# Raising & Investing an SBIC Fund

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# Overview of Renovus Capital

- SBIC Fund founded in January 2010
  - Received Greenlight in September 2010
  - Licensed in August 2011
- $170 million debentures fund with 2x leverage
  - Raised $56 million of private capital
  - $5 million GP commitment
  - $13.5 million in capital from institutional investors (e.g., Prudential, TD Bank)
  - Balance raised from wealthy individuals / small family offices
- Focused on investing in the education and training sector
  - Founders had been a deal team together at Leeds Equity, a $500 million buyout fund focused on education and training
- Primarily do small buyouts of businesses with $2-$5 million of EBITDA
  - Interested in growing but profitable companies
  - Buying primarily from founders
  - Closed three buyouts in 2012

# Overview of Fundraising Environment

- Recent years have been the worst fundraising environment ever for private equity
  - Individual investors are focused on liquidity and current yield
  - Banks have been scared out of the market due to losses and new regulations
  - Family offices are more focused on fees and are looking to in-source
  - Institutional investors are shrinking allocations and number of relationships
- There is an institutional investor bias against SBIC funds
  - SBIC funds seen as "bush-league"
  - Management fees seen as 6% rather than 2%
  - SBIC funds too small for many investors
- Nonetheless, capital can still be found by a good team with a good strategy
  - SBIC's 2:1 matching more than outweighs the negatives
  - A lot of $100-150MM SBIC funds are being raised
- World is starting to change
  - More institutions are looking at SBIC funds
  - The banks are getting back into the market
  - Structure is appealing to individual investors

# Potential LP Categories

- Individual Investors
  - Pros: Quick to decide, rarely ask for special deals, lots of them out there
  - Cons: Typically $500K-$1MM, often can’t scale for later funds
  - How to Find Them: Network (rich people know rich people)

- Banks
  - Pros: Attracted by CRA credit; can do $3-5MM
  - Cons: Conservative investors; still scared of new regulatory environment
  - Most Active: TD, Wells Fargo, Cole Taylor, Harris Bank, Capital One

- Traditional Institutional Investors (Pensions, Endowments, etc.)
  - Pros: Can easily do $10-$50MM
  - Cons: Concentration limits and minimums, little experience with SBICs, slow to make decisions
  - How to Find Them: SBIA, Preqin, agents

- Fund of Funds / Family Offices
  - Pros: Starting to look at SBICs; can do $5-$20MM, concentration limits and minimum are not as big a problem
  - Cons: Many lack capital; fee adverse; looking to do deals rather than funds; may want a special deal

# Fundraising & The SBIC Process

- Important to coordinate the SBIC licensing process with fundraising
  - Need to make parallel progress on both to be successful
- SBA takes fundraising progress into account when awarding the Greenlight letter and prioritizing your license application
  - Minimum commitment needed for licensure has trended up from $15MM to $30MM
  - Need to have a hard close and call capital before getting final approval
- Potential investors similarly focused on SBIC licensure progress
  - Banks and institutional investors will generally not tale a real look at an unlicensed fund
- Focus on individual investors as a starting point
  - More willing to commit to an unlicensed fund
  - Can provide the critical mass to get through licensure
- Understand the SBIC rules regarding fees
  - First close starts the 5-year clock on being able to collect full fees
  - You cannot collect back fees for investors who come in after the first close so these fees are lost

# The SBIC Pitch

- Small businesses are the best place to invest private equity
  - Large number of potential targets
  - Increasingly underserved by traditional private equity funds and other sources of capital
  - Lower valuations
  - Best growth prospects
  - Greatest ability for investors to add value

- SBIC structure enhances LP returns
  - Government only gets ~4% return on its money
  - All other profits accrue to the private investors
  - Turns a 2x fund into a 3.5x fund

- Terms on the SBIC debt are highly attractive
  - Fixed rate
  - 10-year term
  - No covenants other than solvency and making interest payments

- Debentures program is highly stable
  - Created in 1958
  - Has made money for the government
  - Strong bi-partisan support

# How to Answer the Tough Questions

- Am I really paying a 6% management fee?
  - Charging 2% on the capital being invested
  - Have 3x the capital to generate enough profit to pay 3x the fees
  - This cost embedded in third-party debt
- Doesn't cross-collateralization create a lot more risk for the private investors?
  - Cross-collateralization cuts both ways
  - In a balanced portfolio, good companies can subsidize one or two struggling investments through a dip
  - Key is to avoid wipeouts by focusing on low-beta investments
- Isn't this just financial engineering masquerading as good investing?
  - All LBOs are financial engineering
  - SBIC structure uses financial engineering to reduce dependence on growth to generate returns
  - Growth is hard to find in the current economic environment
- If you're such a good team why are you an SBIC?
  - SBIC structure offers real benefits in a low-growth environment
  - There is virtually no path for a first-time fund to raise meaningful capital outside of the SBIC program

# What Makes a Good SBIC Deal

- Limited downside risk
  - Cross-collateralization makes avoiding wipeouts a top priority
  - Avoid highly cyclical businesses and those with fragile business models
  - Turnarounds and startups are not a fit except as perhaps the last deal or two in a fund
- Conservative valuations
  - 2/3rds of your investment is debt that needs to be serviced
  - Anything above ~6-7x results in too much leverage
- Strong free cash flow
  - With no outside leverage, free cash flow can be distributed to the fund
  - Services SBIC debt and offsets capital calls from LPs
  - Significantly enhances IRRs since effectively providing dividends to 30%-cost equity rather than paying down 4%-cost debt
  - Helps address concentration limit by providing internally-generated growth capital
- Modest growth potential
  - Flipside of limited downside and conservative valuation
  - With SBIC structure, 5% growth produces very attractive returns to private LPs
  - Concentration limit makes aggressive, capital-intensive growth strategies difficult to execute (e.g., rollups)

# Avoiding Insolvency

- Insolvency is the biggest risk in the SBIC program
  - Very hard to miss an interest payment on debt that costs 4%
  - Much easier to lose 40% of private capital with 2:1 leverage and 6% fees
- Understand the SBIC valuation guidelines
  - Not the same as FASB 157
  - Write downs are handled like FASB 157
  - Write ups are limited to third-party transactions (e.g., a follow-on financing) and actual cash exits
  - Management fees, organizational costs and broken deal expenses all count towards 40% test
- Avoid early losses at all costs
  - Inability to write up current portfolio really limits ability to offset losses in a fund's early years
- Generate current income
  - Builds up cushion against losses
  - Deal and monitoring fees can supplement interest income
- Negotiate good discounts with vendors on broken deals

# Explaining the SBIC Program to Management Teams

- Faster and more certain path to closing a deal
  - No financing out
  - No need to identify a lender and negotiate a credit agreement
  - Single party doing all the diligence and making all the decisions
  - Provides real differentiation in competitive processes
- More modest and achievable growth targets
  - SBIC structure generates much better returns than what a traditional fund can achieve with third-party leverage
  - 30% returns at 5-7% growth vs. 15% growth for traditional private equity funds
  - Less pressure on management to take big risks
- Much looser covenants going forward
  - Debt at 4%vs. debt at 10%
  - No performance covenants like Fixed Charge that one bad quarter can easily trip
- Attractive co-investment
  - Can offer management mix of debt and equity securities
  - Provides for immediate current yield