# An Evaluation of the Small Business Investment Company Program, It's History and Development, with Emphasis on the Utah SBIC Industry

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AN EVALUATION OF THE SMALL BUSINESS INVESTMENT COMPANY

PROGRAM, IT'S HISTORY AND DEVELOPMENT, WITH

EMPHASIS ON THE UTAH SBIC INDUSTRY

by

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A thesis submitted in partial fulfillment
of the requirements for the degree

of

MASTER OF BUSINESS ADMINISTRATION

Approved:

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Logan, Utah

1966

ACKNOWLEDGEMENTS

The author wishes to express sincere thanks and appreciation to his thesis committee chairman, Professor Judith Bills for the assistance and time which she has contributed to this study. She has spent many hours in the reading, criticizing, and evaluating of the thesis material. Her help has made it possible for this report to be written.

Appreciation is also expressed to the Utah SBIC officials who supplied information for this study. Without their cooperation, this study would have been lacking in depth and fact.

Very special thanks must be expressed to my wife, Anita, and my parents, who have helped and encouraged me in the writing of this report.

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CHAPTER I

# INTRODUCTION

## Origin and Nature of Study

Does the small business concern in this country have access to sufficient amounts of growth capital? For the past several years there has been much controversy concerning this question. Articles have been written both pro and con voicing opinions as to whether small businesses are being discriminated against in the acquisition of long-term loans to finance growth and business expansion. The majority of the written information on this subject appears to support the theory that too many small business firms are under-capitalized and the sources of long-term investment and growth funds are seriously limited to the small businessman. The Small Business Administration pamphlet, "SBIC Financing for Small Business," offers this statement:

> Small businesses generally have difficulty obtaining long-term capital to finance their growth. Prior to 1958 there were few places a small company could turn for money once it had exhausted its secured line of credit from banks or the SBA.[1]

Several studies have been undertaken within the past few years to establish the sources of long-term capital and whether additional sources should be made available to small businesses. Perhaps the most comprehensive of these studies was made during 1957 by the

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[1]"Money for Growth," SBIC Financing for Small Business, A pamphlet prepared by the Small Business Administration, (Washington: Government Printing Office, 1965), p. 2.

Federal Reserve System.[2] In completing this study, the research team went to great lengths to discover the sources and availability of short-term, intermediate-term, and long-term credit.[3] In general, the findings of this study revealed that small businesses did have access to sufficient sources and amounts of short-term credit, fair sources and amounts of intermediate-term credit, but long-term credit, or equity capital sources were not adequate.

The findings of the Federal Reserve study, as well as many other studies, played an important role in the passage of the Small Business Investment Act of 1958. This Act authorized the Small Business Administration to license, regulate and help finance privately organized and privately operated investment companies whose prime purpose was to supply long-term money to small firms. Pursuant to the Act, the Small Business Administration would work closely with the investment companies, acting as both advisor and regulatory agency.

The Small Business Investment Company Program grew rapidly during the first few years of its existence. Within six years after the Act was passed, there were over 700 operating small business investment companies throughout the nation. Their individual capital ranged from $300,000, the minimum amount of capitalization allowed by the Small Business Administration, to about $25 million. As an

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[2] The Federal Reserve System, Financing Small Businesses, (Washington D. C. Government Printing Office, 1958), 28 p.

[3] In this study, short-term credit extended up to 1 year, intermediate-term credit extended from 1 to 3 years and could be extended to 5 years, and long-term credit was considered to be 5 to 20 years.

industry, these approximately 700 small business investment companies had total assets of about $750 million, with additional funds being available to them from the Small Business Administration and private sources. By the end of 1964, these investment companies had invested more than $500 million in small businesses.[4]

Generally speaking, the small business investment company program was well accepted by the public. In 1962, over fifty companies were traded to the public. The small business investment company industry stocks were considered glamour stocks.

The issue in this study, however, is not to question whether or not Congress was justified in passing the Small Business Investment Act of 1958. The main thesis of this study deals with an investigation of the Small Business Investment Act of 1958 and the subsequent amendments to this Act. This investigation was made to determine how well the management of small business investment companies were satisfied with their operations under the Act, and to what extent the services of the small business investment companies are being utilized by small businesses. An inquiry was also made to determine the extent to which the management of small business investment companies are participating in the program of supplying financial aid and managerial advice to their clients.

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[4] _SBIC Financing for Small Business_, _loc. cit._

## Limitations of the Study

Although there are vast amounts of information available on small business financing, it is beyond the scope of this study to try to present a complete picture of small business financing. It is the authors intention that by briefly explaining the financial needs of small firms and the importance of these firms to the national economy, the reader will find the remainder of the thesis more meaningful.

Congressional records, Small Business Administration reports, and current periodicals were reviewed[5] on the operations of the small business investment company program in the United States. However, the administration of a questionnaire[6] concerning various phases of the program was limited to those companies licensed in the state of Utah. There has been a total of six small business investment companies licensed in Utah. However, one company has ceased operations and relinquished its charter. The remaining five companies are, (1) Creative Capital Corporation, (2) Empire Capital Corporation of Utah, (3) Intermountain Capital Corporation of Utah, (4) Lockhart Capital Corporation, and (5) Utah Capital Corporation. All five of these companies are located in Utah's capital city, Salt Lake City.

## Significance of the Study

During the first year of operation of the small business investment program, 61 companies were formed. Six months later this number

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[5] A list of the literature reviewed by the author may be found in the Bibliography.

[6] A copy of the questionnaire used in this study may be found in Appendix B.

had increased to 107 companies. By January of 1964 there were over 700 licensed small business investment companies in operation. By mid-1960, the Small Business Administration had already answered several thousand inquiries about the Small Business Investment Company Act, operations under the Act, and problems of formation and operations of small business investment companies. The large number of inquiries about the program and the speed with which the program has grown is sufficient evidence to conclude that wide-spread interest is being shown in the small business investment company program.

It is intended that this study will be of value to three different groups of people in supplying them with the needed information to make a decision as to whether they want to become further involved with the SBIC program. First, to those businessmen who have an interest in forming a small business investment company, but as of yet, have not done, so, secondly, to the management and stockholders of the operating small business investment companies, and third, and most important in the opinion of the author, it is hoped that this study will be of value to the small business manager who is prospective client of a small business investment company and is seriously considering the small business investment company program as a source of money for growth and expansion of his business.

## Methodology

Library research is basic to any well designed research project. There is a wide variety of published material on small business financing which was utilized in this study. Available information on the formation and operation of the small business investment company program was of a more limited nature. The data for this study was gathered from published texts, from current periodicals and trade publications, and from government sources.

Field study was an important means of gathering information concerning Utah's small business investment companies. While the personal-interview questionnaire method is, in practically all cases, superior to a mail survey, it was particularly well suited to this study. The population consisted of only five companies, all located in Salt Lake City, Utah. It was therefore possible for the author to personally administer the questionnaires to key officials of the five companies. All respondents were invited to make comments on any areas which were pertinent to the study.

## Definition of Terms

### A small business under the small business act of 1953

Section 203 of the Small Business Act of 1953, as amended, defines a small business as follows:

> For the purposes of this title, a small-business concern shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation. In addition to the foregoing criteria, the Administration, in making a detailed definition may use these criteria among others; Number of employees and dollar volume of business.[7]

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[7]U. S. Congress, House, Select Committee on Small Business, *Definition of "Small Business" Within Meaning of Small Business Act of 1953, as Amended, H. Res. 114*. 84th Cong. 1st Sess., 1956. p. 19.

A small business firm for purposes of receiving assistance from small business investment companies

Before assistance can be offered by a small business investment company, a business firm must qualify under the preceeding paragraph or be classified as a business concern which together with its affiliates is independently owned and operated, is not dominant in its field of operation, does not have assets exceeding $5,000,000, does not have net worth in excess of $2,500,000, and does not have an average net income, after Federal income taxes, for the preceeding two years in excess of $250,000 (average net income to be computed without benefit of any carry-over loss).[8]

Small business investment company

The terms, Small Business Investment Company, SBIC, and Company, refer to a corporation organized under the provisions of Title III of the Small Business Investment Act of 1958, as amended, including a state-chartered investment company which has obtained the approval of the administration to operate under the provisions of this Act as provided in section 309 and a company converted into a small business investment company under Section 401 of this Act.[9]

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[8] 25th Federal Register, 10087, (Oct. 22, 1960), Section 121, p. 3-11.

[9] Small Business Administration, Consolidated Reference Regulations to the Small Business Investment Act of 1958 as amended June, 1960. (Washington D. C.: Government Printing Office, 1960,) p. 3.

Licensee

The term, Licensee, refers to a corporation which is chartered under State law or by the SBA under section 301 of the Small Business Investment Act of 1958 to conduct, in the territory in which it operates, the activities described under Title III of the Act.[10]

Operating territory

The area in which the operation of an SBIC is to be carried on is referred to as the "operating territory." It refers to the territorial area or areas in which a licensee is authorized to furnish equity capital, long-term credit, and consulting and advisory services to small business concerns.[11]

Small business administration

The terms Small Business Administration, SBA, and Agency, refer to that agency created by the Small Business Act of 1953, Public Law 85-356.[12]

## Organization of the Study

Chapter II of this study is offered largely as background material investigating the role of small business in the American economy. This chapter discusses the different types of funds needed by the small businessman and the different stages of growth during

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[10] 23 Federal Register 9383 (December 4, 1958), Section 107, p. 103.

[11] Ibid.

[12] U. S. Senate, Select Committee on Small Business. Small Business Act of 1953, (72 Stat. 384).

which these types of funds are needed.

Chapter III discusses the principal provisions of the Small Business Investment Act as it was passed in 1958. With each succeeding year, new provisions have been added and parts amended. These several amendments are discussed in order to present the current status of the program.

The actual operational experience of small business investment companies will be discussed in the fourth chapter. The time period covered here was that period from 1958 until January 1965. Much of the information used in the writing of this chapter was taken from current periodicals, Small Business Administration literature, and Congressional reports. This chapter also includes the opinions of small business investment company officials with regard to rules, regulations, and general administrative policies and procedures as administered by the SBA.

Chapter V of this study contains the findings of a questionnaire administered to the five small business investment companies operating in the state of Utah. This questionnaire concerning various phases of the small business investment company program and operations was personally administered to key officials of each of the Utah SBIC's.

The sixth and final chapter of the study contains the summary and conclusions of the author. Suggestions and criticisms are offered at this time.

## CHAPTER II

## ADEQUACY OF SMALL BUSINESS FINANCING

### The Importance of Small Business

> The small business sector of the American economy is basically strong and vigorous. In financing small businesses one is not dealing with a declining segment of the American business population. One is not shoring up weakness, he is buttressing strength. The odds in favor of the success of a small business in America are not worsening; they are holding steady, and may even be improving.[1]

The preceeding statement by Dr. Jacoby reflects the opinion of many of the nations business leaders in expounding their belief in the importance and "health" of small business. Although big business makes up the larger part of the dollar volume of business in the United States, there are some 30 million people, including seven million proprietors and partners who earn their living in small firms. If we take into consideration the exemptions of these 30 million workers, roughly one third of the national population is dependent upon small business for its support.

Because of the degree of importance which is placed on the existance of small business, it seems reasonable to expect that the small business sector of our economy be given equal opportunity, along with big business, to grow and develop. This second chapter will discuss the importance of small business in the American economy,

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[1]Neil H. Jacoby, "Improving the Risk-Attractiveness of Small Investment Companies," The Commercial and Financial Chronicle, (Sept. 1, 1960) p. 1.

and the sources and adequacy of financing available to small business firms.

Number of small business firms

For several years the total business and total human population have been moving in remarkable consonance. In 1957 there were about 25 business firms for every 1000 persons in the country. In 1929, the comparable figure was 24.9 business firms per 1000 population. This has only varied slightly in the past sixty years. In 1900 there were 21 firms per 1000 population. This slight change in the business/human population ratio from 1900 until now has been a slow but steady increase in the number of businesses with the only exception occurring during the depths of the great depression, when the number of firms fell from 24.5 to 23.2 firms per 1000 population.[2]

The small business sector of the U. S. economy makes up the greater part of the total business world when we compare the number of small firms to the number of large firms. At the end of 1957, with approximately 4.3 million business firms in the U. S., 99 per cent of these firms were considered to be small business firms.[3] According to the office of Business Economics, U. S. Department of Commerce survey in 1951, 95 per cent of the U. S. businessmen employed less than 20 employees,[4] and a later study reported that 99.8 per cent

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[2]Charles L. Prather, Financing Business Firms, (Homewood, Illinois, Richard D. Irvin, Inc., 1955) p. 13.

[3]U. S. Congress, House, Select Committee on Small Business, Problems of Small Business Financing, 85 Cong., 1st Sess., 1957. p. 18.

[4]Ibid.

of the total business firms in this nation employed less than 500 workers.[5]

Although one out of every eight businesses goes out of existance every year because of the death or retirement of the owners, or their inability to operate profitably, there is an even larger number of new firms which begin operations. These new firms bring about a net increase in the enterprise population of about 50,000 businesses each year.[6] The information in Figures 1 and 2 on the following pages present graphic representations of the number of business incorporations and the number of business failures between the years of 1947 and 1964.

Business volume of small firms

For the past several years business volume has been increasing rapidly in the U. S. Business volume concentration ratios indicate that small firms have been increasing their business volume in proportion with large firms. There has been no tendency for larger firms to become relatively more important in their respective industries.[7]

One area of business in which small firms have been increasingly active is the defense industry. According to the Department of Defense records, about 20 per cent of the net value of all military prime contracts during the years 1951-1957 went to small business

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[5]Federal Reserve System. Financing Small Business. op cit.

[6]Jacoby, loc. cit.

[7]Ibid. p. 24.

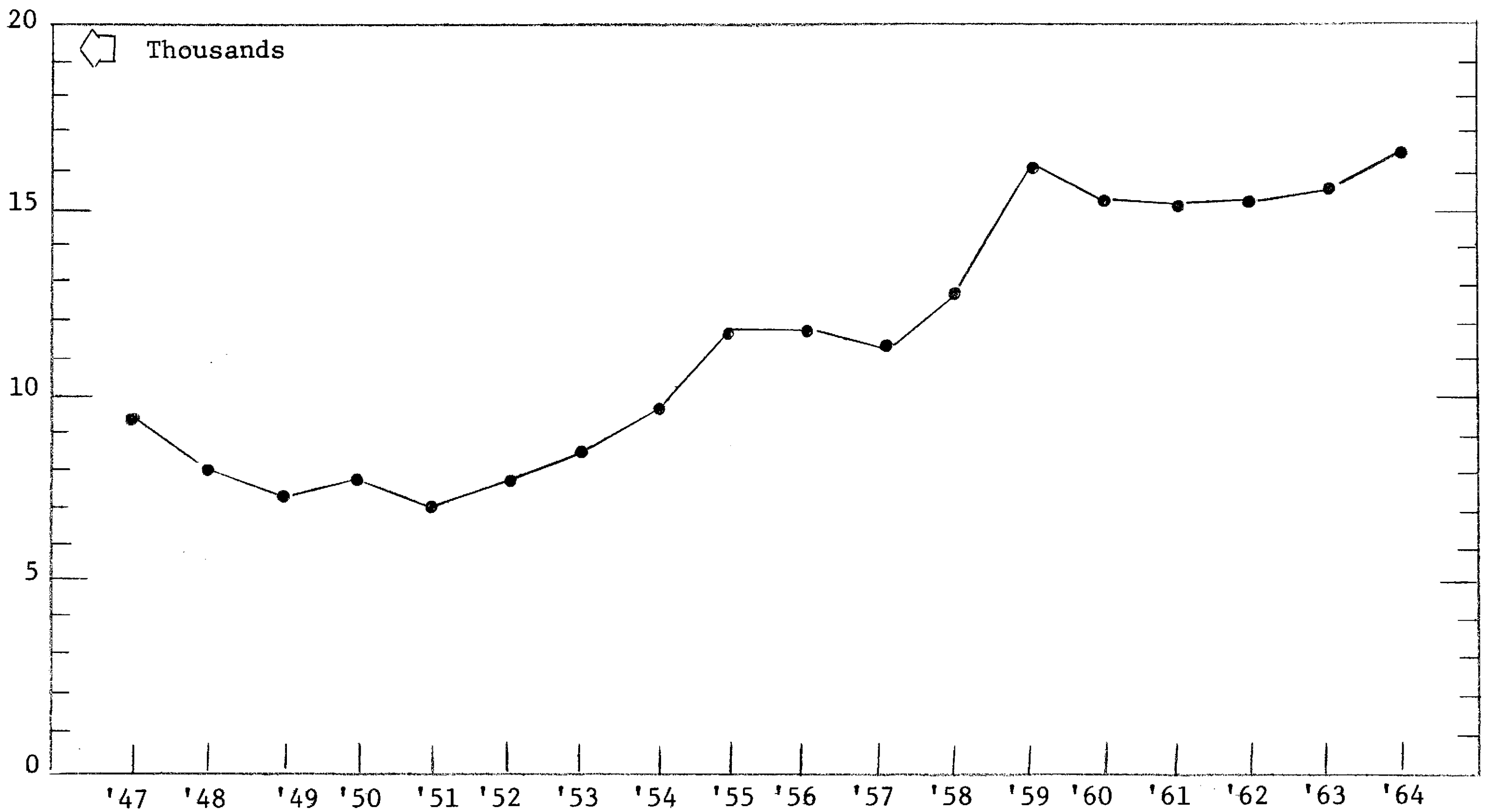


Figure 1. New business incorporations, 1947 through 1964.

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Source: Annual Report of the Small Business Administration, (Washington: Government Printing Office, 1964) p. 6.

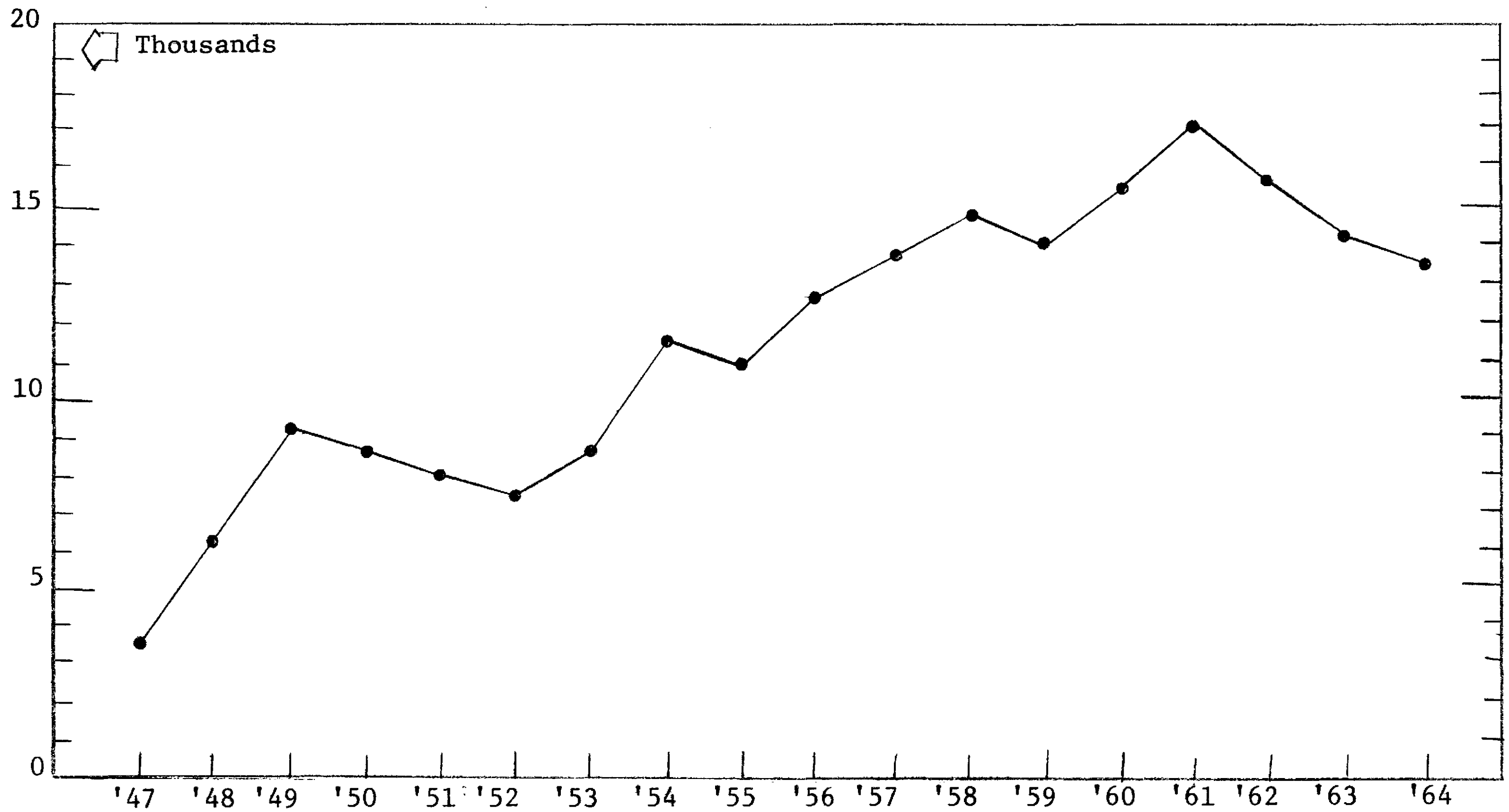


Figure 2. Number of business failures, 1947 through 1964.

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Source: Annual Report of the Small Business Administration, (Washington: Government Printing Office, 1964) p. 6.

firms. These were firms which were not dominant in their fields of operation and were employing fewer than 500 employees.[8] The total volume of defense business to small contractors would be larger and more pronounced if small business participation by way of subcontracts and sales of materials and services to prime contractors were taken into consideration. One reason that small businesses participate in defense contracts to the extent that they do, is because of Government regulations which require that small firms be given preference on contracts which are suited to their abilities. However, the small firms must meet the same standards of quality and performance as their larger competitors, in order to qualify for a contract.

Since it is felt by many that a healthy birth and growth rate for small businesses is important to the satisfactory economic development of our country, and since small businesses do contribute to the competitive and progressive attitude of the U. S. economy, it is generally felt[9] that a national goal to stress the equality of opportunity to small business should be supported.

## Availability of Capital and Credit

If the small business sector of the economy is to continue to grow, it must of course, be able to attract outside capital to finance growth and development. In general, the financial needs of a small firm are no different than those of a large firm except that these

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[8]Ibid.

[9]Two legislative acts which stress this view are the Small Business Act of 1953, and the Small Business Investment Act of 1958.

financial needs are on a smaller scale. The problems encountered in obtaining outside financial assistance however, vary considerably from the small to the large firm. The task of obtaining financial assistance is not an easy task for a big business and becomes an especially difficult situation for a small firm. Although small businessmen are not at a particular disadvantage in short-term and intermediate-term borrowing, in many cases when growth and expansion are at stake, only a long-term loan will suffice, and the sources of long-term capital to the small firm are extremely limited. As an example, the investment banking system which is an important source of funds to the big business, is of practically no use to the small business because of the small scale of borrowing.[10]

Short-term loans

Of the three types of loans which have been mentioned in this chapter, the short-term loan is by far the easiest for the small businessman to obtain. This, of course, is due to the lack of risk involved and the ability of the small firm to forecast revenue for a short period of time. Because of this lack of risk, the commercial bank is generally an excellent source of funds.

Short-term loans usually run anywhere from 30 days up to six months or a year. The shorter-term loans (30 to 90 days) generally take the form of trade credit from the wholesaler, while those loans over three months are usually interest bearing loans from a commerical lending institution.[11]

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[10] Financing Small Business, (Economic Policy Division Series No. 35, National Association of Manufacturers, New York) 1960. p. 26.

[11] Ibid.

Intermediate-term loans

While short-term loans are the most plentiful type of loans available to the small businessman, often the repayment period is too short to suit the firms needs. When the purpose of the loan includes such things as plant improvement, inventory expansion, addition of machinery or equipment, or expanding into new business territories it becomes necessary for the business-man to seek intermediate-term funds. These funds usually run from one to three years and can be extended to five years in many cases.[12]

While the prime source of short-term loans is the commerical bank, intermediate-term loans may often be obtained from sales finance companies and insurance companies, as well as commercial banks. However, one problem which the small businessman often encounters when seeking intermediate-term money is the unwillingness of many lending institutions to lend small amounts of money. Because of the expense involved in investigating the credit standing of a firm and the expense of making the loan, many financial institutions prefer to loan money in larger increments; the loan size depending upon the individual institution.

Another area of prime concern to the lending institution is the risk involved in a loan. While there is more risk involved in a three year loan than a six month loan, sales and profits can still be forecasted with a fairly high degree of accuracy for an intermediate-term loan. However, when the loan extends past the five year repayment period, and becomes a long-term loan, the future cannot be

[12] Ibid. p. 26.

forecasted so pricisely and the risk increases considerably.

Long-term loans

The most difficult problem of obtaining outside financing occurs when the small businessman finds himself in need of a long-term loan to finance growth and expansion of his business. This type of loan generally has a repayment period of from five to twenty years, and the money involved is often referred to as "venture capital," because of the amount of risk involved.[13] While the large business is often in a position to turn to the securities market for long-term equity financing, the small firm will usually find this source much too expensive for smaller amounts of financing. In fact, in most cases, investment banking firms will not even consider underwritings of less than $300,000.[14] Since commercial banks are primarily interested in short-term loans, the small businessman finds the field of available money sources very limited, especially during certain stages of his firms growth. The following section discusses the available fund sources in relation to the firms growth cycle.

## Small Business Financing and the Growth Curve

In many cases, the type of financing and the source of financing available are linked closely with the stage of growth in which the small firm finds itself. It is not the authors intention that the

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[13] James E. Mahar, Dean C. Coddington, The Financial Gap--Real or Imaginary, (Denver Research Institute, University of Denver) August, 1962. p. 24.

[14] Ibid.

reader think of new firms and small firms as being the same. However every firm, large and small, experiences changing financial needs as the firm progresses through the different stages of the growth curve. During some stages of growth, fund sources are more limiting to the firm than during other growth stages. The following discussion examines the financial needs of the small firm as it progresses through the growth cycle.

The information contained in Table 1 on the following page illustrates how the need for different types of financing, and the sources of financing vary as the firm moves from one growth stage to another. The following pages will discuss in more detail, the information in Table 1.

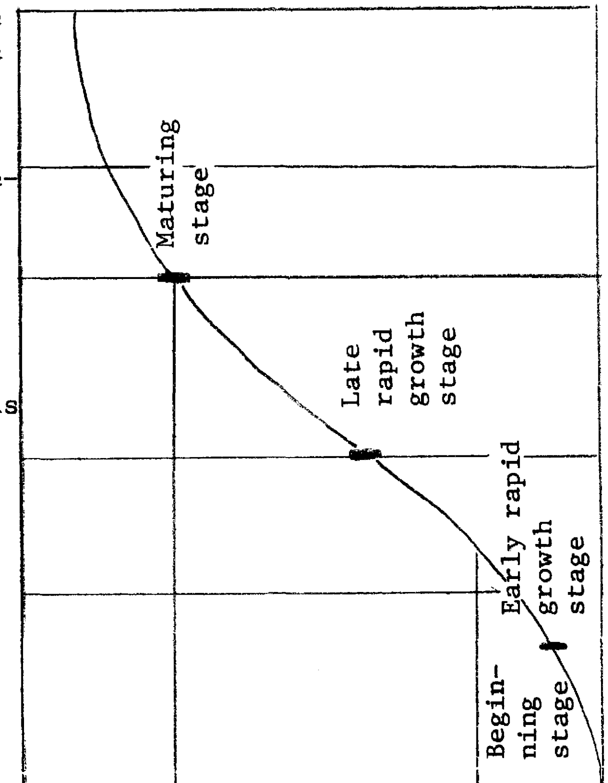
The beginning growth stage

Firms in the beginning growth stage are in the process of beginning actual operations and experience conditions particular to this growth stage. The prime financial needs of new firms are for such things as advertising and promotion of products, establishing market channels, and covering of operating losses. Many new firms are operating with new, untried management and cannot offer the safety requirements and proven growth potential to attract most institutional funds. Because of the risk involved, commercial banks are usually not interested unless the loan is a short-term loan using the managers personal assets as collateral. Even the SBA, in cases where the amount of the loan exceeds the firms equity, may feel the risk is too great and show no interest.[15] This leaves only one major

[15] *Ibid.* p. 25.

Table 1. Need versus availability of long-term funds related to typical growth curve.

GROWTH IN $ SALES




Commercial Banks can often be successfully approached for a long-term loan.

SBA relaxes its collateral requirements; gives consideration to general credit of the corporation

Investment Banks take notice as company grows successfully, as management proves itself, and as needs for funds approach $300,000.

Until the development of SBIC's, this period was practically void of available funds.

Private Sources, such as personal savings, friends, relatives and private investors are usually the most likely suppliers of long-term funds.

SOURCES OF FUNDS

NEED FOR FUNDS

| | | | |
|---|---|---|---|
| Funds needed for new product development and promotion, for plant modernization (cost reduction) and for refinancing of existing obligations. | Company needs permanent working capital; accounts receivable and inventories increasing more rapidly than accounts payable and short-term credit. | Additional plant and equipment usually required to keep productive capacity up to sales levels. | Funds needed for product improvement, promotion, establishing channels of distribution, working capital, and plant and equipment. |

Source: Mahar and Coddington, The Financial Gap--Real or Imaginary, Denver Research Institute, University of Denver, August, 1962.

source of funds available to the beginning firm; the private investor.

Finding private investors who are willing to invest their money in beginning, untried firms is generally a difficult task and requires great skill and effort on the part of management. This is especially true if the firm is in need of a loan in excess of $25,000. As the size of the loan increases, the number of private investors who are willing or able to supply the necessary money decreases. Since practically all beginning firms must depend upon private backing at one time or another the problem of finding private investment funds can be a serious one.

### The early rapid growth stage

As the firm moves from the beginning growth stage to the early part of the rapid growth stage, many changes take place. The firm senses this growth change as its financial needs increase. This stage is characterized by a shortage of cash because of a need for increased amounts of working capital for added sales or productive capacity. Although in most cases the firm is not operating at a loss, the retained earnings are not usually sufficient to supply more than a small part of the company's financial needs.[16]

As the firm changed from the beginning stage to the rapid growth stage, the financial needs changed from short-term to long-term needs. Management is trying to push the firm into a growth situation in which the demand for outside financing with repayment terms in excess of five years is greatly needed.[17] As was the case with the

[16] Ibid. p. 35.

[17] Ibid. p. 46.

firm in the beginning growth stage, lending institutions are apt to be skeptical because of the risk involved, and especially because of the length of time for which the funds are needed.

### The latter rapid growth stage

The financial needs of the firm varies only slightly as the firm moves from the early to the latter part of the rapid growth stage. Management is still concerned with the shortage of working capital. By this time the firm can in most cases obtain short-term and intermediate-term loans, and will usually make considerable use of these funds.[18] The need for a source of long-term money is still pressing and if the firm is to continue rapid growth these funds must be obtained. Conventional lending institutions are still very hesitant when confronted with the prospects of making a loan for a five to twenty year period. It is during these rapid growth stages that the management of small firms feel a keen need for a lending institution that specializes in long-term lending to small businessmen in order that the business may grow and flourish from its beginning until it reaches the mature stage.

### The mature stage

As the firm passes into the mature stage of its development, several significant changes take place. Sales begin to level off and competition becomes more prominent. Production and sales capacity are adequate and the firms financial needs are no longer a pressing problem. Most companies which reach this growth stage have established a profitable history and can offer this, as well

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[18] Ibid.

as experienced management and a profitable forecast of the future as security for a loan when the need arises.[19] The long-term financing which was so desperately needed during the rapid growth stages is generally not needed now. Seasonal fluctuations may necessitate short-term loans, and the replacement of machinery might necessitate an occasional intermediate-term loan, but generally, the long-term loan is needed only for growth and expansion of the business.[20]

## The Financial Gap

The term "financial gap" is used to describe the scarcity of long-term funds to small businesses. While the term is not used synonomously with any particular growth stage, the fact that it is concerned with long-term capital ties it in closely with the rapid growth periods. The financial gap affects investments. Because of the scarcity of funds, investors are not able to make investments as they normally would, and thus, the number of investments is decreased.[21]

One reason for the existance of the financial gap is that many lending institutions, because of the time and expense involved in investigating a loan applicant, are reluctant to make the necessary

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[19] Ibid.

[20] The reader is reminded that the preceeding discussion concerning a firms financial needs in relation to the growth cycle, is not limited to the small firm. All firms, both large and small follow some type of a growth curve from the beginning to the mature stage. This subject was discussed primarily to acquaint the reader with the needs and problems encountered by the small businessman in his quest for outside financial assistance.

[21] Ibid. p. 28.

investigation to supply small loans to small firms. This is especially true if the small firm is also new and untried.[22]

Another reason for the existance of the financial gap is due to the inadequate knowledge of both the lending institution and the small firm. The small firm's management is often directed from one lending institution to another, because financial institution managers aren't adequately informed of the criteria used by other lending institutions. Therefore, they aren't able to direct clients whom they can't help. In many such cases, small business managers become discouraged, abandon their search for growth funds, and the financial gap continues to exist.

Also, few small businessmen have adequate knowledge of the different types of lending institutions and the regulations and policies which govern their lending procedures. Because the lending policies do vary among the different lending institutions it is to the advantage of the borrower to gain a thorough knowledge of the types of lending institutions with which he will be dealing.

## Types of Lending Institutions

### Commercial banks

Most small businessmen in need of outside long-term financing have had contact with several types of financial institutions.[23]

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[22] Ibid. p. 29.

[23] While there are many sources of financing available to small businessmen only four of the most important sources will be discussed. These are commercial banks, investment banks, commercial finance companies, and Government sources of financing.

Commercial banks are usually at the top of the list. If the banks cannot satisfy his financial needs, then, and usually only then, will he turn to another source of funds. Most small businessmen are aware however, that commercial banks are primarily interested in making short-term loans and only occasionally will these banks deviate from this policy and grant a loan with a repayment period of five years or more. In the few instances when a bank does grant a long-term loan, in order to comply with the state and federal banking regulations, the bank must impose severe standards of safety which exclude most small firms.

Another limiting factor of commercial banks is the legal loan limit. This can often be a factor when a firm is dealing with a small rural bank. While most small banks have larger correspondent banks in nearby cities, small banks are often reluctant to call upon these correspondents to assist in making a loan. The larger correspondent banks place considerable weight on the judgement of the small bank's management because of their intimate knowledge of the borrowing firm, and will usually give little consideration to a firm that has already been rejected by this smaller bank. This is just one of many restrictions imposed upon the commercial banking system which make this lending institution a rather unlikely source of long-term capital for the small businessman.

Investment banks

Although investment banks are generally a source of "big business" capital occasionally they are also useful to the small firm in supplying growth funds. Investment bankers are usually interested in small businesses only when they show excellent potential growth prospects. Only occasionally is this growth potential evidenced, and then usually in glamour industries such as electronics and aerospace.

Investment banks, just as commercial banks, have many restrictive policies which cause them to be of little value to the small firm. While a very limited number of small banks will consider raising small amounts of capital (as little as $50,000)[24] the majority of investment bankers will not consider underwritings under $300,000. The reasons for this attitude are just and valid ones. It is very expensive for a bank to underwrite a small offering of stock. The direct costs alone may run as high as 15 percent of the proceeds, and indirect costs can add to this. While total flotation costs of larger common stock offerings (over $0.5 million) average 10 percent to 15 percent of proceeds, total flotation costs for common stock offerings of less than $0.5 million often run as high as 25 percent.[25] The information presented on Table 2 on the following page shows a breakdown of the cost of issues by size and type of security issued. Although the information is rather limited for issues of less than $0.5 million, the comparison illustrates the expense involved in financing small offerings of securities.

The cost of financing small security offerings is not the only adverse condition facing small firms when dealing with investment bankers. Most investment bankers feel that until a company has proven itself as a profitable enterprise, stock in such a firm

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[24]Mahar and Coddington, <u>op. cit.</u> p. 30.

[25]<u>Ibid.</u>

Table 2. Cost of flotation of registered issues offered to the general public as a percentage of proceeds to the issuer classified by size of issue-type of security; 1951, 1953, 1955.

| Issue size (millions of $) | Total flotation cost | | | Compensation to underwriter | | |
|---|---|---|---|---|---|---|
| | bonds notes | preferred stock | common stock | bonds stock | preferred stock | common stock |
| Under 0.5 | --- | --- | 27.15% | --- | --- | 20.99% |
| 0.5 - 0.9 | 11.49% | 12.63% | 21.76 | 7.53% | 8.67% | 17.12 |
| 1.0 - 1.9 | 8.17 | 8.07 | 13.58 | 5.80 | 5.98 | 11.27 |
| 2.0 - 4.9 | 3.78 | 4.88 | 9.97 | 2.37 | 3.83 | 8.47 |
| 5.0 - 9.9 | 1.83 | 3.72 | 6.17 | 1.01 | 2.93 | 5.31 |
| 10.0 - 19.9 | 1.52 | 2.92 | 4.66 | .88 | 2.40 | 4.20 |
| 20.0 - 49.9 | 1.33 | 3.20 | 5.37 | .85 | 2.84 | 4.98 |
| 50.0 and over | 1.19 | 2.51 | --- | .88 | 2.12 | --- |
| Mediam | 1.49 | 4.34 | 10.28 | .88 | 3.34 | 8.75 |

Source: Securities and Exchange Commission, Cost of Flotation of Corporate Securities, 1951-1955 (Washington D. C.: U. S. Government Printing Office, 1957). p. 37.

cannot be sold on the most favorable terms, and the long-range financial condition of the firm can be limited. This is especially true if later financing is necessary and most of the authorized stock has already been sold.[26] Also "thin market" trading may result in which there are not enough stock shares available to support an active market. This causes sporadic trading and unrepresentative values on the stock. This not only is a serious problem to the small firm but also to the banking establishment. It must not be forgotten that the bankers reputation rides upon his underwritings and there is much to lose if an underwriting is unsuccessful. Therefore, the small firm will in most cases be forced to turn to commercial finance companies or Government lending agencies as another potential source of funds.

Commercial finance companies

Commercial finance companies are a source of capital for small firms but tend to supply more short and intermediate-term money than long-term loans. While these companies are not restricted by the same regulations as commercial banks, they too are hesitant, for many of the same reasons, to risk long-term money with small firms. In most cases equipment loans, inventory financing, and rediscounts make up the bulk of their lending activities to small firms, and, of course, these loans are usually in the three month to three year repayment category. If the firm finds that long-term funds are unavailable here, there is usually one more lending institution to approach; the Federal Government.

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[26] G. H. B. Gould and Dean C. Coddington, "Timing: The Key to Public Financing," Western Business Review, August, 1962. p. 30.

Federal Government financing sources

The Federal Government has instituted several lending programs over the years. Many of these programs were helpful in financing small businesses even though they were not established especially for the small businessman. Table 3 on the following page contains information concerning several of these Government programs. As can be readily observed, the first program to be developed especially for small business was the Small Business Administration.

The Small Business Act was passed on July 30, 1953 in order to encourage the development of small business. The policy, as stated in Section 2 of the Act, reads as follows:

> It is declared the policy of the Congress that the Government should aid, counsel, assist, and protect insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts or subcontracts for property and services for the Government (including but not limited to contracts or subcontracts for maintenance, repair, and construction) be placed with small-business enterprises, to insure that a fair proportion of the total sales of Government property be made to such enterprises, and to maintain and strengthen the overall economy of the nation.[27]

Government officials recognized that if small businesses were to survive they must have access to outside financing. However, it was not the purpose of the Act that the Government become the only lending source to small business. Therefore one of the stipulations of the Act is that the small firm must not be able to obtain financial assistance from any other source at reasonable terms, in order to qualify as an SBA loan applicant. However, the fact that a

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[27] U. S. Congress, Senate, Select Committee on Small Business. Small Business Act of 1953. 82nd Cong., 2d Sess., 1953.

Table 3. Business loans and loan guarantees of federal agencies, 1934-1957, by periods and by agency (amounts in millions of dollars)

| Agency or program | Program established Year | Authorization of direct loan participations or commitments, and insured or guaranteed loans 1934-41 Number | 1934-41 Amount | 1942-53 Number | 1942-53 Amount | 1954-57 Number | 1954-57 Amount |
|---|---|---|---|---|---|---|---|
| Reconstruction Finance Corp. | 1934 | 10,527 | $765 | 51,288 | 4,848 | --- | --- |
| Federal Reserve Banks | 1934 | 3,202 | 280 | 563 | 535 | 21 | 36 |
| Smaller War Plants Corp. | 1942 | --- | -- | 4,775[a] | 480[a] | --- | --- |
| Regulation V loans | 1942[b] | --- | -- | 9,965 | 12,702 | 206 | 530 |
| Veterans Administration | 1944 | --- | -- | 210,986 | 566 | 20,221 | 72 |
| Small Business Administration | 1953 | --- | -- | --- | --- | 8,597 | 398 |
| Fisheries loan program | -- | --- | -- | --- | --- | 174 | 5 |
| **Type of lending** | | | | | | | |
| Direct loans | | 9,520[c] | $638[c] | 30,253 | 3,254 | 2,839 | 120 |

Table 3. Continued

| Type of lending | Program established Year | Authorization of direct loan participations or commitments, and insured or guaranteed loans: 1934-41 Number | 1934-41 Amount | 1942-53 Number | 1942-53 Amount | 1954-57 Number | 1954-57 Amount |
|---|---|---|---|---|---|---|---|
| Immediate participation[d] | | 692 | $ 36 | 3,606 | 191 | 3,535 | 178 |
| Deferred participation[d] | | 1,614 | 145 | 22,202 | 1,883[e] | 2,397 | 104 |
| Loan guarantees | | --- | -- | 220,951 | 13,268 | 20,427 | 602 |
| Unclassified | | 1,903 | 226 | 563 | 535 | 21 | 36 |

[a]Reconstruction Finance Corporation; loan program terminated September 28, 1953.

[b]First program inaugurated in 1942; second program inaugurated in 1950.

[c]Figures for Federal Reserve banks are for 1934-1940. Classified data not available for 1941.

[d]A precise classification of Reconstruction Finance Corporation participation loans is not available. Figures for the two types of participation for this agency are estimates based on information indicating that deferred participation loans accounted for 70 percent of the number and 8 percent of the amount of all participation loans in 1934-41, and for 85 percent of the number and 90 percent of the amount in 1942-53.

[e]Includes $172,000,000 as Small War Plants Corporation share of deferred participations. Data on bank share of participations not available.

[f]Includes Veterans Administration insured as well as guaranteed loans.

manager cannot obtain reasonable financing from commercial lending institutions is no guarantee that the SBA will grant him a loan. The SBA is very selective in making loans. The firm's management must qualify in managerial experience, growth prospects, and several other areas before the SBA will consider granting a loan.

The SBA loans vary somewhat from those of commercial lending institutions. One particular type loan permits the SBA to participate with a commercial lending institution in making a loan. The SBA's maximum share is $350,000 with an interest rate not to exceed 5½ percent per annum.[28] However, the bulk of SBA loans are not participation loans and generally do not exceed a ten year repayment period.

While the SBA has done much to help the small firm grow it was still felt that there was a need for another source of long-term growth capital for small businesses.[29] After much controversy on the need for such a program, the Small Business Investment Act was passed in 1958

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[28] Ibid.

[29] See Chapter I, page 2 for further explanation of the studies undertaken prior to the passage of the Small Business Investment Company Act of 1958.

## CHAPTER III

## PROVISIONS AND AMENDMENTS OF THE SMALL BUSINESS INVESTMENT ACT

After more than a century of debate on the financial needs of small-business concerns, Congress passed on August 7, 1958, the Small Business Investment Act. It was intended that the long-term funds supplied through this Act would help to bridge the financial gap which existed within the small business sector of the economy by extending to small businessmen an additional source of long-term capital through privately owned and operated small business investment companies to finance needed growth and expansion. This type of financial assistance to small businessmen is in keeping with the goals of the national economy in that the private sector of the nation's economy should lead the way in meeting the essential needs of the nation.[1]

This chapter will discuss the Small Business Investment Act of 1958 with it's provisions for the organization, establishment, and operation of small business investment companies. Also, the amendments to the act, up to and including the year of 1964, are discussed.

### Objectives of the Small Business Investment Company Act

In December, 1960, a press release by the SBA stated the objectives and purpose of the Act, as follows:

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[1]Small Business Administration, Annual Report to the President and Congress, (Washington: Government Printing Office, 1964) p. 31.

> It is declared to be the policy of the Congress and the purpose of this act to improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity for sound financing of their business operations and for their growth, expansion and modernization, which are not available in adequate supply.[2]

With the enactment of the Small Business Investment Act, Congress gave the Small Business Administration the authority to license and regulate privately owned and operated small business investment companies. Once licensed, these investment companies would serve a two-fold purpose. First, they were to provide long-term (5 to 20 year) capital to small firms. This would be accomplished through the disbursement of a long-term loan which may be an interest-bearing loan, or a loan secured by equity securities which evidence a debt and provide either the option to convert into stock or provide non-detatchable or detatchable stock purchase warrants or options. The second purpose of these investment companies was to help small firms solve management problems which hinder their growth and expansion.

## Types of Small Business Investment Companies

There are three basic types of small business investment companies which have developed. These are the "Pro Bono Publico" company, whose motive is not profit, but community growth and welfare; the "Collateral Advantage" company[3] which is owned by conventional financing institutions, whose main objective is to extend their line of services, build their

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[2]U. S. Small Business Administration Press Release, December 14, 1960.

[3]The Collateral Advantage Company is also commonly referred to as the "Bank-subsidiary" type investment company.

clientele and thus increase profits, and the "Profit Motive" company, organized by professional investors for capital gains through growth situations.[4] While the latter two types have become very popular, very little interest has been manifested in the "Pro Bono Publico" company, and the information available on this type of SBIC is very limited. Therefore, only the "Collateral Advantage" and "Profit Motive" companies will be discussed in further detail.

"Collateral Advantage" companies

The Bank-subsidiary-type small business investment company has been very popular since its beginning.[5] This type company offers many advantages to the lending institution with which it is affiliated. In many cases, commercial banks are in a position to grant a loan to a small firm only to find that banking regulations prohibit them from doing so. Through an affiliated SBIC, the bank can in many cases grant the loan and make an extra profit in an area where restrictions would otherwise prohibit participation. The affiliation with, or ownership of an SBIC gives bankers their first opportunity since 1933 to participate in equities.

Another advantage with the bank-subsidiary type SBIC is the organization which already exists within the bank. Since finance is their business the bank officials are in a position to be aware of the financial needs of the business community and already have an

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[4] H. T. Smith, Loans and Equity Capital for Small Business, (Kalamazoo: The W. E. Upjohn Institute, 1959) p. 19.

[5] Russel Freeburg, "Banks Boarding the SBIC Bandwagon," Business Week, June 24, 1961. p. 64.

organization for contacting small-business concerns. Frequently, banks have branch offices at which SBIC's are widely publicized and made readily available. As an example, in 1960 there were already six banks and bank holding companies with a total of over 1,100 branches, that had organized SBIC's.[6]

### "Profit Motive" companies

Equally popular with the "Collateral Advantage" type SBIC is the "Profit Motive" company. These SBIC's are organized by small groups of professional investors and operate as closed corporations. Often these SBIC organizers are individuals and groups with very specialized experience, and the SBIC's they organize generally specialize with one specific industry in order that the investor's management talent can be pooled in an area where they are most competent. These specialized SBIC's are common and range from companies that specialize in making loans to cemeteries to other SBIC's who work only with the grocery industry.

## Sources of SBIC Funds

### Loans to SBIC's

Under the provisions of the Small Business Investment Act, the Small Business Administration is authorized to offer financial assistance to SBIC's in two different ways. First, the SBA may buy subordinated debentures from the SBIC in order to assist in the

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[6]U. S. Congress, Senate, Select Committee on Small Business, Small Business Investment Act of 1958, 86 Congress, 2d Sess., Report No. 1293, April 27, 1960, (Washington: Government Printing Office, 1960).

creation of the initial operating capital. The Small Business Investment Act requires that an SBIC have a minimum of $300,000 in paid-in capital and surplus. However, in order to encourage the formation of the companies, section 302 of the Act authorizes the SBA to purchase the debentures of any SBIC up to an amount of $150,000, which is half the minimum capitalization.[7] These debentures purchased by the SBA are subordinated to any other obligations and are considered part of the company's capital and surplus.[8] The second way the SBA may offer financial assistance to an SBIC is through a loan, not to exceed 50 percent of an SBIC's paid-in capital and surplus, granted after the SBIC has been licensed and is an operating concern.[9] Through these two lending programs, an SBIC may begin operations with capitalization of only $150,000 and increase it's capital many times through SBA loans.

Investments

While SBA loans are a major source of capital for the SBIC, particularly in the initial capitalization of the company, a second major source of capital is through the sale of the SBIC's own capital stock.[10] In the early years of the SBIC program the majority of SBIC

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[7]Section 302 of the Small Business Investment Act was amended in 1961, increasing the amount of subordinated debentures that the SBA may purchase, from $150,000 to $400,000, and in 1964, another increase brought the amount to $700,000.

[8]Small Business Investment Act. Section 302. op. cit.

[9]Ibid. Section 303.

[10]"Providing Venture Capital for Small Business," Annual Report of the Small Business Administration to the President and Congress. December 31, 1964, (Washington: Government Printing Office, 1965) p. 32.

funds were provided by capital stock and paid-in surplus. While most sales were private, some stock was sold to the public. The Small Business Investment Act authorizes national banks and member banks of the Federal Reserve System to participate in the purchase of SBIC stock so long as the amount does not exceed one percent of the banks capital and surplus.[11]

The information presented in Figure 3 on the following page shows a breakdown of SBIC fund sources, by funds borrowed from the SBA, funds borrowed from others, and capital stock and paid-in surplus. The total amount of funds increased very rapidly from 1960 to 1964. The reader is reminded however, that the number of reporting companies is also increasing at a rapid rate.

## Furnishing Capital to Small Business Concerns

According to the provisions of the Small Business Investment Act, and SBIC may furnish long-term funds to a small-business concern through the purchase of debentures of the small business, or through a long-term loan. If the SBIC purchases debentures of the small concern, these debentures contain terms, and bear interest at a rate which the SBIC may fix with approval of the SBA. These debentures are callable on any interest payment date at par plus accrued interest upon three months notice. These debentures are convertible at the option of the SBIC, up to and including the effective date of any call by the issuer, into stock of the small-business concern, at

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[11]Small Business Investment Act. loc. cit.

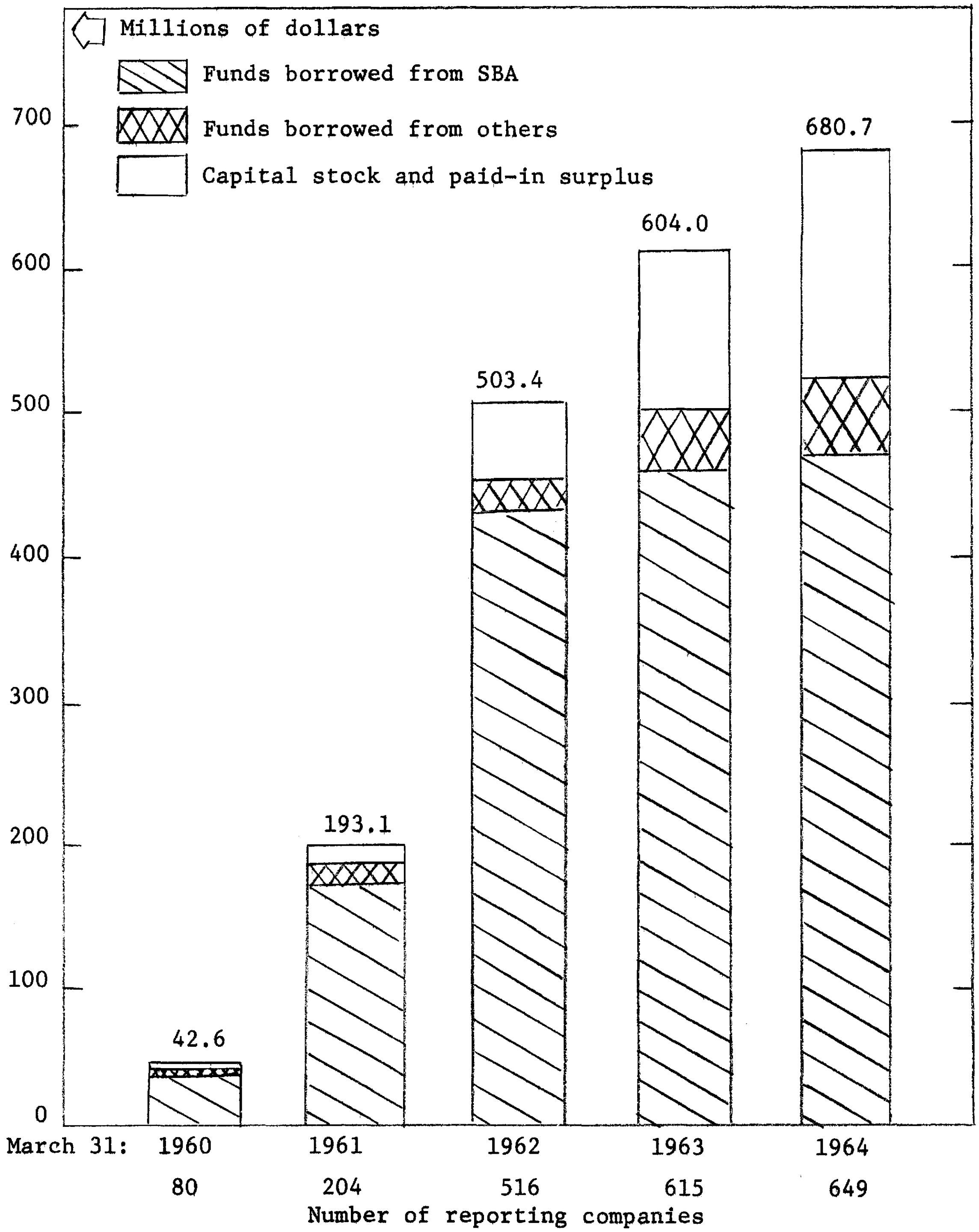


Figure 3. Sources of SBIC funds.

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Source: Annual Report of the Small Business Administration, (Washington: Government Printing Office, 1964) p. 32.

the sound book value of such stock determined at the time of the issuance of the debentures.[12]

Another of the Act's requirements is that whenever a company provides capital to a small-business concern, the concern is required to become a stockholder-proprietor in the SBIC by investing in the capital stock of the SBIC in an amount of at least two, but not more than five, percent of the amount of the capital provided the concern by the SBIC.[13]

Along with the provisions already mentioned, the SBIC may impose other conditions upon the small concern. These conditions may include requiring the refinancing of all outstanding indebtedness so that the SBIC will hold all indebtedness. The SBIC may also require that the small company incur no additional indebtedness without first consulting the SBIC and offering the SBIC the first opportunity to finance the additional indebtedness. These are only two of the more common provisions. The terms on both the purchase of debentures, and long-term loans by SBIC's are tailored to fit the particular firm and the conditions which exist.

Many small businessmen are very hesitant about giving up equity in their firm and prefer a long-term interest-bearing loan to selling equity type debentures to an SBIC. In such a case, an SBIC may grant a direct loan to the firm or participate with another lending institution in making the loan. When making the direct loan, the SBIC may

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[12] Ibid.

[13] Ibid.

not loan more than 20 percent of its combined capital and paid-in surplus to one small concern. This is also true in the participation type loan. This loan ceiling is very often limiting in that it prohibits smaller SBIC's with minimum capitalization from making large long-term loans in lew of buying equity-type debentures from clients.[14]

## Tax Provisions

### SBIC tax advantages

Since September 2, 1958, small business investment companies and their shareholders have received a number of tax advantages under the Technical Amendments Act. The first advantage of this Act makes it possible for a small business investment company to wholly exclude dividends from domestic corporations, whereas ordinary business corporations may exclude only 85 percent of dividends income in arriving at taxable income. This advantage does not apply to the interest income.[15]

Another advantage granted by the Technical Amendments Act provides that any losses incurred through the sale or exchange of equity debentures may be considered as an ordinary operating loss and written off against taxable income. Ordinarily such losses would be considered capital losses and would be subject to the $1,000 maximum deduction. The corporation may claim for income tax purposes, a loss-carry-back

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[14] Ibid.

[15] Technical Amendments Act of 1958. (72 Stat, 1645), Section 243 as amended by section 57b.

for three years and a loss-carry-over for five years. The SBIC's must submit with it's income tax return a statement that it is a Federal licensee under the Small Business Investment Act of 1958, the name and address of the small-business concern on whose securities the loss was sustained, and all pertinent information concerning the accrued loss.[16]

A third advantage under this Act applies to the small-business concern. It permits a lump sum depreciation of 20 percent of the cost price of new or used machinery and equipment in addition to the ordinary depreciation deduction. This special depreciation deduction is limited to $10,000 per year on a single return or twice that amount on a joint return. The balance of the depreciable amount of the asset is spread over the remaining life of the asset. This provision, however, is limited to assets with a depreciable life of six or more years. Although this is merely a postponement of income taxes, it helps companies to finance themselves. Being able to retain cash which would ordinarily be disbursed for taxes helps the firm to pay for plant and equipment during the years of acquisition, helps the firm to strengthen its working capital, and makes it possible to use the money at its present value.[17]

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[16] Ibid. Section 1.1234-1.

[17] "Small Business Gets a Bundle," Engineering News Record, CLVI (September 11, 1958) p. 75.

Tax advantages to SBIC investors

The individual investor in SBIC stock may deduct losses on such stock, in full from his ordinary income. The stockholder may, if he wishes to do so, claim a loss-carry-back or a loss-carry-over for income tax purposes. Although net capital losses of ordinary capital assets deducted from ordinary income is limited to $1,000 per year for an individual, there is not limit to the amount of loss on SBIC stock which may be so deducted. A taxpayer claiming a deduction for a loss on the stock of an SBIC must file with his income tax return a statement containing all pertinent information concerning the accrued loss.[18] Although investors do not invest in an SBIC or any other company with the idea of losing money, this is still an important advantage to the SBIC in inticing investors to help capitalize the SBIC.

## Amendments to the Small Business Investment Company Act of 1958

Since the Small Business Investment Act came into being, there have been several changes made to improve the Act. This chapter has been concerned with the Small Business Investment Act as it was passed in its original form in 1958, making no mention of any subsequent changes or revisions. The following pages will discuss some of the amendments which have become a part of the Act, in order that the reader may have a current understanding of what is contained in the Act.

One of the very important amendments to the Small Business

[18]Technical Ammendment Act, loc. cit.

Investment Act which has helped to strengthen the program is the authorization allowing the SBA to increase the amount it may lend an SBIC through the purchase of subordinated debentures. The original Act set the maximum amount at $150,000. This amount was increased in 1961 to $400,000 and again increased in 1964 to $700,000.[19] It was hoped that this would stimulate more SBIC's to increase their activity in the program.

In 1961, the SBA placed at $500,000 or, 20 percent of the SBIC's combined paid-in capital and surplus, whichever is less, the maximum amount which an SBIC could invest in a single small business. Three years later the dollar limit was removed. Although an SBIC is still restricted to lending not more than 20 percent of it's paid-in capital and surplus to one small firm, this has allowed SBIC's with greater amounts of capital to make larger loans. Also, some smaller SBIC's which have been considering mergers in order to form companies with a larger financial bases.[20]

Another amendment in 1961 permitted banks, to the extent permitted under applicable state laws, to invest up to two percent of their capital and surplus in SBIC's. The former maximum had been set at one percent.[21]

Previous to 1961, an SBIC was permitted to participate only with financial institutions in financing small businesses. However a 1961 amendment extended to the SBIC the opportunity to participate

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[19]Annual SBA Report, 1961, loc. cit.

[20]Ibid.

[21]Ibid.

not only with financial institutions, but also with other types of investors, incorporated or unincorporated, when participation was desired.[22] This had the effect of opening up many new avenues of investment to the SBIC.

In 1962 the SBA ruled favorably upon the bank guarantee loan program. This plan[23] was initiated to encourage banks to participate with the SBA in supplying operating loans to SBIC's. The plan provided for the granting of a loan by the SBA and immediate assignment of the loan to a bank under an agreement whereby the bank can deliver the note to the SBA at any time and obtain the outstanding principal balance. This makes such a loan particularly attractive to a bank because of the absence of risk on the part of the bank.

Due to a 1964 amendment, SBIC's were allowed to invest idle funds in savings accounts of any institution insured by the Federal Deposit Insurance Corporation. This was an aid to SBIC's in that they could receive additional income from money which would have otherwise been idle.[24]

Another amendment which was of great value to the SBIC program was passed in 1964. This amendment granted SBIC's the authority to employ common managers. Most SBIC's could not afford to hire full-time managers who were capable of running an SBIC profitably. Many managers were hired on a part-time basis and were not expending their full capacity and talent in furthering the interests of the SBIC.

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[22] Ibid.

[23] This plan, also known as the "stand-by" plan, was ruled as being consistant with the intent of the SBIC program by the Comptroller General of the United States in September, 1962.

[24] Small Business Administration, Annual Report to the President and Congress, (Washington: Government Printing Office, 1963) p. 28.

This, of course, was detrimental to the SBIC program. However, by using common managers, two SBIC's could share the cost of hiring a competent manager who would have the best interests of both SBIC's in mind.[25]

While these amendments which have been discussed are not completely inclusive of all amendments passed, they do cover the more important ones which have had the greatest effect in strengthening the program. The following chapter discusses some of the operating experiences of the SBIC's which are functioning at this time.

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[25]Annual Report of the SBA, 1964, loc. cit.

# CHAPTER IV

# DEVELOPMENT OF THE SBIC PROGRAM

The small business investment company program has had two distinctly different periods of development since its beginning in 1958. The first period of development during the 1959 thru 1961 period was a period of very rapid growth. During this time the SBIC industry was considered a glamour industry. The second period of development came after the stock market decline of 1962. During this time period, the program grew very slowly, and problems were numerous. This fourth chapter will discuss the growth and development of the SBIC program throughout the nation, in order to give the reader current information concerning the status of the program.

## Growth of the SBIC Program

In December 1963, President Johnson made the following statement:

> As one of the original sponsors of the legislation which made this program possible, I have followed developments in this industry with great interest and am gratified at the role SBIC's are playing in assisting small businessmen . . . I see great promise in this program and I look to small business investment companies to play an increasingly important role in enabling small business to share in and contribute to a growing and prospering economy.[1]

This statement by President Lyndon B. Johnson reflects the opinion of several of the nation's businessmen. The following pages

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[1]Eugene P. Foley, "Taking a New Look at the SBIC Industry," The Commercial and Financial Chronicle, (August 20, 1964) p. 20.

will discuss this increasingly important role which SBIC's are playing in the nation's economy.

Growth in numbers of SBIC's

By the time the Small Business Investment Act was passed, much interest in the program had been generated. During December of 1958, the first nine license applications were received by the SBA. By June 30, of the following year, 16 licenses had been issued and an additional 46 notices to proceed had been mailed.[2] This rapid rate of growth continued during the first three years of the program. By the end of 1961, 448 SBIC's had been chartered and 449 proposals were under consideration of the SBA.[3]

In 1962, however, the program received a serious setback when the stock market took its historic plunge. This is clearly illustrated by the information presented in Figure 4 on the following page. Because the stockmarket decline didn't take place until mid-1962, the number of licenses issued did not drop significantly because most of these licenses were in process at the time. The number of proposals dropped by more than two-thirds however. Practically no proposals were received by the SBA during the latter half of 1962. The stock market decline and its effect will be discussed in more detail later on in this chapter.

The following two years, 1963 and 1964 were years of very little growth in the SBIC program. During 1963, only 65 licenses were

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[2]Small Business Administration, 11th Semi-Annual Report to the President and Congress, (Washington: Government Printing Office, 1958) p. 62.

[3]Various Annual Reports of the Small Business Administration during the years, 1958-1961.

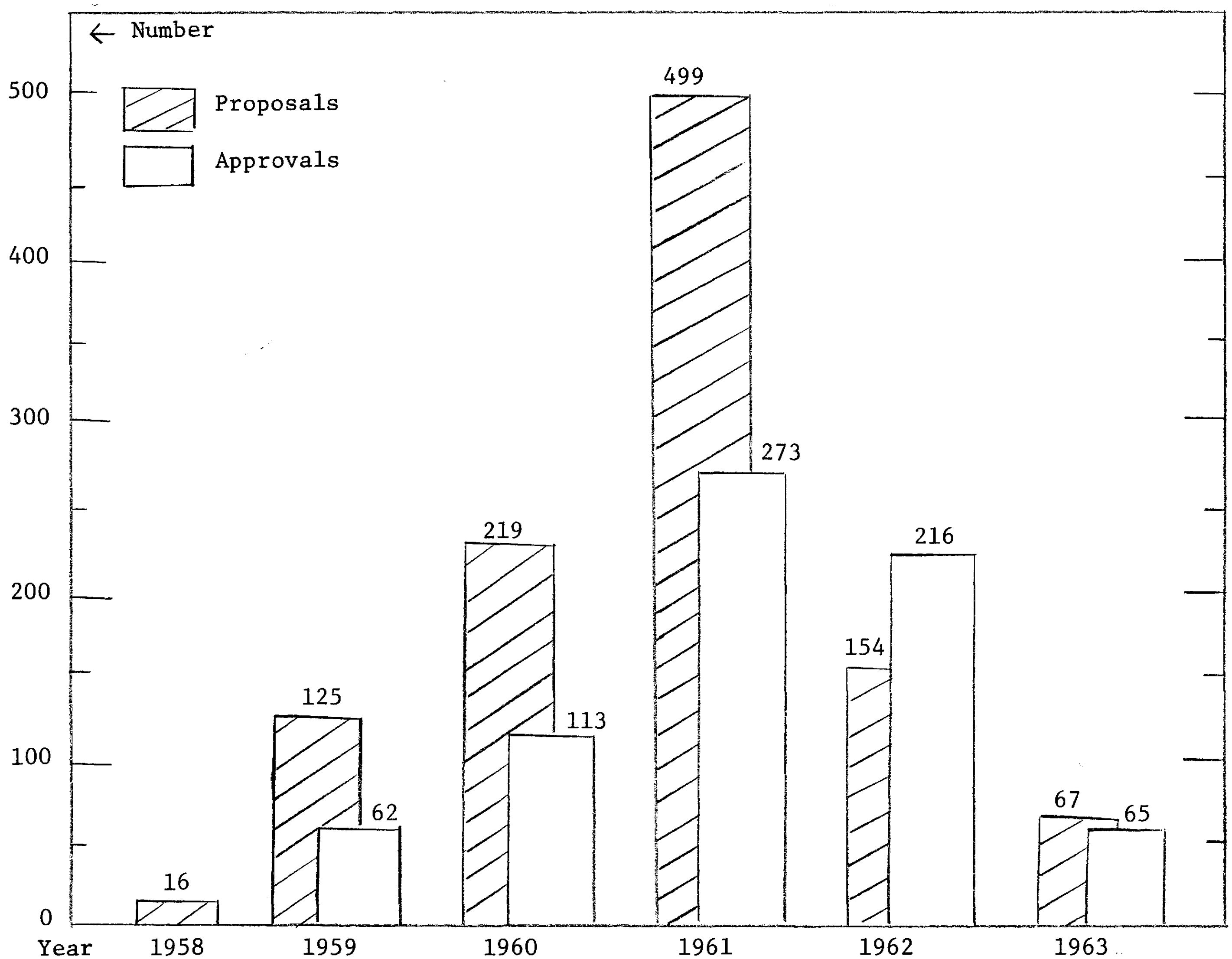


Figure 4. Comparison of new SBIC proposals received and new SBIC licenses approved.

Source: Annual Reports of the Small Business Administration, 1958 through 1963.

approved, and as of April 1, 1964, 48 additional licenses had been approved, bringing the total number of operating SBIC's to 740. However, it was generally felt by many, that the SBIC program should merit a fresh look by investors.[4]

Capital investments of SBIC's

The initial proposed capital of SBIC's increased proportionately with its growth in numbers. During the first six months of the program the proposed capital increased to $33.5 million. Of this total only $7.5 involved government subordinated debentures.[5] The fact that SBIC's were furnishing almost 80 percent of their capital and were not leaning heavily on the Government, was very encouraging to SBIC backers.

The first public sale of SBIC stock in early 1960 brought an additional $31.7 million into the program. As of December 31, 1960, an additional $28.8 million in public stock had been registered with the Securities and Exchange Commission. Although 1962 showed a 28 percent increase in total capitalization, to $533 million, the market decline brought about a leveling off in capitalization during 1963 and 1964. While SBIC capital from private sources increased from $455 million in 1962, to $478 million in 1963, SBIC capital from the SBA increased from $98 million to $116 million. The increase in capital borrowed from the SBA during 1964 brought total borrowings from the

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[4]L. A. Armour, "Businessmen's Risks; Prospects are Brightening For The Small Business Investment Companies," Barrons, (April 6, 1964) p. 3.

[5]Small Business Administration, 12th Semi-Annual Report to the President and Congress, (Washington: Government Printing Office, 1959) p. 60.

SBA above $165 million while capital stock totals remained practically the same as the 1963 total.

SBIC investments in small concerns

While SBIC's were eager to obtain charters, they were rather slow to start investing their funds in small concerns and had made only 747 transactions for a total of $30,200,000 as of September 31, 1960. However, from this point on, the number of transactions as well as the total amount invested in small concerns increased very rapidly. September, 1961, brought total transactions up to 2700 for a total of $152,000,000 invested. December, 1962, showed 6937 transactions completed for a total of $360 million. Activity during 1963 and 1964 continued at a somewhat slower pace as SBIC's continued to invest in small businesses. As of June 30, 1963, 620 SBIC's reported $421.3 million in financing outstanding. This was an increase of $143 million for the year. By March 31, 1964, an additional $70 million was invested in small firms bringing the total amount invested, to $491 million.[6]

During 1964, a total of $220 million was disbursed to small concerns by SBIC's. This increased outstanding balance by only $104 million however, due to repayments. Figures 5 and 6 on the following pages present a graphic representation of investments compared with uninvested funds, and a comparison of loans and investments. Further informative tables may be found in appendix 1A of this study. These tables illustrate SBIC loan and equity financing outstanding as of

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[6]1963 Annual report of the SBA. op. cit. p. 28.

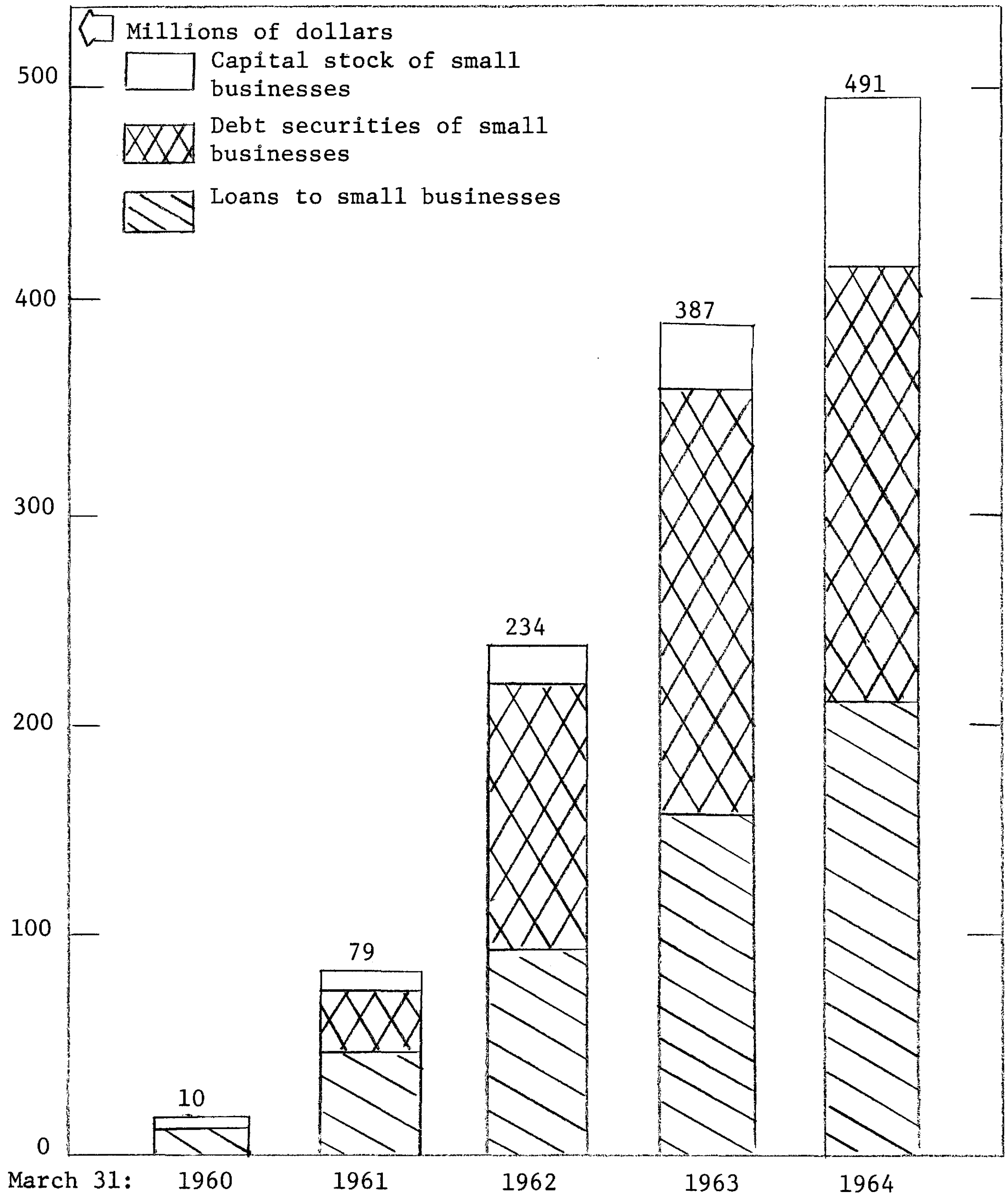


Figure 5. SBIC gross loans and investments.

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Source: Annual Report of the Small Business Administration, (Washington: Government Printing Office, 1964) p. 32.

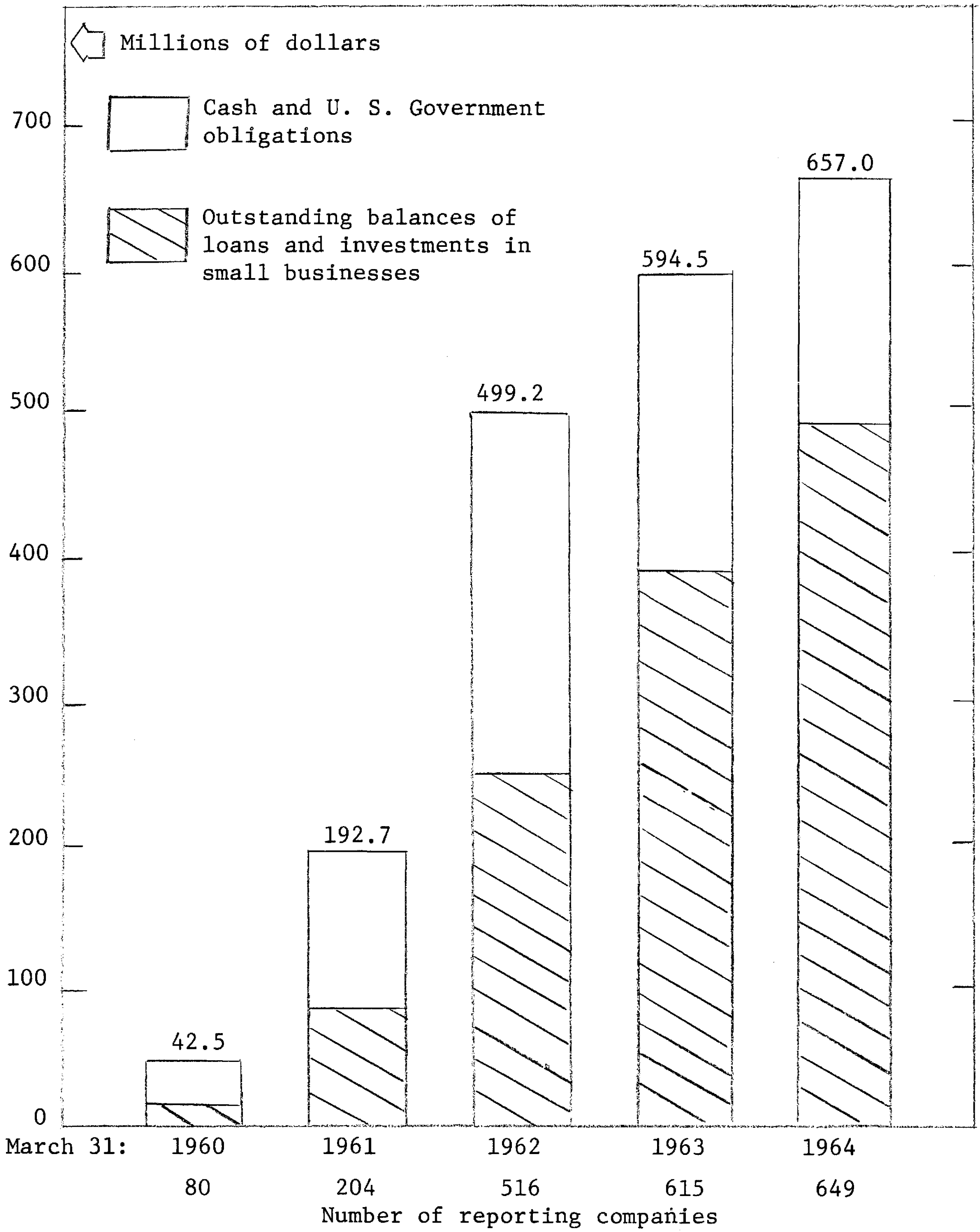


Figure 6. SBIC investments and uninvested funds.

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Source: Annual Report of the Small Business Administration, (Washington: Government Printing Office, 1964) p. 32.

September 30, 1964, broken down into the industry receiving the funds, the number of borrowers employees, and the borrowers sales.

Effect of the Stock Market Decline on SBIC's

The SBIC program experienced rapid growth until mid-1962 when the stock market took its spectacular plunge. In the speculative aura of the early 1960's, investors eagerly bid up prices of the 50-odd SBIC stocks that were being traded to the public.[7] SBIC stock was considered glamour stock and many issues were selling at two to three times their original offering price.

After the sudden 1962 market break, SBIC's took part in the wide spread disenchantment that spread among glamour issues. SBIC issues were among the first to fall, and the stocks of SBIC portfolio companies traded over the counter were quick to follow. Losses by some SBIC's, industry growing pains, impatient stockholders, and unfavorable publicity, combined with other market factors, helped to drop the SBIC shares to unrealistically low levels. Not only were virtually all SBIC's trading below book value, but for a while many were priced well under the value of cash on hand.[8] The information in Table 4 on the following page shows how badily some of the leading companies were affected by the market plunge. One observer stated shortly after the sudden decline that prices at that time made as little sense as did

[7]"SBIC's; Short Lived Glamour; with Data on Leaders," Financial World, (October 23, 1963) p. 10.

[8]Eugene P. Foley, "Tighter Standards and Liberalizing Changes Assure Bright SBIC Future," Commercial and Financial Chronicle, (Aug. 21, 1964) p. 665.

Table 4. Stock losses experienced by 17 leading SBIC's (October 1963)

| SBIC | Original offering price | Recent price | Net asset value | Dis- count |
|---|---|---|---|---|
| Boston Capital | 15 | 7 | $13.24 | 47% |
| Business Funds | 11 | 6 | 10.27 | 42 |
| Capital for Tech. Industries | 10 | 6 | 8.91 | 33 |
| Capital Southwest | 11 | 5 | 9.96 | 50 |
| Electronics Capital | 10 | 11 | 12.48 | 12 |
| Florida Capital | 8 | 3½ | 6.77 | 48 |
| Franklin Corporation | 10 | 7 | 8.96 | 22 |
| Growth Capital Corp. | 20 | 9 | 16.61 | 46 |
| Gulf-Southwest Capital | 12 | 4½ | 10.85 | 59 |
| Marine Capital | 15 | 8½ | 13.19 | 36 |
| Midland Capital | 12½ | 7½ | 11.65 | 36 |
| Narragansett Capital | 11 | 4 | 9.32 | 57 |
| St. Louis Capital | 10 | 9 | 8.96 | -- |
| Sierra Capital | 10 | 5 | 9.17 | 45 |
| S.B.I.C. of New York | 20 | 10 | 18.00 | 44 |
| Southeastern Capital | 12½ | 5 | 11.23 | 55 |
| Techno Fund | 12½ | 3¼ | 7.81 | 58 |
| Westland Capital | 11 | 9 | 10.02 | 10 |

Source: "SBIC's Short-Lived Glamour; With Data on Leaders." Financial World, (October 23, 1963) p. 10.

the premiums people were willing to pay when SBIC's were new and untried.[9]

In the case of SBIC's, a sudden shift of sentiment accompanied the market break and worked a double hardship on the companies. While the rude awakening of investors, that SBIC stock prices were inflated precipitated the plunge in SBIC shares, it also dried up the flow of new flotations, which at that time was the primary channel by which many SBIC's were obtaining capital.

The industry was also hurt at that time by some unfavorable publicity. Several SBIC's lost their licenses after making improper loans. Also, officers of Midwest Capital were indicted for allegedly embezzeling the company's funds. This was the first such action involving an SBIC.[10]

Since experiencing these adverse conditions, the SBIC industry has had a difficult time regaining the confidence of investors. The industry has been proceeding with caution, and this cautious approach has helped to improve the overall program by improving the quality of SBIC portfolios. It has also helped to show investors that SBIC's are not "get-rich-quick" vehicles. Although progress has been slow, SBIC program officials feel that the program is on stronger footing than ever before.[11]

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[9]S. S. Snreder, "After a Spell of Adversity, the SBIC's Now Rate a Second Look," <u>Barrons</u>, (July 31, 1962) p. 3.

[10]SBIC's Short Lived Glamour. <u>loc. cit.</u>

[11]<u>Ibid.</u>

## SBIC Cancellations

Although the SBIC program has experienced a difficult period of development since 1962, there have been a surprisingly small number of companies that have chosen to relinquish their licenses. As of December 31, 1963, a total of 37 companies had surrendered their licenses. The first six licenses were surrendered during 1961, an additional fifteen licenses were surrendered during 1962, and the remaining sixteen were surrendered during 1963. These companies took approximately $30 million out of the total capitalization of the program. Although this $30 million was removed from the program, a considerable part of this amount was already invested in small businesses prior to surrendering their licenses.[12]

There were three major reasons for these license surrenders; (1) the SBIC wanted to do things which SBA regulations would not permit, such as investing in large businesses, buying listed securities, or acquiring a majority interest in a small business; (2) inactivity as a result of disagreement in management about what type of investments should be made; and (3) developments in the director's other business interests which precluded devoting the necessary time to operation of the SBIC.[13]

Although SBIC industry officials did not feel that charter cancellations were excessive, they did feel that it was time to take stock of the program and its goals. Therefore, during July, 1963,

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[12]1963 Annual report of the SBA. _op. cit._ p. 26.

[13]_Ibid._

the SBA placed a 90-day moratorium on issuing new licenses for small business investment companies. It was hoped that this 90-day moratorium would give SBA officials a chance to take stock of existing operations, look toward weeding out ineffective companies, develop a program to keep SBIC's from channeling funds only into specific industries, and chart long-term policies.[14]

## Current SBIC Trends

### Capital gains

Operating statistics on SBIC's still do not shed a great amount of light on potential profitability of the program. For the year ended March 31, 1963,[15] the larger SBIC's earned about 2 percent on total loans before application of income tax loss reserves. The smaller SBIC's broke about even. Since the industry is still new and continuing to build its loss reserves, write-offs during the 1963 year were about 2 percent of net worth for both large and small SBIC's. Few SBIC's had paid income taxes as of March, 1964.

SBIC's expect most of their profits to come from capital gains from security transactions, rather than interest income. Although some gains have already appeared, it is still very early in the development of the industry to try to determine whether capital gains will materialize in sufficient amounts to justify the investment

[14]"A Freeze on Forming New SBIC's," Business Week, (July 11, 1964) p. 34.

[15]Most SBIC's used the 1963 fiscal year for the purpose of standardization of operating data.

risks required.[16]

Concentration in equity loans

Most SBIC's concentrate their investments in equity-type securities. This is especially true with the larger publicly held companies. This is advantageous to the larger companies because they can, in many cases, qualify as regulated investment companies, and thus avoid corporate taxes. This allows them to seek out investments with a lower return and still offer a good yield to their stockholders. The economies are such as to gradually compel SBIC's to become larger and to qualify as regulated investment companies.[17]

These SBIC's which qualify as regulated investment companies are in a position to offer lower interest rates and can therefore secure safer investments. Small business concerns may seek out SBIC's anywhere in the country, and can therefore be expected to investigate offerings of several SBIC's before making a final decision. The small business concern with excellent growth potential will probably find a number of SBIC's interested in financing it and can probably get very favorable terms.

These SBIC's that concentrate their investments in equity-type securities establish a base for future gains on a very favorable basis. The majority of such investments are made via the purchase of convertable debentures, or debentures with warrants. Both types

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[16]Stanley M. Rubel, "Lets take a Fresh Look at SBIC's," Bankers Monthly, (March 1964) p. 45.

[17]J. W. Howard, "SBIC's, Their Problems and Prospects," Burroughs Clearing House, (October 1962) p. 94.

of debentures are interest bearing and thus provide the SBIC with current income to cover current operating expenses, and at the same time, establish the right to share in potential future profits. For this reason small concerns which possess good long-range growth possibilities are of prime interest to the SBIC. At a later date when the SBIC's equity interest in the small concern appreciates the SBIC is in a position to sell this equity interest in the small concern at capital gains tax rates. For this reason, many SBIC's are not as interested in high interest rates as they are in an increase of value in their equity interest.

The small business concern can also profit greatly through the use of equity funds. They obtain their funds and strengthen their balance sheets, and yet have no interest obligation to meet if the SBIC purchases either common or perferred stock.[18]

SBIC interest rates

Those SBIC's that stress loan agreements charge a higher interest rate than SBIC's purchasing equity-type securities. These interest rates range from 5 percent to 15 percent, the maximum permitted by the SBA. In determining the effective rate, the SBA requires that all costs to the small concern be included. Thus, interest, filing fees, discounts, commissions, and any other charges must be compared to the actual funds disbursed and the total effective interest rate calculated on the actual dollar amount outstanding. The majority of SBIC loans and investments appear to be made at about a 7 percent to 10 percent

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[18]*Ibid.*

effective rate. Those SBIC's that specialize in loan agreements only average a little higher, usually between 10 percent and 15 percent.[19] This, of course, is understandable since the SBIC has no opportunity to reap a profit through stock appreciation.

While some SBIC's have indicated that their future investments are going to be limited to conservative-type investments, many other SBIC's are looking more to the overall potential of a small concern rather than the present situation. These latter type of SBIC's are particularly interested in and alert to special situations where there are management problems, inadequate capital, or unfavorable conditions brought about by tight financial situations. They feel that such companies offer especially good future profit possibilities.

Most SBIC's are willing to look at new businesses. The larger SBIC's appear to have a number of new companies included in their portfolios. These include completely new organizations, as well as companies established to buy existing businesses. Although each SBIC operates on an individual basis, it is felt that eventually most companies will include a broad spectrum of small concerns, ranging from the most speculative, to reasonably well secured firms. Each will probably modify its policies as experience and judgement dictate.

While there are many other interesting aspects in the development and progress of the SBIC program, it would be impossible to

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[19] Ibid.

cover all of these in this particular study. However, the following chapter is concerned with the SBIC industry in the state of Utah, and many other important aspects of the SBIC program will be discussed at this time.

# CHAPTER V

## SMALL BUSINESS INVESTMENT COMPANIES OF UTAH

At years end, 1964, more than 700 SBIC's were in operation throughout the country.[1] The latest list of these 700+ companies, published by the SBA, lists six companies in the state of Utah. These six listed SBIC's are: (1) Creative Capital Corporation, (2) Empire Capital Corporation of Utah, (3) First Capital Corporation of Utah, (4) Intermountain Capital Corporation of Utah, (5) Lockhart Capital Corporation, and (6) Utah Capital Corporation. Since the time of this publication however, First Capital Corporation of Utah no longer has possession of an SBIC charter. This SBIC merged with Intermountain Capital Corporation of Utah, leaving a total of five SBIC's in the state of Utah.

A questionnaire was developed and administered by the author, to key executives of each of the Utah SBIC's. This chapter is devoted to a presentation of the findings of this questionnaire.

### Findings of the Questionnaire

#### Dates Utah SBIC's received charters

It can be observed from Table 5 that three of the five Utah SBIC's were formed during the 1960-1961 period during which time the SBIC industry was rated among the glamour industries. However, two charters

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[1]1964 Annual Report of the Small Business Administration, *op. cit.* p. 30.

Table 5. Dates charters were issued to Utah SBIC's

| Date charter was issued | Number of SBIC's | Percentage of Utah SBIC's |
|---|---|---|
| 1959 | 0 | 0 |
| 1960 | 1 | 20 |
| 1961 | 2 | 40 |
| 1962 | 0 | 0 |
| 1963 | 2 | 40 |
| 1964 | 0 | 0 |
| Total | 5 | 100 |

Source: Data taken from questionnaires used while interviewing Utah SBIC's.

were issued in Utah after the stock market decline. These two charters were issued during 1963. This speaks well for the confidence of investors in these two companies.

Number of initial stockholders

The five SBIC's in Utah varied widely in the number of initial stockholders. SBA regulations set the minimum number of stockholders at ten. There is no restriction concerning the maximum number of stockholders. While the majority of Utah SBIC's reported have 20 or less initial stockholders, one company reported having 55 (Table 6).

Table 6. Number of initial SBIC stockholders in Utah SBIC's.

| Number of initial stockholders | Number of SBIC's reporting | Percentage of total SBIC's |
|---|---|---|
| 1-10 | 2 | 40 |
| 11-15 | 1 | 20 |
| 16-20 | 1 | 20 |
| 21-25 | 0 | 0 |
| 26 or more | 1 | 20 |
| Total | 5 | 100 |

Source: <u>Ibid.</u>

## Amount of beginning capital and surplus

From Table 7 it can be observed that three of the five Utah SBIC's were organized with minimum, or near minimum capital. The minimum amount of capitalization required by SBA regulations is $150,000. However, the amount of initial capitalization is in no way predictive of the future success of a SBIC. As an example, taking the two most active and financially successful SBIC's in Utah, one was incorporated with near minimum capitalization, while the other began operations with practically double the amount of initial capitalization.

## Comparison of number of applications for financial aid received, and applicants financed

Table 8 indicates that a little over ten percent of the applications received by Utah SBIC's are being financed through the SBIC

Table 7. Amount of beginning capital and surplus of 5 Utah SBIC's.

| SBIC | Amount of beginning capital and surplus |
|---|---|
| SBIC #1 | $150,000 |
| SBIC #2 | 300,000 |
| SBIC #3 | 152,000 |
| SBIC #4 | 310,000 |
| SBIC #5 | 152,000 |

Source: Ibid.

Table 8. Comparison of number of applications for financial aid received, and number of applicants receiving financial aid from 5 Utah SBIC's.

| SBIC | Approximate number of | |
|---|---|---|
| | Applications received | Applicants financed |
| SBIC #1 | 75 | 7 |
| SBIC #2 | 200 | 15 |
| SBIC #3 | 30 | 0 |
| SBIC #4 | 40 | 1 |
| SBIC #5 | 50 | 20 |
| Total | 395 | 43 |

Source: Ibid.

program. Both the number of applications received, and the number of applicants financed would undoubtedly be much higher if all companies in the Utah area were actively engaged in seeking SBIC business. The lack of industry in Utah makes it very difficult for SBIC officials to operate profitably without having other sources of income. Often Utah SBIC's are only a business sideline. As can be observed from Table 8, one company has never granted any small firm financial assistance, and another company has only assisted one small firm. It could be assumed that these two SBIC's are not representative of the SBIC program as a whole. The other three Utah companies are offering approximately 10 to 15 percent of their applicants financial assistance.

Percentage breakdown of invested portfolio

As can be readily observed from Table 9, Utah SBIC's follow a somewhat similar pattern of investments. While the SBIC program was planned around the purchase of small firm equity through the use of convertable debentures, none of the Utah SBIC's have made any use of convertable debentures. One SBIC has concentrated completely in making term loans, while two others have divided their investment portfolio between term loans and other equity securities.

Table 9. Percentage of portfolio of 5 Utah SBIC's invested in term loans, convertable debentures, other equity securities, or government securities

| SBIC | Percent of portfolio invested in | | | |
|---|---|---|---|---|
| | Term loans | Convertable debentures | Other equity securities | Government securities |
| SBIC #1 | 100 | 0 | 0 | 0 |
| SBIC #2 | 40 | 0 | 60 | 0 |
| SBIC #3 | 0 | 0 | 0 | 0 |
| SBIC #4 | 0 | 0 | 100 | 0 |
| SBIC #5 | 83 | 0 | 17 | 0 |

Source: Ibid.

Concentration of investments

The question was asked, "Do you expect to concentrate your investments in new firms, or established firms?" The third alternative given was "No Set Policy." To this question, all five Utah SBIC's stated that they had no set policy in making investments in small businesses.

Type of income emphasized

Table 10 indicates the type of SBIC income emphasized by Utah SBIC's. As indicated, four of the five SBIC companies were interested in only one type of income, while one company stated that both growth and capital appreciation and interest income were emphasized within the company.

Table 10. Type of income emphasized by Utah SBIC's.

| Income emphasized | Number of respondents | Percentage of SBIC's |
|---|---|---|
| Growth and capital appreciation | 1 | 20 |
| Interest income | 3 | 60 |
| Both of the above mentioned | 1 | 20 |
| Total | 5 | 100 |

Source: Ibid.

Concentration of investments in specific industries

As was mentioned earlier in this study, many SBIC's were developed to render assistance to one specific industry. These specialized SBIC's are usually managed by a group of highly trained experts in the industry in which they concentrate. When asked the question, "Do you expect to concentrate your investments in only one industry, or, diversified industries?", all five Utah SBIC's stated that they did not intend to limit themselves to investing in any one specific industry. None of the five Utah SBIC's are managed by specialized groups of industry experts.

Total charge to borrowers

SBA regulations state that all charges incurred by the SBIC in the investigation of an applicant, and the granting of financial assistance to that applicant, must be included in the total interest charge on the loan. Table 11 indicates the most frequent total charge to small business concerns when receiving financial assistance from Utah SBIC's. The information is broken down into a category for loans, and securities.

Investigation costs borne by SBIC or customer

Although all costs of granting financial assistance must be included in the total interest rate charged by a SBIC, the SBIC may choose not to pass these costs, as such, on to the customer. When asked whether investigation costs were borne by the SBIC or the customer, one company stated that the customer always paid investigation costs, one SBIC stated that costs were borne occasionally by the SBIC and occasionally by the customer, and two SBIC's stated that they always absorbed investigation costs themselves. One company declined to answer.

Table 11. Most frequent total charge to borrower by Utah SBIC's.

| Total charge to borrower | Number of SBIC's charging | |
|---|---|---|
| | loans | securities |
| Less than 1% | 0 | 0 |
| 1% - 2.9% | 0 | 0 |
| 3% - 4.9% | 0 | 0 |
| 5% - 6.9% | 0 | 0 |
| 7% - 8.9% | 2 | 2 |
| 9% - 10.9% | 2 | 1 |
| 11% or more | 0 | 0 |

Source: Ibid.

Note: Totals do not equal 5 because some companies specialized in making "only loans," or "only security investments."

Security provisions and additional restrictions

While it is not possible to include in a questionnaire, all security provisions which a SBIC may demand, six provisions which the writer considered important were included. Table 12 shows which of these provisions Utah SBIC's require when giving granting financial loans to small business firms. Table 13 indicates whether two additional restrictions were placed upon small firms when receiving money from Utah SBIC's.

Management and advisory services

Utah SBIC's were asked to indicate whether they offered management and advisory services to the small firms that received loans

Table 12. Security provisions required by Utah SBIC's.

| Provision | Number of SBIC's requiring | Number of SBIC's not requiring | Percentage requiring |
|---|---|---|---|
| Acceleration of due date for delinquency | 2 | 2 | 50 |
| SBIC employee as board member of small firm | 3 | 1 | 75 |
| Insurance | 1 | 3 | 25 |
| Management contract | 0 | 4 | 0 |
| Penalty for pre-payment | 0 | 4 | 0 |
| Delinquency charge | 1 | 3 | 25 |

Source: _Ibid._

Table 13. Additional restrictions placed upon small business firms by Utah SBIC's

| Restrictions | Number of SBIC's requiring | Number of SBIC's not requiring | Percentage requiring |
|---|---|---|---|
| Salaries of officers | 2 | 3 | 40 |
| Additional indebtedness | 4 | 1 | 80 |

Source: _Ibid._

from them. All Utah SBIC's indicated that they did offer these services. However, when asked whether the SBIC's utilized the advisory services of the Federal Reserve System or the Department of Commerce, all Utah SBIC's stated that they did not.

### Frequency of use of Utah SBIC advisory and management services

Utah SBIC's were asked to state whether small business concerns made frequent use, infrequent use, or no use at all, of the management and advisory services offered them by SBIC's. All five SBIC's indicated that their management and advisory services were infrequently used. When questioned further by the author, as to the reasons why SBIC officials felt that these small concerns did not utilize advisory and management services offered them, officials of the five Utah SBIC's stated that in their opinions, the small business concerns felt that they were not in need of management or advisory services. The small concerns felt that their problems were in other areas, and that the firms were being managed efficiently.

### Sources used for contacting prospects

Utah SBIC's were asked which sources they used to contact prospects. As is indicated in Table 14, personal contact and contact through banks are the two most frequently stated sources of contacting prospects.

### Reasons small firms need SBIC money

The question was asked, "In those small business concerns which you have lent money or invested, what have been the two most important

Table 14. Sources used by Utah SBIC's for contacting prospects

| Source | Number of SBIC's using source | Percentage of SBIC's using source |
|---|---|---|
| Advertising (Newspaper or Periodicals) | 1 | 20 |
| Investment bankers | 0 | 0 |
| Banks | 3 | 60 |
| Stockholders | 2 | 40 |
| Lawyers | 1 | 20 |
| Direct mail | 1 | 20 |
| Personal contact | 4 | 40 |

Source: Ibid.

or frequently stated reasons for the need of the money?" Table 15 gives a breakdown of the reasons given by these small business concerns when making application for SBIC money.

## Criterion for accepting or rejecting applications

Utah SBIC's were asked to state the criterion upon which they based their decision to approve or reject an application for financial aid. While this is a very difficult question to generalize on, four of the five SBIC's submitted answers as indicated in Table 16.

## Financial statements required by SBIC's

Utah SBIC's were asked what financial statements and other reports were periodically required from their customers, and how

Table 16. Most frequent reasons cited by Utah small firms for applying for SBIC aid.

| Reason | Number of SBIC's reporting | |
|---|---|---|
| | Most frequent reason given | Second most frequent reason |
| Additional capitalization | 2 | 0 |
| Expansion and growth | 2 | 0 |
| Consolidate indebtedness | 0 | 2 |
| Capital investment | 0 | 1 |
| Product development | 0 | 1 |
| New business venture | 1 | 0 |
| Increase sales, research, etc. | 0 | 1 |

Source: _Ibid._

Table 16. Most important criterion used by Utah SBIC's in accepting or rejecting applications for aid

| Criterion | Number of SBIC's reporting | |
|---|---|---|
| | Most important requirement | Second most important requirement |
| Security | 1 | 1 |
| Product potential | 1 | 1 |
| Credit | 0 | 1 |
| Management potential | 3 | 1 |
| History | 0 | 1 |

Source: _Ibid._

often these were required. All SBIC's stated that general profit and loss statements, balance sheets, etc., were required. They also stated that often it depended upon the specific customer whether these statements and reports were required monthly, quarterly, or annually.

Small business reluctance to give up equity interest

When asked if Utah SBIC officials had noticed much reluctance on the part of small businessmen to give up an equity interest in their small businesses, four of the five Utah SBIC officials interviewed stated that small firms were quite reluctant to bring in outside interest. This was especially true when dealing with the small one-owner operations.

SBIC program improvements

The final question on the questionnaire asked Utah SBIC officials to state what improvements they felt would increase the effectiveness of the small business investment company program and the operations of all SBIC's. Table 13 gives the reasons stated by SBIC officials in the state of Utah.

Table 13. SBIC program improvements as suggested by Utah SBIC's.

| Suggested improvement | Number of SBIC's | |
|---|---|---|
| | Requesting improvements | Not requesting improvements |
| Simplify accounting procedure | 3 | 2 |
| Reduce SBA influence on SBIC's | 2 | 3 |
| Reduce overall restrictive regulations on SBIC's | 4 | 1 |
| More flexibility in interest rates SBIC's can charge | 2 | 3 |
| Reduce SBA restrictions on real estate investments | 2 | 3 |
| Reduce number of reports required by SBA | 2 | 3 |

Source: Ibid.

# CHAPTER VI

# SUMMARY AND CONCLUSIONS

## Summary

Four major objectives were included in this study of the small business Investment Company program. These objectives were: (1) to present the reader with a brief analysis of small business financing problems and fund sources prior to 1958, (2) to present a discussion of the Small Business Investment Act of 1958 with it's provisions and amendments, (3) to present a discussion of the program established from the Small Business Investment Act, and (4) to present factual information concerning the small business investment companies operating in the state of Utah.

The first objective was discussed in chapter II. After reviewing the financial needs of the small firm, and comparing these needs with the sources of small business funds, it becomes evident that there is a serious lack of growth capital for many of the nation's small businesses. These financial needs of small firms, and large firms alike, can be linked closely with the different growth stages which the firm passes through. It is during the early growth stages that the firm's capital needs are greatest, and yet, the small firm cannot meet the safety provisions of the conventional lending institutions.

Generally, by the time the firm has progressed from the beginning stage to the early growth stages, it has outgrown the private investor and has practically no place to turn for long-term growth capital. Short-term loans are available if the manager has good credit. Also, small firms receive a considerable amount of short-term credit from larger wholesalers in the form of trade credit. Generally, it is only with loans of five to twenty years that the businessman finds the sources to be practically non-existant.

Several different groups have made studies prior to 1958, to investigate the financing problems of small businessmen. Perhaps the most comprehensive study was submitted by the Federal Reserve System to the Committee on Banking and Currency and the selected Committees on Small Business on April 11, 1958. The Federal Reserve officials stated in their study, that they felt the overall data suggested that the net direct discrimination suffered by small firms was not severe, because a significant part of loan increase for large firms came to the small ones in the form of increased trade credit. Also, the short-term demand for loans was satisfactorily being met. However, the small businessman did have a serious problem in obtaining long-term growth capital, and the study group felt that the small businessman needed an institution to which he could bring his case for long-term capital.

The second objective of this study was discussed in Chapter III. Here, the Small Business Investment Act, as it was passed in 1958, was reviewed. As was stated in the chapter, the objective of the Small Business Investment Act is to stimulate the flow of long-term capital to small business firms, through privately owned and operated small business investment companies. With a minimum capitalization of $150,000, a group of investors may, after complying with SBA regulations, apply for a charter and form a small business investment company. The SBIC may assist small businessmen through long-term loans or through equity capital. The SBIC's profit will be derived either through interest or through the sale of a small firm's stock which has appreciated. Chapter III explores the regulations of the Small Business Investment Act and the many ways SBIC's may operate and assist small business firms.

The third objective of this study is to discuss the progress which the small business investment program has made since it began operation in 1958. Chapter IV discusses the program's growth from 1958 to 1964, at which time there were over 740 operating SBIC's. These SBIC's had invested over 725 million dollars in small business concerns by the end of 1964, proving SBIC's value to the small business community.

The 1962 stockmarket decline has had serious and lasting effects on the SBIC industry's progress. Prior to 1962, the program growth had been rapid. Since 1962, the growth has been very slow, and the SBIC's have been experiencing many problems. SBIC stocks were listed among the glamour stocks before the market break, but in many cases, ever since 1962, the stocks of many SBIC's have been selling below the initial offering price. In order to try to help the industry to get back on its feet, the SBA placed a freeze on the formation of new companies during July, 1964. During this time, policy changes were made and steps were taken to strengthen the SBIC program. The latter part of Chapter IV discusses some of the current operating practices of SBIC's.

The fourth and final objective of this study is contained in Chapter V. Here, the small business investment program in the state of Utah was analyzed. A questionnaire was administered by the author to officials of the five SBIC's in the state. From this questionnaire the following information was gained:

The five Utah SBIC's formed in the 1960-1963 period varied considerably in many respects. While one of the companies is relatively inactive, the other four SBIC's have granted loans to 43 different applicants, out of the 395 applications they have received. Most of these loans have been in the form of term loans.

It was found that the majority of Utah SBIC's were more interested in interest income than capital appreciation of stock. This was expected because of the small amount of equity financing undertaken by Utah SBIC's. The interest rates charged by Utah SBIC's ranged from 7 to 10 percent of the loans.

The security provisions and restrictions enforced by Utah SBIC's varied greatly among the companies. The services offered by the companies, however, did not vary. All five SBIC's offered management and advisory services, but SBIC officials indicated that these services were infrequently used.

Personal contact was the most frequent source used to contact customers. These loan applicants stated to SBIC officials that their greatest need for SBIC money was for additional capitalization for expansion and growth.

Utah SBIC officials used different criterion for accepting or rejecting loan applications. Although each SBIC had different criterion, their officials seemed to place great emphasis on management potential as an indicator of the future success of the firm.

The final question asked Utah SBIC officials concerned the improvements in the program which they felt were needed. While the answers varied, most of the officials stated that they felt that the SBA was too restrictive in the overall control of the program, and the program contained too much "red tape." They felt that accounting procedures were too complicated and time consuming.

## Conclusions

When the officials of the five existing SBIC's in Salt Lake City, Utah were interviewed concerning their companies and the operations, they were also asked to state their feelings concerning the future of the SBIC program. Their answers varied from one executive who stated that he felt that the SBIC industry was on the verge of becoming a profitable business, to another company official's statement which was exactly the opposite. This latter official felt that the SBIC program was a poor program and was doomed to failure.

The SBIC program has always been a very controversial program, and many pro and con statements have been made about it's progress and future. By almost any measure, the operating success of most SBIC's has been only fair. A few of the larger companies were doing well before the stock market decline of 1962, but even these companies have experienced many difficulties since the market decline.

The past record should not be taken as a prediction of the future however. The industry is still new and it is very difficult to judge the program at this time. Many of the companies have been operating for only a couple of years and have not yet realized a profit. This, however, does not mean that they will not do so in the future. Perhaps after the necessary incubation period, these companies will report a profit and go on to become very successful companies.

Perhaps one reason for the slow progress of the program is the lack of full-time officers. The majority of the SBIC officials are involved in SBIC activities only on a part-time basis. In fact, most SBIC's are being run as a sideline, along with another business interest. This alone, is not a healthy environment. Add to this, the relatively small amount of capital invested in most SBIC's and there is an indication of the reason so many SBIC's are lying dormant. As was stated by one Utah SBIC official, "If we could afford to operate this SBIC as a full-time business and put our full time and talents into its operation, I am certain we could do a much larger business." He stated further that the SBIC could not afford to operate if the SBIC had to absorb overhead and pay salaries to full-time employees.

While the greater majority of SBIC's offer management and advisory services, the bulk of small concerns dealing with SBIC's are not making use of these services. This would indicate that SBIC's are not doing a complete job of selling themselves and their services. Because most of these small businessmen feel that they are not in need of these services, it is the responsibility of the

SBIC officials to help these small firm managers to recognize their problem areas and help solve them. This is as important a part of the SBIC program as the actual disbursement of money. The SBIC program was developed to strengthen small business.

The SBIC is faced with two difficult and often conflicting tasks. They must screen all applicants and reject the overwhelming majority, and yet, continually seek ways of encouraging more prospects to apply for financing. This high rejection rate is necessary in order to conclude the best investments and work toward the welfare of their stockholders.

An SBIC, just as any other lending institution, must insist that any firm obtaining funds from them must have good management, a good competitive and profit outlook, and be a credit worthy firm. SBIC officials estimate that the overwhelming majority of firms to which they have lent money, or in which they have invested, would have been unable to obtain financing on similar terms from any other source; some SBIC officials claim that most of their applicants are completely uncreditworthy. To a certain extent, this is expected however, since in the majority of cases, the SBIC is a "last resort" financial source.

It is felt by many, and the number of applications recieved by SBIC's bears this out, that small business concerns are interested in the SBIC program as a new source of financing growth and expansion. Many small business managers have stated their intentions of using this source of funds to continue their progress. However, many small firm managers fail to recognize, that the SBIC program is still new and is experiencing more than it's share of growth problems. Some have spoken out harshly against the SBIC program. However, the principal behind the program is a sound one. There is definately a demand for a source of long-term funds for small businesses. The SBIC program can help to supply this capital. Given an opportunity to show it's worth, without another setback like the 1962 stock-market decline, the SBIC industry will grow into a profitable industry and be of great value in helping to fill the financial void facing many small businessmen in their search for new sources of long-term growth capital.

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APPENDIXES

## Appendix A

Table 18. Loan and equity financing outstanding balances of 664 small business investment companies (September 30, 1964)

| Industry | Number | Amount |
|---|---|---|
| Ordinance and accessories | 24 | $ 1,489,627 |
| Food and kindred products | 162 | 9,081,118 |
| Tobacco manufacturers | 1 | 60,000 |
| Textile mill products | 26 | 1,036,619 |
| Apparel and similiar products | 43 | 2,478,918 |
| Lumber and wood products except furniture | 63 | 4,725,642 |
| Furniture and fixtures | 84 | 3,725,695 |
| Paper and allied products | 27 | 1,603,228 |
| Printing, publishing and allied products | 156 | 5,443,757 |
| Chemicals and allied products | 139 | 8,120,150 |
| Petroleum refining & related industries | 8 | 2,188,845 |
| Rubber & miscellaneous plastic products | 145 | 5,847,043 |
| Leather and leather products | 19 | 1,206,831 |
| Stone, clay and glass products | 57 | 3,450,638 |
| Primary metal industries | 24 | 2,484,516 |
| Fabricated metal products except machinery | 277 | 20,225,290 |
| Machinery, except electrical | 135 | 13,877,343 |
| Electrical machinery, equipment & supplies | 476 | 36,782,414 |
| Transportation equipment | 36 | 1,307,193 |
| Professional, scientific, etc., equipment | 397 | 39,786,605 |
| Miscellaneous manufacturing industries | 399 | 29,757,610 |
| Total manufacturing | 2,698 | $194,679,082 |
| Total non-manufacturing | 8,602 | 219,731,702 |
| Total all industries | 11,300 | $524,421,785 |

Source: Memorandum No. 65-20, Small Business Administration, (Washington: Government Printing Office), April 9, 1965.

Table 19. Loan and equity disbursements of 664 small business investment companies for 6 months ended September 30, 1964 (by number of borrowers employees)

| Number of employees of manufacturing small business concerns | Number of disbursements | Percent | Amount of disbursements | Percent |
|---|---|---|---|---|
| 0 - 9 employees | 149 | 31.4% | $ 2,411,745 | 10.0% |
| 10 - 19 employees | 98 | 20.7 | 2,720,724 | 11.3 |
| 20 - 49 employees | 82 | 17.3 | 3,160,278 | 13.1 |
| 50 - 99 employees | 88 | 18.6 | 7,508,547 | 31.2 |
| 100 - 249 employees | 43 | 9.1 | 6,046,445 | 25.1 |
| 250 - 499 employees | 7 | 1.5 | 1,627,659 | 6.8 |
| 500 - or more employees | 3 | .6 | 340,000 | 1.4 |
| Number not known | 4 | .8 | 234,975 | 1.0 |
| Total manufacturing concerns | 474 | 100.0 | $24,050,373 | 99.9%[a] |

[a]Total does not equal 100% due to rounding.

Source: Memorandum No. 65-20, Small Business Administration, (Washington: Government Printing Office), April 9, 1965.

Table 20. Loan and equity disbursements of 664 small business investment companies for 6 months ended September 30, 1964 (by borrowers annual sales)

| Annual sales of non-manufacturing small business concerns | Number of disbursements | Percent | Amount of disbursements | Percent |
|---|---|---|---|---|
| $ 0 - $ 49,999 | 768 | 38.4% | $22,033,991 | 30.6% |
| 50,000 - 99,999 | 387 | 19.3 | 10,141,228 | 14.1 |
| 100,000 - 249,999 | 385 | 19.2 | 12,775,330 | 17.6 |
| 250,000 - 499,999 | 185 | 9.2 | 9,267,990 | 12.9 |
| 500,000 - 999,999 | 143 | 7.1 | 6,116,836 | 8.5 |
| 1,000,000 - 1,999,999 | 70 | 3.5 | 5,806,742 | 8.1 |
| 2,000,000 and over | 45 | 2.2 | 5,006,421 | 7.0 |
| Annual sales unknown | 19 | .9 | 837,619 | 1.2 |
| Total non-manufacturing concerns | 2,002 | 99.9%[a] | $71,956,217 | 100.0% |

[a]Total does not equal 100% due to rounding.

Source: Memorandum No. 65-20, Small Business Administration, (Washington: Government Printing Office), April 9, 1965.

Appendix B

Questionnaire used for Utah SBIC Survey

1. Name of Agency? ________________________________________

2. Date SBIC license was received?____________________________

3. Number of initial stockholders?____________________________

4. Amount of beginning capital and surplus?___________________

5. Was there subsequent SBIC stock offerings? Yes _____ No _____

6. Since the formation of your company, approximately how many applications for financial aid have you received?_________

7. To how many of these applicants have you given financial aid?_____

8. Approximately what percentage of your investment portfolio is made up of:
   A. Term loans? __________%
   B. Convertible debentures__________%
   C. Other equity securities_________%
   D. Government securities__________%

9. Do you expect to concentrate your investments in: New Firms?_____ Established Firms?_____ No Set Policy?_____

10. What type of income do you emphasize for your company? Growth and Capital appreciation_____ Interest income_____ Both_____

11. Do you expect to concentrate your investments in only one specific industry?_____ Diversified industries?_____
    If "one specific industry," please specify.______________

12. What are your approximate investment costs per application?_______

13. What is your typical or most frequently used total charge to the borrower? Loans __________% Securities __________%

14. Are investigation costs borne by the SBIC?_____ or Customer?______

15. Generally, do your loan or equity security provisions provide for:
    Acceleration of due date for delinquency? Yes _____ No _____
    Employee of SBIC as board member? Yes _____ No _____
    Insurance? Yes _____ No _____
    Management contract? Yes _____ No _____
    Penalty for prepayment? Yes _____ No _____
    Delinquency charge? Yes _____ No _____

16. What additional restrictions do you place on small business concerns?
    Salaries of officers? Yes _____ No _____
    Additional indebtedness? Yes _____ No _____
    Others? (Please specify) ______________________________

17. Do you offer management or advisory services? Yes _____ No _____

18. To what extent do small business concerns use these services?
    Frequently _____ Infrequently _____ Not at all _____

19. Is it your policy to participate with other SBIC's or institutions?
    Yes _____ No _____

20. How many small business concerns have incorporated in order to obtain equity capital from you? ______________

21. How many small business concerns have established a market for their stock as a result of your investment in them? ____________

22. Which of the following sources do you use for contacting prospects?
    Advertising (Newspaper or periodical) _____ Banks __________
    Investment bankers __________________ Stockholders ________
    Others (specify) ________________________________________

23. In those small business concerns which you have lent money or invested what have been the two most important or frequently stated reasons for the need of the money?
    (1) ________________________________________________
    (2) ________________________________________________

24. On what criterion do you base your decision to reject or approve an application for:
    A term loan? ____________________________________________
    ________________________________________________________
    A debenture issue? ______________________________________
    ________________________________________________________
    Other equity issues? ____________________________________
    ________________________________________________________

25. What financial statements and other reports do you require periodically from your customers? ____________________________________
    ________________________________________________________________

    How often? ____________________________________________________

26. Have you noticed much reluctance on the part of your applicants to give up an equity interest in their small businesses?
    Yes _____ No _____

27. Have you utilized the advisory services of the Federal Reserve System or the Department of Commerce? Yes _____ No _____

28. Please list below, in order of importance, three improvements which you feel would increase the effectiveness of the Small Business Investment Act and the operations of the Small Business Investment Companies.

(1) ______________________________

______________________________

(2) ______________________________

______________________________

(3) ______________________________

______________________________