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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

Memorandum

To: Members, Subcommittee on Economic Growth, Tax and Capital Access
From: Committee Staff
Date: April 1, 2016
Re: Field Hearing: "Bridging the Gap—Increasing Access to Venture Capital for Small Businesses"

On April 5, 2016 at 10:00 a.m., the Subcommittee on Economic Growth, Tax and Capital Access will conduct a field hearing at Pasadena City Hall, 100 Garfield Avenue, Pasadena, CA 91101. The hearing titled "Bridging the Gap—Increasing Access to Venture Capital for Small Businesses," will examine the challenges faced by entrepreneurs looking to obtain venture capital, with a particular focus on entrepreneurs typically underserved by the venture capital community. The hearing will examine ways to increase access to venture capital funding to small businesses, both in the private sector and through the Small Business Administration's Small Business Investment Company (SBIC) program.

Background

Unlike large enterprises that can obtain funds from commercial debt and equity markets, small businesses must often rely on their own personal assets, retained earnings, and commercial banks for needed capital. Starting a business can present challenges for all entrepreneurs, and many cite funding as the primary obstacle they face.[1] The availability of bank loans, an important source of capital for small business, have vacillated throughout the last 16 years. The demand for small business loans declined from 2000 to 2004, increased from 2004 to late 2006, declined somewhat in 2007 and 2008, and declined significantly in 2009.[2] Demand then leveled off (at a relatively reduced level) during 2010, increased somewhat during the first half of 2011, declined somewhat during the latter half of 2011, generally increased in 2012 through 2015, and declined somewhat early in 2016.[3]

At times when bank loans are unavailable, entrepreneurs turn the four Fs: founders, family, friends, and foolhardy investors.[4] While many entrepreneurs either self-fund their business or obtain capital from friends and family, some are able to access capital from outside investors. The four Fs

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[1] http://www.kauffman.org/what-we-do/resources/entrepreneurship-policy-digest/how-entrepreneurs-access-capital-and-get-funded.
[2] http://www.federalreserve.gov/boarddocs/SnLoanSurvey/.
[3] *Id.*
[4] William Bygrave and Andrew Zacharakis, ENTREPRENEURSHIP 340 (2ND ED 2011).

refer to these investors as “foolhardy” because of the risk involved in startup small businesses. According to research by the Kauffman Foundation, approximately fifty percent of new firms do not survive past five years.[5] Given the volatility in the survival rate of new firms and their lack of collateral, most banks are unwilling to lend to a startup business.[6] Equity investors, on the other hand, are willing to take on risk because of the upside potential if a business becomes successful.

Equity Finance Overview

A benefit of equity financing over debt financing is that it allows a business to obtain funds without having to repay a specific amount of money in a particular time period. Unlike debt financing (e.g., bank loans) that require the business to make a monthly payment, which can restrict cash flow at a time when the business might be struggling to turn a profit, an equity investment typically does not require a fixed monthly payment.[7] Rather, the business owner receives funding in exchange for an ownership stake in the company. This ownership stake guarantees the investor a percentage of future earnings. While there is the potential to profit from the growth of a firm, if the endeavor fails, equity investors will not see a return on their investment.[8] Along with receiving an injection of capital, an advantage of an equity investment to a small company is that the investor has a stake in the business’s success. So, investors are usually willing to offer strategic advice and management assistance to the entrepreneur, as well as introduce the entrepreneur to the investor’s network of business contacts. This is extremely valuable to nascent entrepreneurs who do not have experience growing a company. The main drawback to this kind of investment is that the entrepreneur must give up a share of their business to an investor who may not share the same vision on how the company should be managed.

Venture capital is a type of equity financing that addresses the funding needs of entrepreneurial companies that for reasons of size, assets, and stage of development cannot seek capital from more traditional sources, such as public markets and banks. Venture capital investments are generally made as cash in exchange for shares and an active role in the invested company. Venture capital differs from traditional financing sources in that venture capital typically focuses on young, high-growth companies, takes higher risks in exchange for potential higher returns, and has a longer investment horizon than traditional financing.[9]

Venture capital provides businesses a financial cushion. However, equity providers have the last call against the company’s assets.[10] In view of this lower priority and the usual lack of a current pay requirement, equity providers require a higher rate of return/return on investment (ROI) than lenders receive.[11]

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[5] DANE STANGLER AND PAUL KEDROSKY, NEUTRALISM AND ENTREPRENEURSHIP: THE STRUCTURAL DYNAMICS OF STARTUPS, YOUNG FIRMS AND JOB CREATION, KAUFFMAN FOUNDATION, *available at.* http://www.kauffman.org/uploadedfiles/firm-formation-neutralism.pdf.
[6] ROBERT D. HISRICH, MICHAEL P. PETERS & DEAN A. SHEPHERD, ENTREPRENEURSHIP 347 (7th ed. 2008).
[7] *Id.* at 346.
[8] The ownership stake in the company will allow the investor to recover a percentage of the remaining business assets after debt creditors are repaid.
[9] https://www.sba.gov/starting-business/finance-your-business/venture-capital/venture-capital.
[10] *Id.*
[11] *Id.*

Venture capital for new and emerging businesses typically comes from high net worth individuals ("angel investors") and venture capital firms. These investors usually provide capital unsecured by assets to young, private companies with the potential for rapid growth. This type of investing inherently carries a high degree of risk.

Venture capital is also an active rather than passive form of financing. These investors seek to add value, in addition to capital, to the companies in which they invest in an effort to help them grow and achieve a greater return on the investment. Although investors are committed to a company for the long haul, that does not mean indefinitely. The primary objective of equity investors is to achieve a superior rate of return through the eventual and timely disposal of investments.

SBIC Program

SBICs are for-profit enterprises organized under state law as either a corporation or partnership or a variant thereof. SBICs receive a license to operate from the SBA pursuant to authority in Title III of the Small Business Investment Act of 1958. The SBA may not grant a license until it is satisfied that the licensee has: a) sufficient capital to operate soundly and profitably; and b) has qualified management.[12] If the SBA is satisfied with these aforementioned determinations, then the agency, prior to issuing a license, must consider whether: a) there is a need for investment in the area in which the applicant will operate; b) the reputation of the owners of the applicant; and c) the prospect that the ownership will manage the business in a profitable manner. Essentially, the licensing process requires the SBA to consider the business plan of the SBIC before issuing a license.[13]

Once licensed, the SBIC is able to use leverage provided by the federal government to invest in small businesses.[14] There are three types of SBICs: Conventional, Impact, and Early Stage. Funds have been licensed as Conventional Licensees since the program was founded in 1958. They have the broadest investment mandate, are licensed through a rolling admissions process and are eligible for two tiers of leverage capped at $150 million and obtaining a license can take up to two years. The Impact License is for funds with an investment mandate targeted to social as well as financial returns. The managers of these funds pledge to invest 50 percent of their capital in 'impact' investments and are eligible for an expedited licensing process. The Early-Stage License is designed to attract investment fund managers with experience supporting companies in their earliest stages of growth. They have access to one tier of leverage, capped at $50 million and are licensed through an

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[12] 15 U.S.C. § 681(c)(3)(A).

[13] *See* 13 C.F.R. § 107.130.

[14] For every dollar of private investment, an SBIC is entitled to draw up three dollars in government funding (but is not required to draw that maximum amount). Rather than simply borrowing directly from the federal government, SBICs sell securities that are sold in the private market (essentially a loan by private investors to the SBIC) and the federal government guarantees that the "lenders" to the SBIC are repaid with interest. The SBICs must repay the federal government for the leverage. In essence, there are two separate "loan" transactions; a loan of leverage by the SBA to the SBIC and a loan of private funds by investors to the SBIC who receive either a debenture to the total value of funds provided by the private investors as "collateral." The SBA guarantees the repayment of the funds provided to the SBIC by the private investors who purchased the leverage.

annual call (issued in December or January of each year) rather than on a rolling basis. As of FY2015, more than 300 SBICs have in excess of $24 billion in capital under management.[15]

The State of Venture Capital in the United States

For every 100 business plans that come to a venture capital firm for funding, usually only 10 or so get a serious look, and only one ends up being funded.[16] The venture capital firm looks at the management team, the concept, the marketplace, fit to the fund's objectives, the value-added potential for the firm, and the capital needed to build a successful business.[17]

The activity level of the United States venture capital industry increased in 2015 for the sixth consecutive year after the post-2000-era low reached in 2009.[18] However, the activity level was still well below those seen in 2000. Overall, more than 3,700 companies received venture funding in 2015, with over 1,400 companies receiving funding for the first time.[19] In 2015, 718 firms each invested $5 million or more during the year (compared to 1,050 firms in 2000). The number of active firms also increased in 2015 compared to 2014.[20]

Entrepreneurs in 46 states and the District of Columbia raised venture capital funding in 2015, with California receiving the largest share of dollars deployed (57%) and deals (41%).[21] The software sector maintained its dominance among investment sectors, receiving 40% of the dollars deployed in 2015. Geographic location of venture firms remains concentrated. California-domiciled firms managed 55% of the capital at the end of 2015, slightly higher than 54% a year earlier.[22]

Conclusion

Given that access to capital remains a key concern for small firms, legislative and policy changes may offer opportunities to correct and clarify requirements to further maximize small businesses and lenders ability to participate in the SBA's financing programs which bolsters business growth and job creation. Although venture capital investments have increased in recent years, the number of venture firms and the number of private sector investments still lag behind industry highs of the early 2000s. This hearing represents an opportunity to hear from industry leaders on ways to increase access to venture funding for small businesses.

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[15] UNITED STATES SMALL BUSINESS ADMINISTRATION, FY 2017 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2015 ANNUAL PERFORMANCE REVIEW 6 (Feb. 2016), *available at* https://www.sba.gov/sites/default/files/FY17-CBJ_FY15-APR.pdf.
[16] NATIONAL VENTURE CAPITAL ASSOCIATION, 2016 NATIONAL VENTURE CAPITAL ASSOCIATION YEARBOOK 6, *available at* http://nvca.org/blog/a-busy-year-for-venture-capital-nvcas-2016-yearbook-review/.
[17] *Id.*
[18] *Id*. at 9
[19] *Id*.
[20] *Id.*
[21] *Id.*
[22] *Id.*