanine and equity deal allowed Phoenix's management and the Pittsburgh private equity firm 3 Rivers Capital to buy out earlier investors and foster growth.

As of mid-March, FNB Capital Partners had deployed almost $45 million, or just over 25% of the fund, in eight transactions. The team that manages the investments for the new SBIC is the same one that ran the merchant banking arm, which is where it got the experience and track record that the SBA requires.

Bank involvement in SBICs has fluctuated, depending on the regulatory winds, Staebler and Kromkowski say. SBICs originally were popular among banks as a private equity investment workaround to the Glass-Steagall Act, which separated investment banking from retail operations. When Gramm-Leach-Bliley came along in 1999, enabling banks to make more direct investments, interest in SBICs waned.

Now with the Volcker Rule in particular aiming to curb private equity investment by deposit-taking institutions, a resurgence in SBICs is underway.



Staebler says banks are major players in this sector. He estimates that they contribute about 20% of all the private money put into leveraged SBICs.

MONEY OUT

How SBICs Find Borrowers

Canandaigua National Bank & Trust was among five banks in Western New York that invested $2 million each into an SBIC called Cephas Capital Partners back in 1997. The fund received 3-to-1 SBA leverage, giving it a total of $40 million to fund mezzanine loans for local businesses.

"Out of the 30 or so companies we financed, about 95-plus percent were successful investments, which meant they paid back as agreed," says Larry Heilbronner, the CFO at Canandaigua National. "These loans were underwritten very, very well. The banks found the performance to be exceptional."

That's why, in 2012, Canandaigua National joined the four other area institutions in increasing their investments to $3 million each for a new SBIC, called Cephas Capital Partners II, which, with three times leverage from the SBA, is a $60 million fund.

Banks consider SBICs a more diversified and less risky way to tap the lower middle market, because they're sharing the potential for losses, as well as the opportunity for profits, with other lenders. It is a philosophy that also underlies the more familiar strategy of loan participations.

"SBICs allow us to lend at mezzanine financing levels to customers we could not normally book on our bank balance sheet, spread the risk across five institutions, and cultivate the growth of businesses in our respective communities in Western New York," Heilbronner says.

Most of the companies that borrow from the two SBICs in which Canandaigua has invested were introduced to the funds separately by each of the participating banks, Heilbronner adds. The banks already had these local businesses as customers, just not for lending.

For many other SBICs, the opposite is the case. Banks depend on the general partners who manage the fund to find most of the borrowers. One advantage with this approach is the investors get exposure to potential new banking customers.

Wells Fargo's Rafalovich says, in addition to trying to sell non-lending services, the San Francisco banking giant also has a medium-term goal of adding new lending relationships. It is on the lookout for companies that are prospering five years after receiving SBIC money. If those companies meet its underwriting criteria now that they are larger and more stable, Wells Fargo will facilitate replacing the SBIC debt with traditional loans that go on the



bank's balance sheet.

"If SBIC borrowers are at the place where they have doubled or tripled their business within five or six years, a bank like Wells Fargo will say, 'I like the size of these companies now; I like that they've been in business for quite some time; I like the trajectory. We'll pay out that SBIC capital and become your lending institution,'" says Rafalovich.

A typical investment time horizon for a SBIC is 10 years. The first five years are the "investment period," when companies are being provided money to grow. The last five years are the "harvest period," because SBIC managers tend to sell off the debt obligations at that point.

However, SBICs remain active until they repay all the government's debentures, which often takes up to 15 years.

This cycle of investment and harvest is a key consideration for smaller banks attracted to SBICs for the mezzanine returns, because it takes more time to realize a profit. "You're looking for growth in the short term and returns in the long term," says Canandaigua National's Heilbronner. "It takes a few years to make the loans, and you don't make a whole lot of money when you're making them, other than some short-term interest, and you're paying guys to run the SBIC. Over the long term, when those loans are more mature, that's when you're making money in the SBIC."

Often, SBIC fund managers have two funds going at the same time, one in the investment period and the other in the harvest period. The idea is that profits from the harvest in one fund will make up for the expense of gearing up in the other.

Some banks take a similar laddering approach to investing in SBICs for more even returns. Wells Fargo invests in five to 10 SBICs per year, and allocates $2 million to $15 million to each SBIC.

The way that SBICs ultimately retire the investments they make varies. Aside from getting a bank loan, a SBIC-funded firm could get acquired by a larger company in the same industry, with the buyer paying off the SBIC debt in the process.

Some SBICs invest with precisely this type of strategy in mind. Such buyouts can make a fund more profitable, given that they generally hold equity as well as debt.

The SBA generally requires SBICs to structure at least two-thirds of their investments in the form of interest-bearing loans or stock with mandatory dividend payments.

"One reason we like this model is because these SBICs usually start returning capital to [the limited partners] faster than typical private equity," says Matt HoganBruen, managing director at BAML Capital Access Funds Management, a Bank of America unit that invests in venture capital, private equity and mezzanine funds.

"In private equity, it takes longer to do deals; the deals take longer to exit. In straight equity, you have to wait until that equity appreciates," HoganBruen says. "But a mezzanine return is typically an attractive, faster return, with low volatility and a lower loss rate."

The mezzanine funds that the Charlotte, N.C., company invests in are always SBICs, because its goal is strong returns, HoganBruen says. "And the SBIC program with its two tiers of leverage provides that." BAML has eight SBICs in its portfolio. It typically invests in one or two new SBICs a year and puts $10 million to $15 million into each one. The small businesses that borrow from the SBICs generally receive $3 million to $10 million each.

MONEY TRAIL

How SBICs Deliver Economic Upside

Though there's little published data on the loans SBICs make, proponents say the default rates are historically low.

Gary Babbitt, the chief lending officer at Canandaigua National, says its original SBIC showed negative returns on fewer than 10% of its investments. "The great majority of entities financed by the SBIC are still contributing to the local economy today, some as stand-alone operations and others as divisions of larger companies that the original entity was sold to."

Fund managers are chosen for their track records, which makes for a virtuous cycle. Their goal is to help companies grow, not overload them with debt, says BAML's HoganBruen. "They want these companies to survive and to thrive," he says. "Everyone does better in that case."

An analysis of SBICs from the SBA shows that average returns for the 74 leveraged funds originated between 1999 and 2006 ranged between 4.7% and 16.2%, with the larger funds (those holding more than $17.5 million of private capital) generally performing better than smaller ones. One down year was 1998; average returns of the 10 funds originated then were negative (minus 2.6%).

The SBA has historically made money on the debenture investments of SBICs, so the program runs at zero cost to U.S. taxpayers. (A similar program that matched equity-only investments was discontinued in 2004, because the SBA lost money on it when the tech bubble burst.)

Those involved uniformly say the SBIC program is effective, and the SBA's most recent annual report shows growing investor interest and business impact. During the fiscal year ended Sept. 30, 2013, the SBA licensed 34 new funds, bringing the total to 292, and issued $2.16 billion in matching money overall. In the prior fiscal year, 30 new funds started and received $1.92 billion from the SBA.

The SBICs, in turn, invested $3.42 billion in the 2013 fiscal year, up 9% from the prior fiscal year. Of the 966 small businesses receiving those investments, 27% were located in low-to-moderate income areas or were minority- or women-owned. (This is for debenture, non-leveraged, bank-owned and specialized SBICs.)

HoganBruen says that despite BofA's focus on returns, the social impact of its investments also matters. If SBICs pick the right companies to invest in, "they do grow," he says. "So you get a good financial return, but you also get a small business job creation story that we're big fans of, too." □

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