In January 2011, the U.S. Small Business Administration (SBA) announced its one billion dollar Impact Investment Initiative, which will match private capital raised by investment funds that focus explicitly on making impact-oriented investments in small businesses. Reaction to the announcement has been a combination of excitement and skepticism, and it has raised myriad questions: What brings SBA to the impact investing space? Why now? How is it going to work? How does SBA fit into this space?

This essay aims to answer those questions.

We start by recognizing that SBA is a relative newcomer to the impact investing space and that it approaches this new investment realm from a very different starting point than the organizations that have been studying and investing in this space for years. SBA has broad experience with entrepreneurs and small businesses, and with investment funds and capital markets. This experience has led to three key conclusions:

- There are meaningful opportunities and untapped potential in domestic impact investing. These opportunities exist over and above traditional areas of impact investing, such as microfinance or community development finance—that is, in the private equity industry.
- The current economic environment creates both a great need for more impact investment and a formidable set of challenges to making it happen.
- Finally, public-private partnerships can play a critical role in catalyzing investment, but creating these partnerships will require entrepreneurial and innovative approaches to how we attempt to stimulate more entrepreneurship and innovation.

Sean Greene is the Associate Administrator for Investment and Special Advisor for Innovation at the U.S. Small Business Administration. Prior to joining the SBA Greene was the founder and CEO of Away.com, an online travel company that he sold to Orbitz. He was also a cofounder of Rock Creek Ventures and LaunchBox Digital, a seed-stage investment firm in Washington, D.C. Previously, Greene was a management consultant with McKinsey and Co.

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The importance of small businesses to the U.S. economy is well documented. Small businesses employ over 50 percent of U.S. workers, and they generate the bulk of the net new jobs created in the economy. Moreover, multiple studies have shown that a small number of high-growth firms (4 to 5 percent of all firms) account for almost all of that net new job creation.

Small businesses also have a disproportionately large impact on innovation. One study by the SBA Office of Advocacy found that small firms produced 13 to 14 times more patents per employee than large firms, and these patents were cited in applications more often than average patents. Furthermore, it is important to note that innovators like Google and Facebook built on the innovations of once-small companies like Intel and Apple. However, this level of innovation is not limited to technology companies in Silicon Valley. For example, a once-small company named FedEx revolutionized the shipping industry from its headquarters in Memphis, Tennessee. We could provide countless other examples of innovative companies from across all industries that have revolutionized their own sectors.

All of these facts raise several questions. How can the SBA help unleash this innovative spirit to address the country’s most challenging economic and social problems? How can the power of entrepreneurship be unlocked to create jobs in communities that need it the most? How can the innovative capabilities of entrepreneurs be leveraged to solve challenging social problems in sectors like energy, education, and health care? And how is this done in an economic environment that has been very challenging for small businesses?

GAPS IN THE CAPITAL MARKET

One indicator of the challenges in the current economic environment is that the number of new business starts has dropped from 656,000 in 2007 to 505,000 in 2010—a 23 percent decrease. That number is particularly troubling because historically, when the going gets tough, the entrepreneurs get going. In fact, according to a recent Kauffman Foundation study, more than half of the companies in the Fortune 500 were founded during previous recessions or bear markets.

As part of its Startup America initiative, the Obama administration recently held a series of roundtable discussions with over a thousand entrepreneurs from across the country to focus on identifying and reducing barriers to entrepreneurs’ starting and scaling businesses. Difficulty getting access to capital was frequently at the top of these entrepreneurs’ lists. And while much of the press coverage has focused on credit markets and the tightening of bank lending, the challenges are equally great in securing more long-term, patient capital, whether in the form of equity or longer term debt. This is true across the financing continuum: angel, venture capital, and private equity investing are all down meaningfully since 2007.
This type of funding is particularly critical for the high-growth firms referenced above.

Gaps in the capital market are exacerbated in underserved communities, which weren’t getting enough investment capital even before the financial crisis. Geographic disparity offers a prime example. In the venture capital industry, three states (California, Massachusetts, New York) account for 65 percent to 70 percent of financing, despite the fact that those states account for only one-third of the country’s high-growth companies.6 Investments in underserved areas, like low-to-moderate-income neighborhoods, are disproportionately negatively affected.

The same uneven distribution can occur within a sector. For example, in the education sector, much of the capital has flowed into a limited number of areas, such as test preparation, language skills, and for-profit postsecondary education. Structural challenges, such as high distribution and marketing costs and complexities in procurement within the K-12 industry, have reduced the attractiveness of investing in the companies that address the most pressing needs and national priorities in this critically important sector.

To compound matters, the sources of funding for the venture capital and private equity funds themselves have also decreased significantly. Institutional investors such as pension funds, banks, and foundations are all facing their own challenges and thus have meaningfully reduced their commitments to private equity and venture capital.7 This will have a ripple effect for years to come, regardless of any action taken by others.

Together these trends present a critical challenge. We need the help of entrepreneurs in the impact economy now more than ever, precisely at the time when mobilizing capital for anything, let alone something new, faces a daunting set of challenges.

THE SBIC PROGRAM: LEVERAGING EXISTING AUTHORITY AND INFRASTRUCTURE TO HAVE MORE IMMEDIATE IMPACT

There has been no shortage of creative ideas for new government programs to address these challenges over the last two years. With that in mind, the SBA looked back to see how it could leverage programs that already exist, with a particular focus on the Small Business Investment Company (SBIC) program. The SBIC debenture program has operated successfully for more than 50 years. Its mission is to stimulate and supplement the flow of long-term patient capital to small businesses.8

The program’s fundamentals are market driven. Rather than the federal government deciding which companies to invest in, the program attracts high-quality investment professionals who are raising private capital to form a fund. The government then matches the private capital with low-cost, government-guaranteed leverage. In a world of megafunds, the program is particularly effective in helping smaller funds scale up and providing them with more capital. As with other forms of leverage, the SBIC debenture program provides the opportunity to yield higher innovations / volume 6, number 3
returns for the equity investors in the fund. The empirical data backs up the theory. Private investors in SBICs over the last decade have seen 3 to 6 percent of incremental return as a result of accessing SBA’s low-cost leverage. As mentioned above, SBICs have funded some well-known, once-small companies, including Apple, Intel, and FedEx, and thousands more.

Perhaps most importantly, given the current political climate, the program operates at zero cost. Most of the funds repay their debt; for those that do not, annual program fees offset the cost of default. That said, the program has had its ups and downs over the years, but the core debenture program continues to work very effectively, as it has for decades.

In recent years, faced with tremendous challenges in the fundraising environment, demand for the debenture program has increased markedly. SBA has responded to the need in the market by streamlining processes, slashing the average time to license a new fund from 15 months in 2009 to less than 6 months in 2010. As a result, SBA deployed $1.2 billion in commitments to funds in 2010—a 50 percent increase over its average annual commitments in the previous three years and an all-time high in the 50-plus years of the program. SBA set similar records in terms of the private capital attracted to the program and the amount of financing provided to small businesses.

Despite such progress, these levels are well short of SBIC’s annual authorization of $3 billion, which creates a great opportunity to continue the growth trajectory within the existing program authority. Utilizing the existing authority, regulatory framework, and operations infrastructure, SBA can get capital out faster. Conversely, standing up a brand new program would take years. Moreover, existing provisions for SBICs in the Community Reinvestment Act and exemptions under the Volcker Rule make the program a more attractive vehicle for some investors, such as banks.

While SBA wants to grow the SBIC program as a whole, it has been focused on maximizing the impact of SBIC investments, particularly where there appear to be large gaps in the market, such as investing in low-to-moderate-income areas. In evaluating how to address those gaps, the SBA’s Office of Investment (which I lead) started with data and experience within the SBIC program. Interestingly, the results of our data analysis fly in the face of conventional wisdom. The most illuminating findings are in an area for which there is good historical data—performance of growth capital funds that invested more actively in low-to-moderate-income areas.

Economists argue that unequal distribution of capital investment does not necessarily demonstrate market failure. They say that the markets are perhaps performing efficiently and that capital is merely flowing toward its best use. Investors phrase it more in terms of returns. Conventional wisdom is that returns will be lower in low-to-moderate-income areas because they don’t provide as many good investment opportunities.

SBA did not have data to analyze the historical performance of every individual investment, so it used a relatively simple primary measure of financial per-
performance: do the funds, as a whole, pay back what they borrowed? If the conventional wisdom of economists, investors, and others were true, a much higher loss rate would be expected for funds with higher percentages of their investments in low-to-moderate-income areas. The results, however, were surprising. There was no correlation between the fund’s financial performance (loss rate) and the degree to which the investments were concentrated in low-to-moderate-income areas. In fact, funds with the highest concentration of portfolio company investments in those areas (over 40 percent) slightly outperformed the comparison set of funds as a whole.

There are limitations to this analysis: loss rate is only one measure of financial performance; SBA does not have full historical data on fund returns, nor does it calibrate risk-adjusted return; and the analysis does not differentiate funds that invested with “intent” versus those that may have invested in low-to-moderate-income areas without realizing it. Nonetheless, the SBA’s Office of Investment believes the finding is a very important one, particularly because there is little available data in the sector.

Figure 1. Relationship Between Percentage of Loans to Low-to-Moderate Income Areas and Leverage Losses
The data represented in this figure are based on 113 SBICs issuing debentures only and performing at least $1 million in multiple financings between 1998 and 2010, and having no outstanding leverage in operations.
The SBA launched the Impact Investment Initiative to address the gaps described above. The program effectively functions like an impact investing “fund of funds.” It is committing $1 billion to the initiative, which will be deployed as $200 million per year for the next five years.

The SBA’s definition of “impact” centers on two different axes: place-based investments and sector-based investments. Place-based investments are investments in small businesses located in or employing residents of low-to-moderate-income areas or economically distressed regions. Sector-based investments are investments in small businesses in industries that the administration has identified as national priorities. In both cases, the SBA will attempt to attract funds that are investing for financial returns but that also intend to generate a social return. SBA has identified clean energy and education as critical sectors and will add more over time. Impact investment SBICs must invest at least 50 percent of their capital in impact investments. This will allow SBA to focus on funds that primarily have an impact focus yet permit some flexibility in terms of the specific fund’s strategy. The SBA will match private capital up to twice a fund’s investment amount. To ensure diverse participation among funds, maximum leverage with any one fund will be $80 million.

This program provides incentives to private investment that are different from typical government efforts in potential impact areas. Unlike other federal programs that focus on risk mitigation—that is, government taking a first-loss position—this program offers return enhancement.

Partnerships will be critical to the success of the initiative, within both the government and the private sector. SBA will work with other federal agencies, such as the Department of Energy and Department of Education, which will provide sector-specific experience. It will also work with agencies like the Department of Agriculture to improve outreach to potential institutional investors and funds interested in investing in rural small businesses.

SBA also recognizes that reaching out to external constituencies will be important in attracting a broader set of fund managers and institutional investors to the program. As one large institutional investor pointed out, very high-quality funds have been presented to them and they were willing to invest, but there weren’t enough other investors around the table. SBA aims to provide capital to help those funds get to scale, and to attract more private investors “to the table.”

In July 2011, SBA announced that InvestMichigan! Mezzanine Fund is the first licensed Impact Investment fund. The fund will focus exclusively on providing capital to businesses that are headquartered in or have a significant presence in Michigan, and/or are in the process of expanding their operations there. SBA will provide capital to Michigan Growth Capital Partners, L.P., an investment partnership whose anchor investors are the State of Michigan Retirement Systems and the Dow Chemical Company. This fund will provide up to $130 million of investment capital over the next five years to high-growth businesses throughout Michigan.
The Credit Suisse Customized Fund Investment Group will manage the fund in partnership with Beringea, a Michigan-based investment manager.

This represents a great model of an impact investment opportunity. On the one hand, the need is great. Hard-hit by the economic downturn, the overwhelming majority of the counties in Michigan are economically distressed and have high unemployment. On the other hand, with more engineers per capita than any other state and a rich tradition of entrepreneurial activity, the state has ample human capital and many small businesses that are poised for growth, pending access to investment capital.

WHERE WE GO FROM HERE

As SBA moves forward, it will operate with a few guiding principles:

- Start with what we know. The current program is best suited for funds providing capital to existing profitable businesses that need capital to grow. While there are many other needs, including seed and early stage capital, as well as many other potential impact sectors, SBA plans to “walk before we run.”
- Keep it simple. Don’t let the perfect be the enemy of the good. On issues like measurement of impact, SBA will start with simple measures like job creation and evolve from there.
- Focus on quality. The SBIC Impact Initiative, and the impact investment sector as a whole, has the greatest chance of long-term success if it involves high-quality funds that perform well, which would demonstrate the ability to generate both strong financial returns and broader social impact.
- Be market driven. SBA is not setting specific targets for place-based funds or for specific sectors. It believes that the private capital validation and willingness to invest are a critical part of its program.
- Reach out proactively. Actively explore opportunities to attract both new fund managers and new investors to the impact investment space.

Overall, the SBA is taking an approach that is doable, given its scope and the capacity of its Office of Investment. Just as importantly, this approach is targeted at business growth and job creation. SBA recognizes that its focus—growth capital in the U.S.—is one small piece of the broader impact investing landscape.

SBA also recognizes that there is great work being done by a wide variety of groups in the sector. This includes work by organizations like the Rockefeller Foundation, critical research from companies such as J.P. Morgan and Monitor Group, other government agencies, including the Overseas Private Investment Corporation and USAID, or the numerous institutional investors and funds/intermediaries that are part of the Global Impact Investing Network.

Finally, SBA sees a number of important questions that need to be addressed by the sector as a whole:

- How do we get better data, particularly as it relates to financial returns?
- How can we “expand the tent” to attract more investors to the space, including institutional, high-net-worth, and retail investors?
• How can we strengthen the ecosystem by attracting high-quality talent to the sector to develop innovative products?
• What role can the federal government play in attracting more investment in this critically important sector?

The challenges are great, but the power of entrepreneurship is equally great. In this economic environment, the United States needs more than ever to unlock that power.

7. Center for Venture Research at the University of New Hampshire.
8. SBA defines a small business concern as one that is independently owned and operated, is organized for profit, and is not dominant in its field. Depending on the industry, size standard eligibility is based on the average number of employees for the preceding 12 months, or on sales volume averaged over a three-year period. More information is available at http://www.sba.gov/content/what-sbas-definition-small-business-concern.
9. Section 301(a)(1) of PWEDA (42 U.S.C. 3161) provides that an area is economically distressed if it has a per-capita income of 80 percent or less of the national average. Section 301(a)(2) (42 U.S.C. 3161) provides that an area is economically distressed if it has an unemployment rate that is, for the most recent 24-month period for which data are available, at least 1 percent greater than the national average unemployment rate. The Federal Highway Administration maintains a mapping tool that identifies economically distressed counties based on unemployment rate and per-capita income. Available at http://hepgis.fhwa.dot.gov/hepgis_v2/GeneralInfo/Map.aspx.
10. Included in this definition are any energy-saving qualified investments as defined in 13 CFR 107.50, the Energy Independence and Security Act of 2007 (Public Law 110-140); implementing regulations have been designated as a qualifying sector for this initiative.
11. SBA will add sectors in partnership with other mission-driven agencies, including the U.S. Department of Energy and the U.S. Department of Education.