

The Benefits to Banks of Investing in SBICs

By: Lawrence C. Manson, Jr., Senior Managing Director and Chief Executive Officer at NexGen Strategic Advisors, LLC and David E. Brown, Managing Director at NexGen Strategic Advisors, LLC

Overview

Investing in a Small Business Investment Company (**SBIC**) can prove to be very compelling for community banks. The benefits include: (i) potential Community Reinvestment Act (**CRA**) investment credit, (ii) an attractive return and (iii) client retention and development opportunities. **Banking has become increasingly competitive and investments in SBICs may provide a distinct advantage.**

Background on SBICs

In 1958, Congress established the SBIC program to facilitate the flow of capital to small businesses to be administered by the Small Business Administration (**SBA**) who licenses and regulates SBICs. Small businesses account for nearly all of the new jobs created in the United States since 1991. Investments by SBICs have fostered the growth of companies such as Federal Express, Intel, Callaway Golf, America Online, Compaq Computer, Outback Steakhouse and thousands of other small businesses that form the backbone of the U.S. economy. Small businesses represent more than 99 percent of all domestic employers and are the very companies in which SBICs seek to invest.

SBICs can obtain long-term leveraged funds at favorable interest rates to fund loans to and investments in qualifying small businesses. An SBIC can obtain funds through the SBA by issuing debentures, which are guaranteed by the SBA, pooled, securitized and purchased by investors. The debenture funding obtained under this program generally is at a very low cost to the SBIC, enabling the SBIC to use these low cost funds in conjunction with its private capital (raised from investors like banks) to make junior capital investments. This leverage can be as much as a 2 to 1 and in some cases as much as 3 to 1. SBICs can use these funds to invest anywhere in the capital structure but they generally provide mezzanine or subordinated debt (**Debenture SBICs**). As reported by the SBA, there are approximately 130 Debenture SBICs managing approximately \$6.7 billion in committed capital resources and during fiscal year 2007, the Debenture SBICs invested approximately \$1.3 billion in domestic small businesses, a new high for the SBIC program.

Background on CRA

Congress enacted the Community Reinvestment Act in 1977 to encourage banks to help meet the credit needs of the local communities in which they operate. Since July 1997, a bank's investment activity has been included with the lending and service tests in the evaluation to determine a bank's CRA rating. There are four criteria used in evaluating a bank's CRA investment performance: (i) the dollar amount of the qualified investment, (ii) innovativeness and complexity, (iii) responsiveness of the investments to credit and community development needs and (iv) the degree that such investments are not routinely made by private investors. The investment test accounts for approximately 25 percent of the overall CRA rating. The recent passage of the Gramm-Leach-Bliley Act further increased the importance of a bank's CRA rating.

SBICs and CRA

An investment by a bank in a SBIC is expressly identified as a type of investment that is presumed by the regulatory agencies to promote economic development and will meet the standards of a "Qualified Investment" for CRA purposes assuming the marketing focus of the SBIC includes the bank's assessment area.

In addition, the bank's assessment area need not receive an immediate or direct benefit from the SBIC's investing activities, provided the purpose, mandate or function of the SBIC includes serving the broader geographic region where the bank's assessment area is located.

Return Characteristics of SBICs

Investments in SBICs themselves can enhance a bank's profitability. SBICs, like other alternative investment funds, can generate strong returns, albeit over a period of time, while assuming some risks yet achieving a level of diversification both across various geographies and industries which may be difficult to obtain by an individual community bank.

SBICs provide banks with an attractive alternative to other investments routinely used to meet the investment test (e.g., grants, LMI mortgage pools, qualified tax credits, etc.). SBICs routinely produce returns in the mid-teens and above. According to the SBA's SBIC Program Statistical Package, January 2001, the average annual realized rate of return to investors for all SBICs has been approximately 21 percent since 1996. While investing exclusively in SBICs to meet the investment test may not be prudent, including SBIC investments with other investments can provide better diversification and higher returns than most banks are currently realizing.

Bank Client Retention and Development

Banks that invest in SBICs have the opportunity to establish a relationship with a firm that can enhance the bank's ability to serve its current clients and prospects. Mezzanine debt, which can be provided by a SBIC, can serve as a credit product extension that enhances the client/prospect relationship and provides an additional line of defense against client migration.

As a corporate borrower grows, it becomes increasingly more difficult to retain the business. Retention is dependent upon the bank's service and product offerings. The best corporate borrower relationships are typically the most seasoned and profitable, and as they grow, they will likely approach the credit limits of the community bank and will look elsewhere to find an expanded banking relationship. If senior credit has reached its limits, mezzanine debt can give the borrower another financing option. By investing in an SBIC, banks can have direct access to a provider of non-competitive mezzanine debt to offer to their best clients and prospects.

On the other end of the spectrum, SBICs give community banks a valuable banking product, junior capital funding, for small businesses that may not meet the bank's lending standards. This in turn, allows community banks an opportunity to build solid banking relationships with small businesses in the early stages, allowing for a more profitable relationship as these businesses grow and mature.

In addition, from time to time, SBICs pursue banks to consider providing senior secured debt to the portfolio companies. SBICs can not only help community banks retain and grow a current clients and prospects, but can possibly introduce the community bank to new relationships.

Conclusion

The right SBIC can be an attractive stand-alone investment even without considering its CRA attributes and business development enhancers, but considering all of the qualities that may be involved, an investment in a SBIC by any bank should be given the proper consideration.

About NexGen Capital Partners, LLC

NCP offers investment and advisory services to community financial institutions and their corporate clients through its wholly-owned subsidiaries NSI and NSA, respectively, but in the future may conduct other business activities that promote the interests of the Principals and are consistent with the missions of NSI and NSA.

About NexGen Strategic Investors, LLC

NSI has developed several proprietary CRA investment products for a range of institutional investors, including community financial institutions, which should provide them with appropriate geographic and risk diversification, high relative returns and targeted community development initiatives.

About NexGen Strategic Advisors, LLC

NSA assists both private and public companies in meeting their strategic and financial objectives by offering a selective range of services. Specifically, NSA targets community financial institutions and their middle-market corporate clients. Success in providing advice and transaction execution requires vision, commitment, integrity, teamwork and experience. NSA combines these elements to create value for their clients. NSA advises clients from the early stages of tactical, strategic and financial planning to the final implementation of these strategies.