Program Evaluation of The US Department of Treasury State Small Business Credit Initiative

Prepared by the Center for Regional Economic Competitiveness and Cromwell Schmisseur

OCTOBER 2016

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

October 13, 2016

Dear Colleagues,

We are pleased to present the Program Evaluation Of The U.S. Department Of Treasury State Small Business Credit Initiative. This report summarizes the outcomes of 142 state credit support and investment programs funded by the State Small Business Credit Initiative (SSBCI), which supported over $8 billion in new lending and investing to small businesses since 2011.

Small businesses drive innovation and are an important source of employment and economic mobility for American families. Yet for many of the smallest businesses, youngest businesses, and businesses in underserved communities, accessing capital to start and grow is a challenge. Our hope is that this report will demonstrate the pivotal role SSBCI played in the economic recovery and provide evidence to support ongoing federal funding for small business financing programs like SSBCI.

We are grateful to the state program managers who helped thousands of small businesses access financing and whose collaboration with each other and with Treasury is a model for intergovernmental collaboration. Finally, we thank Federal Management Systems, and the authors of this report, the Center for Regional Economic Competitiveness and Cromwell Schmisseur. They have supported SSBCI's work since 2012, and brought a deep familiarity with the state programs to this report.

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Acknowledgements

This report resulted from the efforts of many people including the authors, SSBCI team, and state program managers. We are grateful for the leadership and support of former Under Secretary Mary Miller, former Assistant Secretary Cyrus Amir-Mokri, Counselor to the Secretary Antonio Weiss, Acting Assistant Secretary Amias Gerety, former Deputy Assistant Secretary Don Graves, and former SSBCI Director Cliff Kellogg. We particularly wish to thank the following people for their contributions to SSBCI and this report:

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Executive Summary

Program Evaluation of the U.S. Department of Treasury State Small Business Credit Initiative

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SSBCI

Executive Summary

Small businesses are a vital part of the American economy and their success is a critical component of economic growth. Established by the Small Business Jobs Act of 2010, the State Small Business Credit Initiative (SSBCI) provided nearly $1.5 billion to state small business financing programs. A departure from federal credit programs with uniform requirements, SSBCI gave states significant flexibility to design programs that met local market conditions. For some states, this meant targeting micro-businesses; for others, it meant targeting manufacturers or high-tech businesses. Each state has its own needs and, with them, a unique set of partners to administer the programs.

With this flexibility, states, territories, and municipalities[1] directed SSBCI funds to 152 small business programs with a wide range of models and strategies. Approximately 69 percent of the funding supported lending or credit support programs and 31 percent supported venture capital programs. This report studies program activity based on data reported to Treasury on 16,919 transactions made between 2011 and 2015, and interviews of state program managers and their partners.

Key Program Statistics

- **State SSBCI programs supported nearly $8.4 billion in new capital in small business loans and investments by the end of 2015.** States expended $1.04 billion (72 percent of available SSBCI funds) to leverage nearly $8.4 billion of new lending and investing.
- **SSBCI provided capital to very small and young businesses.** Eighty percent of SSBCI transactions supported businesses with 10 or fewer full-time employees and nearly half the supported businesses were less than five years old.
- **States designed and marketed SSBCI programs that addressed capital needs in low- and moderate-income (LMI) areas.** Through 2015, 42 percent of the 16,919 SSBCI transactions were with small businesses located in LMI census tracts. In several states, a successful relationship with community development financial institutions (CDFIs) resulted in higher percentages of loans in LMI areas.

1 Treasury approved applications from 47 states, the District of Columbia, five territories, and municipalities in three states (collectively referred to as "states").

General Themes

From 2012-2015, the consultants interviewed managers of SSBCI state programs. Several overarching themes emerged from these interviews.

- **The SSBCI program model leveraged state expertise and networks.** States are well positioned to collaborate with the federal government on small business programs because they understand local market needs, can build an integrated support system, and can manage these programs either directly or with local partners.
- **States expanded existing or built new programs that addressed local objectives.** State programs addressed the spectrum of small business financing needs, from loans for microbusinesses and equipment purchases for small manufacturers to equity capital for early stage technology businesses.
- **SSBCI helped build capacity at the state level.** Treasury played an active role as technical assistance provider to facilitate knowledge sharing among state program managers. By participating in a national network of practitioners interested in documenting and sharing detailed information on small business financing programs states replicated best practices and expanded their capabilities.
- **SSBCI state programs complemented existing federal small business programs.** State programs complemented federal programs, such as Small Business Administration (SBA) or U.S. Department of Agriculture (USDA) loan guarantees, which typically have uniform national requirements. Furthermore, SSBCI's state programs filled market gaps that some other federal programs do not cover, such as guaranteeing loans from CDFIs, financing non-profits, directly targeting collateral shortfalls related to falling property values, and supporting equity financing for high-growth potential businesses.
- **Successful state programs shared common characteristics.** State programs that successfully deployed SSBCI funding in support of small business financing:
    - addressed a clearly defined capital gap;
    - were staffed by teams with relevant experience and strong working relationships with private lenders and investors;
    - aligned with state economic development objectives and had the support of their state agency and state leadership; and,
    - aligned with market expectations in terms of pricing and business practices.

Observations from Credit Support Programs

States directed approximately $1 billion, or 69 percent of total SSBCI funds, to credit support programs that supported small business lending, such as capital access, loan guarantee, loan participation, and collateral support programs. Through different mechanisms, each program type shares a portion of the risk of loan repayment with lenders, thereby enabling transactions that might not otherwise have occurred. From 2011 to 2015, states operated 103 active credit support programs supporting nearly 15,600 transactions. Credit support programs expended $766 million in SSBCI funds to spur $5.3 billion in new loans and investments.

- **Capital access programs (CAPs) supported a high volume of very small loans:** The median CAP loan size was approximately $14,800 and almost 47 percent of CAP loans supported businesses in LMI areas. CDFIs actively adopted CAPs in states with pre-existing programs. CDFIs accounted for 65 percent of the 10,561 CAP transactions. Large banks did not adopt CAP as many states had expected in 2011, leading states to reapportion 85 percent of their original CAP allocations to other programs.

- **Other credit support programs varied widely in design, but tended to support larger loans:** Loan guarantee, loan participation, and collateral support programs supported larger transactions, with a median size of $300,000. On average, states used SSBCI funds to support 17.4 percent of each transaction, implying a leverage ratio of 5.75:1. By redeploying funds after repayment (recycling), other credit support programs achieved a leverage ratio of 6.44:1 by year end 2015. Manufacturers were the most common business type, representing 17 percent of all non-CAP credit support transactions.

- **Community banks and CDFIs were the most active lenders:** Community banks and CDFIs were the most active lenders in the credit support programs. Together they represented 81 percent of the total number of loans supported by SSBCI and were critical in helping SSBCI provide capital to underserved areas. Community banks alone accounted for 61 percent of the dollar volume supported by SSBCI credit support programs. Few large national banks participated, representing 6 percent of total loans, but several that did were among the top volume lenders.

- **Lessons learned from implementation:**

    - The most widely used programs incorporated input from lenders in the program design process; aligned their terms, conditions, and documentation with market practice; and engaged in a consistent marketing effort.

    - Programs that subordinated the state's position on collateral to the lender achieved faster market acceptance.

    - CAPs levered private dollars 23.12:1 and all other credit support programs combined achieved 5.69:1 leverage on initial deployment (before recycling).

    - Reaching underserved communities requires focused marketing through a network of lenders connected to targeted communities.

Observations from Venture Capital Programs

Thirty-eight states directed approximately $450 million, or 31 percent of total SSBCI funds, to venture capital programs. Market conditions for equity financing vary widely across the country so states customized their SSBCI venture capital programs to work locally.

This report categorizes venture capital programs into four different groups based on the type of entity primarily responsible for operating the program: funds, state-supported entities, state agencies, and co-investment models. Between 2011 and 2015, venture capital programs supported over 1,300 equity investments with $278 million in SSBCI funding, generating $3.1 billion in new investment.

- **States partnered with specialized third-parties to administer venture capital programs:** In most cases, states partnered with private investment funds (funds) or specialized non-profits (state-supported entities) with expertise to source, structure, close, and manage equity investments in small businesses. Funds and state-supported entities managed 83 percent of the SSBCI funding allocated to venture capital programs.

- **States tended to target early-stage businesses:** Venture capital programs targeted high-growth potential businesses in various stages of development: pre-seed and proof-of-concept; seed-stage and early-stage; growth stage and later stage; and mezzanine and debt investments. About two-thirds of the transactions supported pre-seed and seed capital investments where states saw the greatest immediate need.

- **States with less access to venture capital tended to use SSBCI for equity programs:** States outside the historically dominant venture capital hubs were more likely to allocate SSBCI funds to venture programs.

- **Measures of success varied with program strategy:** States prioritized financial return and economic development outcomes differently depending on their program objectives. The primary measure of success was leverage – the amount of new investment supported by or induced by SSBCI. States also monitored financial return on investment, investee contributions to the state tax base, and quality of jobs created, among other outcomes. However, because venture investments mature over a long timeframe (typically six to 15 years), the full extent of outcomes from these investments will not occur or be measured until after SSBCI sunsets in 2017.

- **Lessons learned from implementation:**

    - Selecting partners and establishing new funds may take up to a year.

    - A base of local investors, specifically local investment funds, is critical to supporting high growth potential businesses.

    - Key operational and compliance considerations include conflicts of interest and the ability to track federal funds through to each transaction.

About the Report

This report presents an analysis of SSBCI program activity from 2011 to 2015. Chapters 1 and 2 provide program background and examine overall outcomes in relation to federal program objectives. Chapters 3 and 4 summarize credit support and venture capital program activity separately. The report concludes with a synopsis of key findings and conclusions derived by the authors from their own experience as well as input provided by state SSBCI program managers. A team of consultants under the management of Ken Poole from the Center for Regional Economic Competitiveness and Eric Cromwell and Dan Schmisseur of Cromwell Schmisseur authored this report.

The report draws on quantitative data reported to Treasury by the states combined with more than 200 telephone interviews with state program managers, several expert practitioner working group reports, more than 50 lender and investor interviews, and more than 20 site visits conducted between 2012 and 2015. From this data and the cumulative insights gleaned from SSBCI staff and consultants retained to provide technical assistance to states, this report offers an assessment of program results and lessons for public-supported financing programs that impacted every state and territory.

Chapter 1

About SSBCI

Program Evaluation of the U.S. Department of Treasury State Small Business Credit Initiative

Center for Regional Economic Competitiveness & Cromwell Schmisseur

OCTOBER 2016

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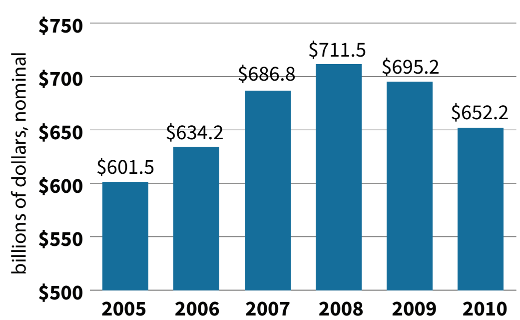
Chapter 1:
About SSBCI

1A. SSBCI in Context

The financial crisis and the recession that followed was particularly hard on small businesses. At a time when they needed capital most, small businesses were shut off from the credit they needed to weather the crisis and recover.[2] Between 2008 and 2010, small business lending (i.e., loans of $1 million or less) fell sharply from $712 billion to $652 billion (more than 8 percent) (see Figure 1-1) after rising steadily in the prior years. Highly reliant on bank lending as a source for debt financing, small businesses reduced operations and shed jobs, contributing further to the economic crisis.

Figure: 1-1: Total Small Business Loans, $1 million or less in billions of dollars



Source: Federal Deposit Insurance Corporation, Statistics on Depository Institutions, June 2005 through June 2010

The recession also constrained private equity investment, another important source of capital for some businesses, especially those with high-growth potential but without sufficient cash flow or tangible assets to secure debt financing. These businesses look to friends and family, high net worth individuals, or venture funds for capital to start and grow. During the recession, uncertainty and falling real estate and stock values diminished the availability of such capital. In response, Congress and the Obama Administration took a number of measures to support access to capital for small businesses, including establishing SSBCI. Through SSBCI, Treasury allocated $1.46 billion to states to support small business financing programs. The state programs provided public funds to leverage private sector lending and equity investment. SSBCI gave the states the flexibility to design and implement their own set of small business finance programs based on basic requirements laid out in the statute.

2 Gordon-Mills, Karen & McCarthy, Brayden. *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game*. Harvard Business School. Working Paper 15-004. 22 July 2014. Pages 15, 18.

1B. How SSBCI Worked

SSBCI funded state agencies either administered credit support and investment programs directly or partnered with other organizations as program administrators. States designed their own program, or portfolio of programs, and developed their own underwriting and operating procedures. SSBCI rules required states to target small businesses, develop a plan to target underserved communities, and design programs that leverage private sector lending and investing. A key SSBCI criteria driving state program design was the expectation that states leverage at least $10 of new small business lending or investing for every $1 of public funds during the life of the program. Appendix 1 describes SSBCI program eligibility criteria in more detail.

Given this flexibility, states funded 142 different active lending and investing programs, which generally fell into one of five types:

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FIVE TYPES OF PROGRAMS

Capital Access Programs (CAPs)

Loan Guarantee Programs (LGPs)

Collateral Support Programs (CSPs)

Loan Participation Programs (LPPs)

Venture Captial Programs (VCPs)

★ ★ ★ ★ ★

- **Capital access programs** (CAPs) provide a portfolio loan loss reserve for which the lender and borrower contribute a share of the loan value (up to 7 percent) that is matched on a dollar for dollar basis with SSBCI funds.
- **Loan guarantee programs** (LGPs) provide an assurance to lenders of partial repayment if a loan goes into default once the lender makes every reasonable effort to liquidate available collateral and collect on personal guarantees.
- **Collateral support programs** (CSPs) provide cash to lenders to boost the value of available collateral.
- **Loan participation programs** (LPPs) purchase of a portion of a loan that a lender makes or make a direct loan from the state in conjunction with a private loan (companion loan). The state often subordinates to the lender's senior loan.
- **Venture capital programs** (VCPs) provide financing by purchasing an ownership interest or providing equity-like loans to enterprises that typically do not participate in debt financing markets due to their business stage and structure. SSBCI categorized VCPs into four different groups based on how the state engaged with the investment process: Funds, State-supported entities, State agencies and Co-Investment Models.

Figure 1-2 illustrates that states employed alternative program designs to achieve different goals, provide different products, and help different types of customers. Even though SSBCI classified the programs within these five program design models or "program types," individual state programs classified together can often offer different terms and conditions, seek to address different capital gaps, or serve different types of customers.

Figure 1-2: Types of SSBCI Programs and Resource Allocation

Type of Program	Primary Purpose	Financing Products	Typical Customers
Capital access	Provide reserve funds to help protect lenders from losses	Working capital	Micro-enterprises (less than 10 employees or $1 million in sales)
Loan guarantee	Provide repayment guarantee for large portion of a loan in the event of default after collateral recovery efforts by lender have failed	Lines of credit, working capital, asset purchases, commercial real estate	Established businesses or turn-around situations
Collateral support	Supplement collateral when borrowers do not otherwise meet loan-to-value ratio requirements	Asset purchases, commercial real estate; gap financing for SBA 504 transactions	Established, growing businesses with a collateral shortfall
Loan participation	Provide subordinated or pari-passu debt to encourage senior lenders to increase loan size or reduce borrower interest expense	Asset purchases, commercial real estate	Established businesses (i.e., more than 3 years of financials) with documented cash flow or collateral shortfall
Venture capital	Provide risk capital to small businesses with high growth potential	Seed, early stage, or growth capital	Start-ups or emerging small businesses (i.e., businesses with new products or growing markets)

1C. How States Used SSBCI

States used SSBCI to create new small business financing programs, restart legacy programs, and to scale existing programs. Over half of the 152 programs proposed by states were newly created. Some states had no pre-existing credit and/or equity support programs and developed an entirely new organizational infrastructure to support business financing. By the end of 2015, states had allocated $574 million to pre-existing programs and $883 million to new programs.

Programs Supported

All states were eligible to participate and 47 states, the District of Columbia, five territories, and four municipalities or consortia of municipalities ultimately applied.[3] The municipal consortia came together to create initiatives when three states opted not to participate directly.

Figure 1-3 summarizes SSBCI allocations to 152 programs by type at the end of 2015. Of the 152 programs, 142 were active and had expended funds to make small business loans and investments.

At the time Congress enacted the Small Business Jobs Act in 2010, CAPs were a widely understood credit support program.[4] Seventeen states recapitalized an existing CAP and seven states created new CAPs. While states initially allocated 20 percent of total funds to CAPs, many states saw only limited use by lenders and eventually modified their program allocations, reducing CAPs to 3 percent of the total SSBCI allocation.

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3 The consortia from North Dakota include 38 municipalities led by the City of Mandan and 36 municipalities led by the City of Carrington. In Wyoming, 17 municipalities led by the City of Laramie formed a consortium.

4 *Capital Access Programs: A Summary of Nationwide Performance.* U.S. Department of the Treasury. November 1999. Web accessed. (https://www.treasury.gov/resource-center/sb-programs/Small-Disadvantaged-Business/Documents/cap.pdf).

Figure: 1-3: SSBCI Allocation by Program Type, through December 31, 2015

Type of Program	Number of Approved Programs	Number of Active Programs	Total Funds Allocated ($ millions)	Average Program Allocation ($ millions)
Capital access (loan loss reserve)	24	22	$45	$1.9
Other credit support				
Loan guarantee	22	20	$232	$10.5
Collateral support	17	17	$261	$15.4
Loan participation	48	44	$471	$9.8
Venture capital	41	39	$448	$10.9
TOTAL	**152**	**142**	**$1,457**	**$9.6**

States allocated more than one-third of all SSBCI funds to 48 different LPPs. LPPs took various forms. In some cases, the state purchased a portion of a bank's loan, in other cases, the state made a separate loan in conjunction with the lead lender (companion loan). In yet another variation, some states committed funds to a CDFI lender, which re-lent the SSBCI dollars alongside its own capital. Nineteen states funded LGPs, representing 16 percent of the available SSBCI allocations. Finally, of the 17 states with CSPs, 16 were new and modeled after a pre-existing Michigan program. States allocated nearly 18 percent of all SSBCI funds to collateral support programs.

Thirty-eight states implemented VCPs, allocating about 31 percent of SSBCI funds to equity finance programs. These programs varied widely in their approach to equity financing. Reflecting the variety of equity capital needs, states created programs that targeted pre-seed and "proof of concept" investments, seed stage and early stage investments, growth stage and later stage investments, as well as mezzanine and debt investments. They also took different approaches to aggregating and disseminating capital – ranging from making direct investments in businesses to a more common approach of investing in or through private investment funds.

Program Management Structures

Participating states administered SSBCI through: (1) the state agency receiving the allocation; (2) a quasi-public agency; or (3) a contracted private entity, either for-profit or non-profit (see Figure 1-4). These administrators executed all or some portion of program operations as determined by the state. The choice of operating model had implications for how states designed and implemented their SSBCI programs, as well the states' ability to recruit staff, design flexible decision-making processes, adapt program models, and engage the lending and investment community.

Figure 1-4: SSBCI Allocation by Program Administrator Type

Program Administrator Type	Number of States Using Operating Model	SSBCI Allocation	
		$ millions	%
Public agency	31	$674	46%
Quasi-public agency	19	$336	23%
Private	21	$447	31%
TOTAL	**71***	**$1,457**	**100%**

**Does not total to 57 Participating States; several states used multiple program administration models.*

- **State Agencies** – state agencies most frequently administered programs when expanding on existing credit support programs.
- **Quasi-Public Authorities** – quasi-public agencies legislatively created, independent organizations such as housing or business financing authorities or economic development corporations, were well-situated to operate small business finance programs because they had existing relationships with private lenders and/or investors.
- **Contracted Private Entities** – states contracted with a wide array of private entities including non-profit CDFIs, for-profit business development corporations (BDCs), and SBA CDCs, among others. VCPs contracted with private sector venture capital funds and specialized non-profits.

1D. Private Lenders and Investors

States designed SSBCI programs to expand access to private debt and equity financing. In almost all cases, this means a private lender or private investor leads the transaction and SSBCI funding fills a gap or provides support to enable the transaction. Private partners are therefore essential to the operation of SSBCI-funded programs.

Participating Lenders

Banks, credit unions, and CDFIs were eligible to participate in SSBCI programs subject to each state's review. In addition, if described in the states' application to Treasury, some alternative lenders, such as equipment lenders and trade credit lenders participated. A third category of lender included finance authorities themselves using non-public monies to match the SSBCI contribution. Community banks, mid-sized banks, and CDFIs were the most active participants, accounting for 94 percent of all SSBCI-supported loans. Community banks alone accounted for 61 percent of all lending activity by dollar amount. Large national banks tended not to participate because of the operational challenges of implementing multiple sets of compliance and reporting requirements, which varied from state to state.

Participating Investors

States typically targeted early-stage businesses raising equity financing to develop new products or services, often technology related, and introduce these innovative solutions to customers. These businesses receive equity financing from "accredited" angel investors and venture capital funds. Accredited angel investors are high-net worth individuals, as defined by the Securities and Exchange Commission, who invest their own money and time in support of small businesses. Venture capital funds receive funding commitments from institutional investors – pension funds, endowments, family offices – to invest in high-growth potential businesses for financial returns. In most cases, co-investors participating in SSBCI transactions were local individual investors or investment funds, however many states had an explicit goal of "importing" risk capital by attracting participation from out of state investors. Importantly, SSBCI not only leveraged private investment from existing investors but also supported the formation of new private investment funds to build additional private investment capacity.

1E. Treasury's Role in Supporting State Programs

The Act gave Treasury standard program administration responsibilities such as developing program rules, disbursing funds, and monitoring program activity and compliance. This responsibility included developing SSBCI program rules that were relevant to a wide variety of transactions, ranging from microloans to equity investments. Due to the short timeframe allotted for the SSBCI program, states were initiating programs as Treasury finalized the rules. SSBCI had to work closely with the states, often on a transaction-by-transaction basis to help address specific questions that could have broad implications.

SSBCI convened three regional meetings and six national meetings for states to share information about their programs. Because of these efforts, many states adapted their program models, developed new marketing approaches, and resolved implementation issues.

SSBCI also provided technical assistance and disseminated best practices. Through periodic calls and site visits, SSBCI deployed subject matter experts (in the form of staff and consultants) to help states refine existing programs and create new ones. Subject matter experts helped states market new programs to lending partners and advised states on options for reaching new markets or improving the appeal of a program.

As part of these efforts, SSBCI convened the states to share information about their programs. The goal was to help states more clearly articulate their challenges, seek solutions, and access assistance as they implemented their programs. SSBCI convened three regional meetings and six national meetings. These meetings addressed persistent challenges for state programs, including how to deepen their reach into targeted communities, how to expand efforts to serve businesses operated by women and minorities, or how to develop sustainable program models. Additionally, SSBCI convened working groups of program managers to develop "best practices" papers in each of the five major program types and to share case studies for using SSBCI to expand access to capital to underserved communities. Because of these efforts, many states adapted their program models, developed new marketing approaches, and resolved implementation issues.

Chapter 2

Program-Wide Outcomes

Program Evaluation of the U.S. Department of Treasury State Small Business Credit Initiative

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OCTOBER 2016

SSBCI

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Chapter 2:

Program–Wide Outcomes

This chapter examines the outcomes of SSBCI-supported lending and investing from 2011 to 2015 in relation to federal program objectives by examining several measures: characteristics of the businesses assisted; new financing leveraged; level of funds expended; and job creation and retention. Figure 2-1 presents a summary of interim program outcomes through December 31, 2015.[5]

Figure 2-1: Summary of Interim Program Outcomes by Objective, cumulative through December 31, 2015

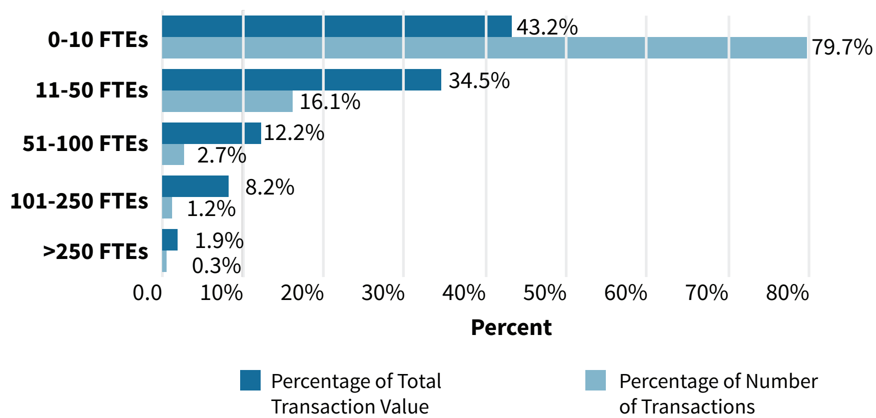
Objective	Interim Program Outcomes	
Support financing of small business	CAP	Median FTEs = 2 Mean Median transaction size = $14,800
	All other	Median FTEs = 6 Mean Median transaction size = $320,500
Expand access to credit to businesses in LMI, minority and other underserved communities	42% of SSBCI-supported transactions in LMI areas 34% of SSBCI funds expended in LMI areas	
Generate new small business lending or investing	$8.4 billion in new capital to small businesses $8.02 in new small business lending or investing for each $1 in SSBCI funds expended	
Expend available SSBCI funding	$1.04 billion or 72% expended as of December 31, 2015	
Create or retain jobs	190,400 projected jobs created or retained (63,891 created, 126,509 retained) within 2 years of loan or investment closing as reported by businesses	

2A. Small Businesses Assisted

Considering three key measures – employee count, sales revenues, and business age – SSBCI programs predominantly supported small businesses. According to the statute, states must limit CAP transactions to businesses with fewer than 500 employees and all other transactions to businesses with fewer than 750 employees. More than 99 percent of the 16,919 transactions assisted businesses with less than 250 workers. Nearly 80 percent of transactions were to businesses with fewer than 10 employees (see Figure 2-2). The median size of an SSBCI-supported business was 3 full-time equivalents (FTEs).

5 As of June 30, 2016, Treasury had disbursed 96 percent of available funding to states, and states reported having expended or obligated $1.22 billion, or 84 percent, of available funding.

Figure 2-2: Share of SSBCI Activity by Size of Business (FTEs) - All Programs, cumulative through December 31, 2015



Furthermore, nearly 40 percent of the SSBCI-assisted businesses had revenues of less than $100,000 at the time of the transaction and 86 percent had revenues below $2 million (see Figure 2-3).

Figure 2-3: Distribution of the number of SSBCI Transactions by Size of Business (Revenues), cumulative through December 31, 2015

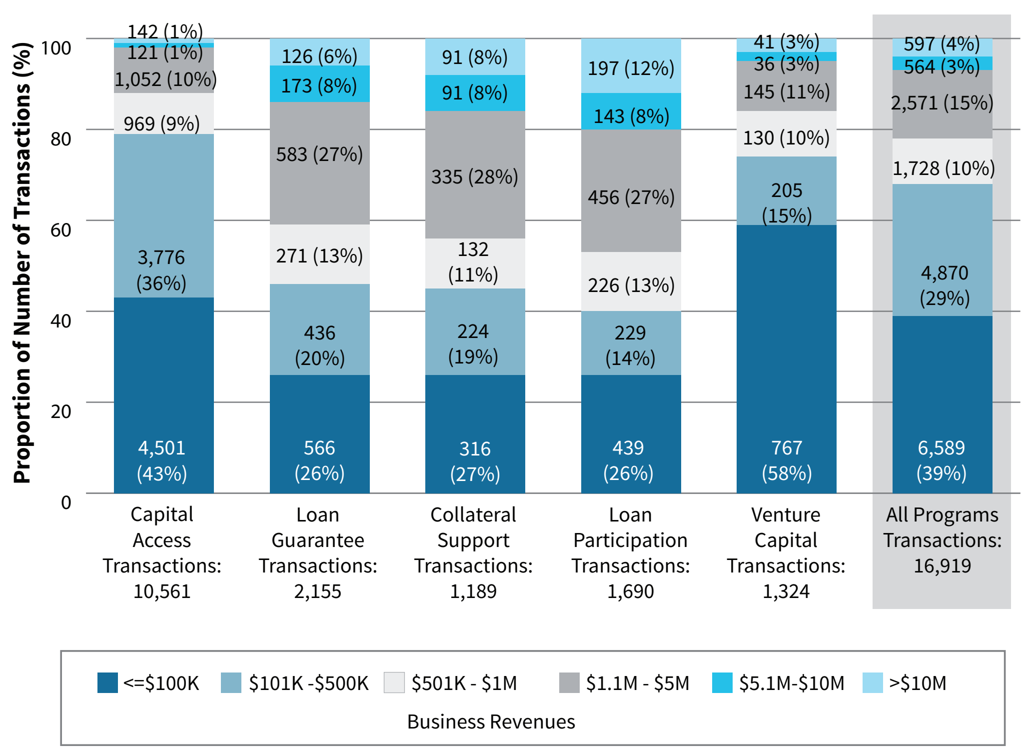


Figure 2-4: Share of SSBCI Activity by Age of Business

Age of Business	Percentage of Total Transaction Amount	Percentage of Number of Transactions
0-1 year	22%	21%
2-5 years	26%	27%
6-10 years	21%	22%
>10 years	31%	30%

Almost half the businesses supported began operating less than five years prior to the transactions. As shown in Figure 2-4, these transactions represented 48 percent of both the number of transactions completed and the total principal amount loaned or invested. About one-third of the transactions (31 percent of the funds) were with well-established businesses—those in businesses for more than 10 years.

SSBCI Transactions

California – After turning to merchant cash advances to finance the rapid expansion of Los Angeles-based Southern Girl Desserts, the owners faced monthly payments equal to 40 percent of the company's cash flow. They refinanced their high cost debt with the CDFI Opportunity Fund through California's CAP program. The transaction cut their monthly payments by ninety percent.

North Carolina – Healing with CAARE is a North Carolina non-profit that treats veterans and others with HIV/AIDs and chronic illnesses. To finance the addition of 16 single rooms in its Duhram County housing facility, the organization needed to borrow $600,000. The North Carolina Community Development Initiative provided the financing and North Carolina's **loan participation program** purchased 20 percent of the loan.

Colorado – When the Colorado Mushroom Farm closed its doors in 2013, 270 employees were out of work. With cash collateral pledged by the Colorado Housing Finance Agency's **collateral support program**, First Southwest Bank provided a $1 million loan to Alamosa-based Colorado Mushroom Farm enabling this rural business to re-open it doors.

Florida – Earnest Products, a fabricator of high-quality sheet metal used in manufacturing custom metal parts, needed to improve its production capacity to meet customers' needs. With a 50 percent guarantee from the Florida's **loan guarantee program**, the business obtained a $1,750,000 line of credit from Fifth Third Bank as part of a financing package that enabled it to add 25 high-wage skilled manufacturing jobs and position the business for additional growth.

Oklahoma – Dr. Madeleine Cunningham and Dr. Craig Shimasaki founded Moleculera Labs to develop a test to help differentiate autism from Pediatric Acute-Onset Neuropsychiatric Syndrome (PANS), a more treatable disorder. Moleculera struggled to obtain financing, a common experience for early-stage businesses. When i2E, a private non-profit that administers Oklahoma's **venture capital program**, committed an investment of SSBCI funds, Moleculara was able to close a round of angel financing and establish a certified commercial laboratory, enhance R&D efforts, and execute on a targeted marketing campaign. Since the SSBCI investment, Moleculera raised Series A preferred equity and is currently seeking Series B financing.

2B. Supporting Small Businesses in Underserved Communities

The Act required that states include plans for targeting underserved communities in their proposed program designs. Recognizing that economic conditions varied across states, SSBCI gave states flexibility to define underserved communities. For example, some programs targeted minority or women owned businesses, others economically distressed communities, still others rural businesses.[6] Given the variety of approaches, Treasury tracked activity using a proxy for underserved communities, the location of a business in census tracts defined as low- and moderate-income (LMI).[7] Through 2015, 42 percent of the 16,919 transactions (34 percent of total dollar volume) were loans to businesses located in LMI communities.

Figure 2-5 shows the state programs with the highest concentration of transactions in LMI communities. Seven of the fifteen programs with over 25 transactions and greater than 40 percent in LMI areas deployed funds either exclusively or primarily through CDFIs. Five of the fifteen are VCPs that invest in startups.

Figure 2-5: State programs with over 25 transactions and more than 40 percent of transactions in LMI Areas, cumulative through December 31, 2015

Approved State Program	VCPs that Invest in Startups	Funds Deployed Mainly through CDFIs	Transactions in LMI Areas	
			#	%
Betaspring (RI)	Y		45	**83%**
New York Capital Access Program		Y	588	**62%**
Florida Venture Capital Program	Y		27	**61%**
Craft3 Fund (WA)		Y	25	**56%**
Pennsylvania Community Development Bank Program		Y	49	**55%**
California Capital Access Program		Y	3509	**53%**
Arizona Expansion Fund			27	**52%**
Capital Access Program (MN)		Y	36	**51%**
Seed and Angel Capital Network (AR)	Y		47	**50%**
Georgia Funding for CDFIs		Y	35	**48%**
Emerging Entrepreneurs Fund (MN)		Y	62	**48%**
Missouri IDEA Fund	Y		38	**45%**
Kentucky Collateral Support Program			48	**43%**
Credit Enhancement Fund (OR)			55	**40%**
INCITE Fund (TN)	Y		33	**40%**

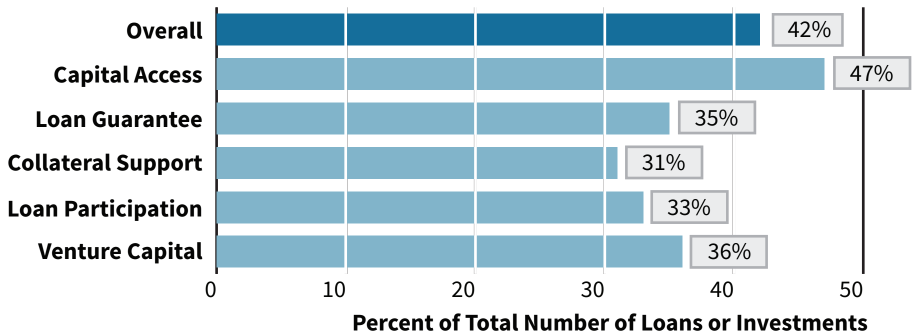
Figure 2-6 shows the percent of transactions with businesses located in LMI areas by program type. CAP provided the largest share of loans to businesses located in LMI tracts at 47 percent,

6 *Using the SSBCI Program to Improve Access to Capital in Underserved Communities.* U.S. Department of the Treasury. October 2014. Web accessed. (https://www.treasury.gov/resource-center/sb-programs/Documents/SSBCI%20in%20Underserved%20Communities%20October%202014.pdf).

7 The definitions used in this analysis are based on the 2010 Census Bureau's 5-year American Community Survey, in which "low income" households are defined as earning less than 50 percent of area median income; "moderate income" households are defined as earning between 50 percent and 80 percent of area median income. These standards were set based on the definition that the U.S. Department of Housing and Urban Development, Office of Community Planning and Development utilizes for low- and moderate-income households. (http://portal.hud.gov/hudportal/HUD?src=/program_offices/comm_planning/library/glossary/l).

followed by venture capital at 36 percent. States that targeted rural businesses implemented a plan to facilitate widespread geographic distribution of SSBCI capital within their states. SSBCI transactions to businesses located in non-metro[8] businesses accounted for 12 percent of all transactions. However, certain states that targeted rural businesses had higher concentrations. For example, 47 percent of all transactions in Kentucky reached businesses in non-metro counties.

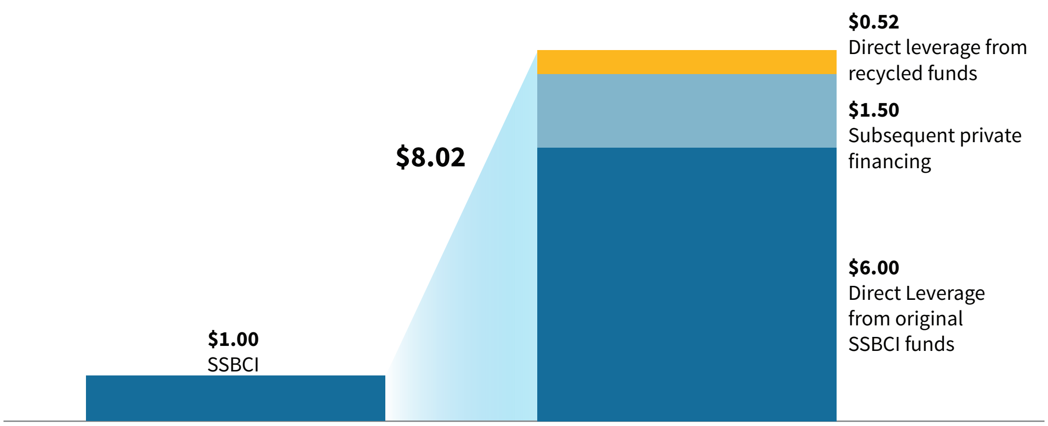
Figure: 2-6: Percent of SSBCI-supported Loans or Investments (by Number) in Low- and Moderate-Income Communities, by Program Type, cumulative through December 31, 2015



2C. Leveraging New Lending and Investing

The Act required states to develop programs that, in aggregate, could reasonably expect to generate at least $10 in new small business lending and investing for every $1 in SSBCI funds. With one year of activity remaining, states reported $8.02 in new financing for every $1 of SSBCI funding expended (see Figure 2-7).

Figure 2-7: Cumulative Financing Catalyzed by SSBCI (as reported by states through December 31, 2015)



8 The definition of the terms “metro” and “non-metro” as used in this report refer to the Office of Management and Budget (OMB) designation of counties containing a core urban area of 50,000 or more in population as metropolitan (“metro”), and all other counties (micropolitan or rural) as non-metropolitan (“non-metro”). This definition is borrowed from the U.S. Department of Health and Human Services and derived from the U.S. Census Bureau Definition. (http://www.hrsa.gov/ruralhealth/aboutus/definition.html).

The level of support offered per transaction and the rate at which the state could recycle repaid funds to support new transactions were the primary drivers of a program's leverage ratio, however a number of factors were at play.

★ ★ ★ ★ ★

FIVE DRIVERS OF PROGRAM LEVERAGE RATIO

Level of Support

Recycling of Funds

Subsequent Financing

Program Start-up

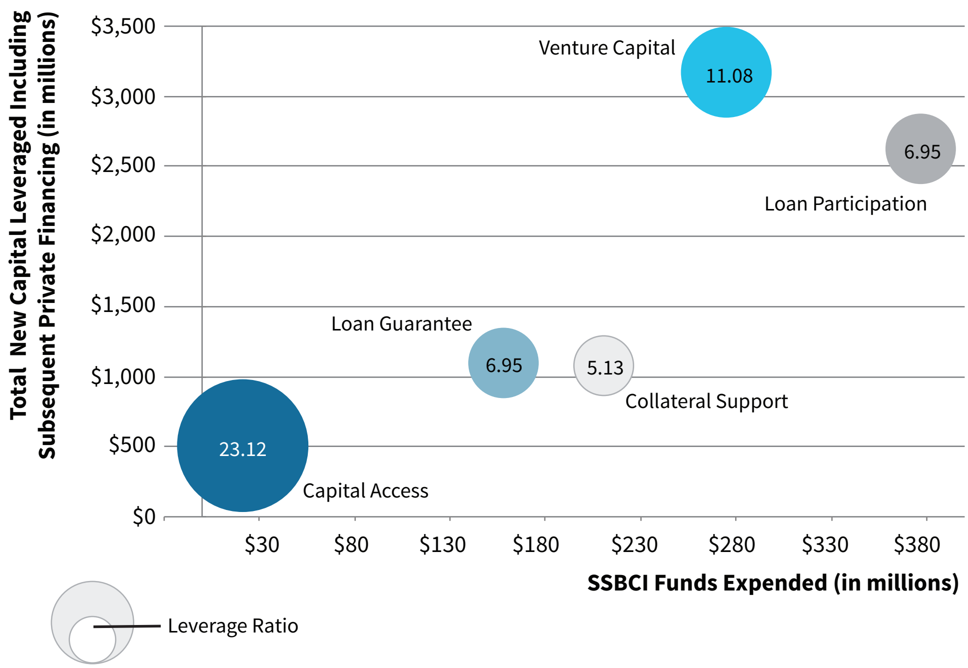
Speed of Deployment

★ ★ ★ ★ ★

- **Level of support** – CAP loans on average contribute 4 percent per transaction while loan participations account for 19 percent of each transaction on average. States determined what level of support to provide and what types and size of transactions to target.
- **Recycling** – Programs that targeted shorter-term transactions or incentivized repayment with annual fees increased their leverage ratio by recycling funds into new transactions. States that were slower in initially deploying capital have had less time to recycle funds during the program period.
- **Subsequent financing** – The SSBCI calculation of leverage took into account subsequent private financing enabled by the SSBCI-supported transaction. This was particularly a factor in venture capital programs when an initial round of investment enabled a future private financing round.
- **Program start-up** – New programs often found they initially had to offer higher levels of SSBCI support to encourage lenders to participate. This led to lower leverage levels.
- **Speed of deployment** – Some programs strategically prioritized speed of deployment, offering higher levels of support to encourage lending during the economic recovery. This led to lower leverage levels.

The structure and design of a state's programs were the primary determinants of the level of direct support. To illustrate, CAPs required states to contribute to reserve funds that ranged, by definition, from no less than 2 percent to no more than 7 percent of the principal loan amount. On average, CAPs provided a 4 percent reserve of public funds, which translated to a 25:1 leverage ratio (100 percent divided by 4 percent) of private to public dollars excluding public funds used for program administrative expenses (see Figure 2-8). By comparison, direct support (on average) for LGPs, LPPs, and CSPs ranged between 16 and 23 percent of the total loan, which generated leverage ratios from 5.13 to 6.95. VCPs contributed about 16 percent in direct support (on average) to an initial funding round, resulting in a direct leverage ratio of about 6.25:1.

Figure 2-8: Leverage by Program Type



Program Type	SSBCI Funds Expended* ($ millions)	Total New Capital Leveraged** ($ millions)	Total Subsequent Financing ($ millions)	Leverage Ratio
Capital Access	$22	$508	$0.0	23.12
Loan Guarantee	$158	$1,098	$0.0	6.95
Collateral Support	$210	$1,079	$0.0	5.13
Loan Participation	$376	$2,612	$254	6.95
Venture Capital	$278	$3,082	$1,318	11.08
TOTAL	**$1,044**	**$8,378**	**$1,572**	**8.02:1**

**Includes SSBCI funds expended for program administration.*
***Includes subsequent private financing and financing leveraged with recycled SSBCI dollars.*

The SSBCI calculation of leverage also took into account subsequent private financing enabled by the SSBCI-supported transaction. This was particularly a factor in VCPs where an initial round of financing facilitated small business development activities that set the stage for one or more future financings. Including subsequent investments, SSBCI VCPs generated $11.08 in private financing for every $1 in SSBCI funds.[9]

In addition to program design, the states' strategic decisions influenced the level of support provided to each transaction. Some states designed programs to hit the 10:1 ratio goal as part of the initial deployment of funds, while some initially offered higher levels of support to encourage participation in new programs, and subsequently decreased the level of support to slow deployment and extend the limited dollars available for credit enhancement.

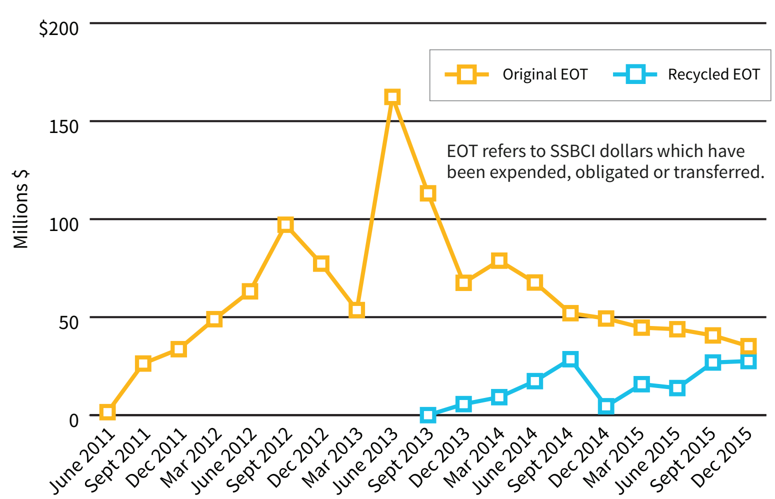
9 States reported the initial loan principal or investment supported by SSBCI funding, and the amount of concurrent and subsequent private financing enabled by the original transaction. These data were combined and used in calculating the leverage ratio.

2D. Deploying Available Funds

Most programs finalized their application to Treasury in mid-2011 and started supporting transactions in the last quarter of 2011 and first half of 2012. Of the $1.46 billion allocated, the states expended nearly $1.04 billion as of December 31, 2015, representing 72 percent of available funds. States obligated an additional $113 million to small business loans or investments or intermediaries.

As a short-term program designed to provide investment stimulus, Treasury monitored deployment rates. Figure 2-9 illustrates the progress that SSBCI has made in deploying[10] funds over time. In 2013 and 2014, the program reached its peak in terms of SSBCI dollar volume activity. Some states deployed all of their allocation in 2014 and had to scale back their lending activity, relying on repaid funds for new lending and investment activities. Beginning in 2013, some states recycled funds repaid to the state to support new transactions. By December 31, 2015, 44 percent of quarterly deployment represented recycled dollars.

Figure 2-9: States' Deployment of SSBCI Funds over Time (as reported in the states' quarterly reports to Treasury)



An assessment of state efforts found that factors influencing the speed of deployment in different states included the design of the program, the experience and capacity of staff, and market conditions.

Program Design and Strategy

Several design and strategy factors influenced deployment of funds. First, the time required to start up new programs influenced the rate of deployment. Second, some states modified approved programs significantly or replaced them. Adjustments to programs took time to complete, influencing the rate of deployment early in the program. Third, some programs

10 SSBCI funds deployed are those legally expended (used to support loans or investments or for administrative expenses), obligated (legally committed to support loans or investments or for administrative expenses), or transferred (to a contracting entity as reimbursement of expenses incurred or to fund a loan or investment). Funds deployed does include obligations to venture capital funds that are not yet expended in specific small business investments.

gained more traction with lenders and co-investors than others. Lenders and investors more readily accepted certain programs because they directly addressed salient capital gaps and were designed with private sector input. For example, lenders responded positively to collateral support programs created to address collateral shortfalls due to declining asset values. Not surprisingly, programs that provided greater support were more appealing. For example, collateral support and loan participation programs, because they offered a higher level of support, were able to expend funds more quickly as illustrated in Figure 2-10. By the end of 2015, collateral support and loan participation programs had deployed 80 percent or more of their total allocations.

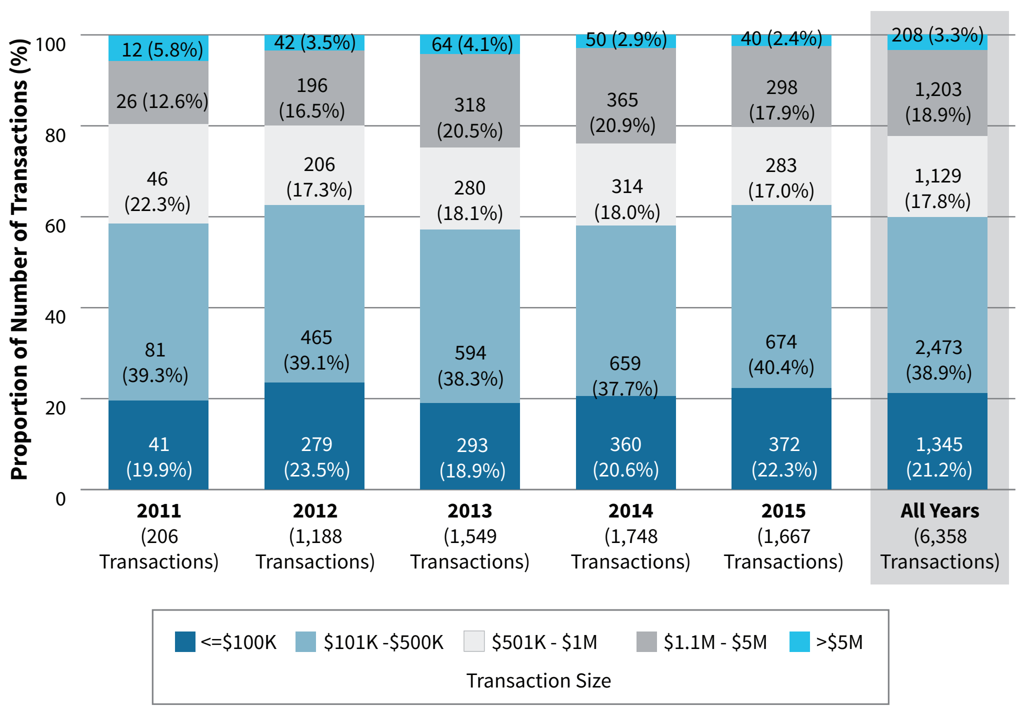
Figure 2-10: SSBCI Funds Expended by Program Type, cumulative through December 31, 2015

Program Type	SSBCI Funds Expended by Program Type* ($ millions)	Percentage of Total SSBCI Funds Expended
Capital Access	$22	49%
Loan Guarantee	$158	68%
Collateral Support	$210	81%
Loan Participation	$376	80%
Venture Capital	$278	62%
TOTAL	**$1,044**	**72%**

**SSBCI Funds Deployed includes weighted Administrative Expenses*

Programs that offered funding for larger transactions were often able to use funds more quickly because they required fewer transactions to generate the same dollar amount of SSBCI expenditures. States demonstrated this preference by setting minimum transaction amounts and by tending toward larger transactions as they faced an intermediate Treasury-set deadline in 2013 for the deployment of the first disbursement. Figure 2-11 shows that the share of non-CAP transactions larger than $1 million increased from 18 percent in 2011 to 24 percent by 2013 and 2014.

Figure 2-11 Transaction Sizes by Year (Non-CAP)



Experience and Management Capacity

The factors influencing the speed of deployment that were the most difficult to quantify and evaluate (due to limited available data) are those related to state experience and management capacity. Observations of state experiences, however, reveal that program staff experience and management capacity influenced how rapidly states were able to deploy funds.

States with the most experienced staff were able to conduct program marketing efforts most effectively. In addition, they were better prepared to manage the program and design (or implement) policies and procedures in ways that inspired confidence in both lending and investment partners

Programs with pre-existing relationships with lender and investor networks deployed funds more quickly. Some states ramped up more slowly than others because they had to identify potential lending partners and determine which were most likely to bring deals to the program. States devoted significant resources to outreach efforts to explain new program offerings and to tactics aimed at building trust with partners.

States with the most experienced staff were able to conduct these marketing efforts most effectively. In addition, they were better prepared to manage the program and design (or implement) policies and procedures in ways that inspired confidence in both lending and investment partners. Furthermore, these individuals were quicker to recognize the need to adapt programs to reflect changing market conditions or respond to customer concerns.

States that experienced a high turnover of these staff, either at the program or management level, were more likely to endure delays in deploying funds.

Market Demand

A few states reported that lenders received a low volume of applications for credit as regional economies lagged. Others, specifically rural states and territories found deployment of funds challenging because they had relatively few active banks and relatively few borrowers seeking loans.

2E. Jobs Supported by SSBCI

The Act did not set a numeric target for job creation or retention, but its context suggests the creation and retention of jobs was a priority. At the transaction closing, businesses reported to states the number of jobs retained and projected number of jobs expected to be created within two years because of the transaction. By the end of 2015, businesses reported that transactions supported by SSBCI would help retain 126,509 existing jobs and help create 63,891 jobs within two years, for a total of 190,400.[11]

As shown in Figure 2-12, CAP loans, though a small proportion of the total SSBCI allocation, represented the largest source of reported jobs retained, with nearly 50,000 existing jobs supported. This number represented 80 percent of the total employment of the small businesses receiving CAP loans.

Loan participation programs represented the largest source of new job creation, with more assistance provided to larger businesses that are likely to generate greater near term job impacts. Venture capital is the only program type to report more jobs created than retained, as recipients were often early stage businesses using invested funds to start, develop, and grow.

Figure 2-12: Jobs Created and Retained by SSBCI Credit Support Program Type, cumulative through December 31, 2015

Program Type	Jobs Created	Jobs Retained
Capital Access	11,202	49,888
Loan Guarantee	13,202	35,366
Collateral Support	10,062	11,273
Loan Participation	18,257	21,330
Venture Capital	11,169	8,652
TOTAL	**63,891**	**126,509**

Few states have invested in systems to verify whether the projected job creation or retention activity actually occurred. This is important for the reader to understand when assessing SSBCI job creation and retention impact data.

A few states attempted to verify business claims. For instance, Minnesota conducted a follow-up survey of its borrowers, but the results were not satisfying due to low response rates. Oregon and Louisiana employed data-sharing agreements with their labor market information agencies to validate job claims with unemployment insurance wage records of borrowers. This approach provides verification of total employment before and after a transaction, but does not capture sole proprietorships or how corporate decisions beyond the SSBCI loan or investment affect employment levels (both upward and downward).

11 "Jobs Created" include the number of new Full-Time Equivalent (FTE) jobs that the business owner indicated that they expect to create as a direct result of the transaction within two years of the closing. "Jobs Retained" is the number of FTE jobs that the business indicated are at risk of loss without the support of the transaction.

CASE STUDY

Oregon

Oregon confirms the job creation impact of programs like SSBCI by analyzing data businesses report to the Oregon Employment Department (OED) at the time of the transaction and in subsequent years. For the population of SSBCI borrowers from January 1, 2012 to June 30, 2015, excluding those that received non-SSBCI support from the state and those with fewer than five employees (which do not report to OED), Oregon confirmed the number of jobs created within two years of the SSBCI transaction.

The 115 businesses assessed had projected to create 420.5 jobs. The total number of jobs created during the period was 507, exceeding projections by 86.5 or 20 percent. The average business reported an average of 16.5 FTEs at the time of application and averaged 4.4 FTEs created per project.

Chapter 3

Observations from Credit Support Programs

Program Evaluation of the U.S. Department of Treasury State Small Business Credit Initiative

Center for Regional Economic Competitiveness & Cromwell Schmisseur

OCTOBER 2016

SSBCI

In This Chapter

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Chapter 3:

Observations from Credit Support Programs

States directed 69 percent of their SSBCI funds to credit support programs that supported small business lending, namely capital access, loan guarantee, collateral support, and loan participation programs.

This chapter presents the range of strategic objectives for credit support programs, characteristics of participating borrowers and lenders, and detailed profiles of each type of credit support program. It concludes with a summary of lessons learned by state program managers.

From 2011 to 2015, credit support programs expended $766 million in SSBCI funds to spur $5.3 billion in new small business loans. Figure 3-1 below presents additional summary metrics for SSBCI credit support programs.

Figure 3-1: Summary of Key Metrics for All SSBCI Credit Support Programs, cumulative through December 31, 2015

SSBCI Metrics for All Credit Support Programs	
Key Data:	
SSBCI Allocation ($ millions)	$1,009
SSBCI Allocation (% of Total Allocation)	69%
Transactions (#)	15,595
**SSBCI Original Funds Expended ($ millions)*	$766
SSBCI Program Funds Expended ($ millions)	$743
**SSBCI Administrative Funds Expended ($ millions)*	$23
SSBCI Recycled Funds Expended ($ millions)	$118
Average Principal Loan Size	$274,069
Program Outputs:	
Percent Expended	76%
***Total Leveraged Financing ($ millions)*	$5,296
****Leverage Ratio*	6.9:1
Program Outcomes:	
Total Jobs Supported	170,579
Jobs Created	52,722
Jobs Retained	117,857
SSBCI Loans in LMI Communities (% of total number of transactions)	43%
Top Three Industries Assisted (by number of transactions)	Retail Trade Accomodation and Food Services Manufacturing

* *Administrative expenses are weighted estimates prorated by proportion of program transactions to total OCSP transactions*

** *Includes subsequent private financing and financing leveraged with recycled SSBCI dollars*

*** *Includes weighted administrative expenses*

3A. Credit Support Program Strategies and Administrators

The states' economic development agencies typically determined the strategy for deploying SSBCI funds taking into account existing programs, gaps in local small business financing, the state's lending community, and local partners. In this way, local economic context and agency objectives drove strategy toward one or more of the following overlapping goals:

1. Address current and/or persistent gaps in small business lending.
    - Many states including California and Ohio developed or funded existing programs meant to support loans to microbusinesses.
    - States with large rural populations, like Idaho and North Carolina, targeted owner-occupied real estate transactions in rural areas because such transactions are difficult to finance due to the lack of comparable properties for appraisers to consider.
    - Florida funded a program that guaranteed loans to export businesses that are too small to access SBA and Export Import Bank programs.
2. Benefit underserved communities or targeted geographies with limited access to capital.
    - Illinois dedicated a portion of its resources to supporting businesses in Rockford, a city that was particularly hard hit by the recession.
    - New York funded a guarantee program targeting minority contractors that bid on public construction projects.
    - Several states designed programs to expand the reach of CDFIs whose mission is to provide access to capital for businesses in underserved geographies.
3. Create second and third order economic benefits by investing in economic base industries such as manufacturing or emerging technologies.
    - Michigan and Oregon, among other states, limited eligibility for some programs to businesses in industries that supply markets outside of the region, because of the potential of those industries to expand the local economic base.

Public agencies managed nearly half of the allocations for credit support programs and expended 74 percent of allocated funds.

Just as local and regional economic circumstances influenced program design, the availability and capacity of local partners also influenced how states administered programs. Some state agencies administered programs directly. This was most often the case when the state had existing programs to build on. Other states determined a third-party administrator had deeper expertise and existing relationships with the lending community to administer programs. Some contracted with quasi-public agencies and others with private partners. While advantages existed for each approach, the state's choice of administrator was a matter of matching program objectives to the best-situated local partner. The following examples illustrate the types of organizations that administered credit support programs.

- State agencies in Oregon, Louisiana, and Illinois expanded existing credit support programs using SSBCI. For example, Oregon's SSBCI funds recapitalized a LGP created in 1994.
- The New Jersey Economic Development Authority, Finance Authority of Maine, and Colorado Housing and Finance Authority are examples of quasi-public authorities that operated SSBCI programs. Some expanded existing programs. Others launched new programs by leveraging relationships with lenders developed during decades of managing housing and bond financing activities.
- South Carolina and Massachusetts partnered with for-profit business development corporations (BDCs), experienced lenders with strong community bank relationships.
- Pennsylvania, Georgia, and Montana ran programs through a network of CDFIs and other non-profit lenders with broad geographic coverage. In contrast, Washington and Nevada funded programs administered by a single CDFI.

As shown below in Figure 3-2, public agencies managed nearly half of the allocations for credit support programs and expended 74 percent of allocated funds. By comparison, quasi-public authorities controlled just 16 percent of SSBCI funds, but they expended 97 percent of allocated funds. Meanwhile, private entities controlled the remaining 15 percent of SSBCI funds but expended 95 percent of allocated funds. Leverage ratios ranged over a relatively narrow band of 6.93-7.35.

Figure: 3-2: Percentage of SSBCI Credit Support Program Funds Allocated, Transactions Completed, and Funds Expended by Type of Organization, cumulative through December 31, 2015

	Transactions		SSBCI Allocation Volume		SSBCI Loan Funds Expended*		Private Leverage Ratio**
Org Type	**(#)**	**(%)**	**($ millions)**	**(%)**	**($ millions)**	**(%)**	
Public Agency	10,712	69%	$471	47%	$347	74%	6.93
Quasi-Public Agency	2,344	15%	$250	25%	$242	97%	7.35
Private Agency	2,539	16%	$287	28%	$272	95%	7.19
TOTAL	**15,595**	**100%**	**$1,009**	**100%**	**$861**	**85%**	**7.13**

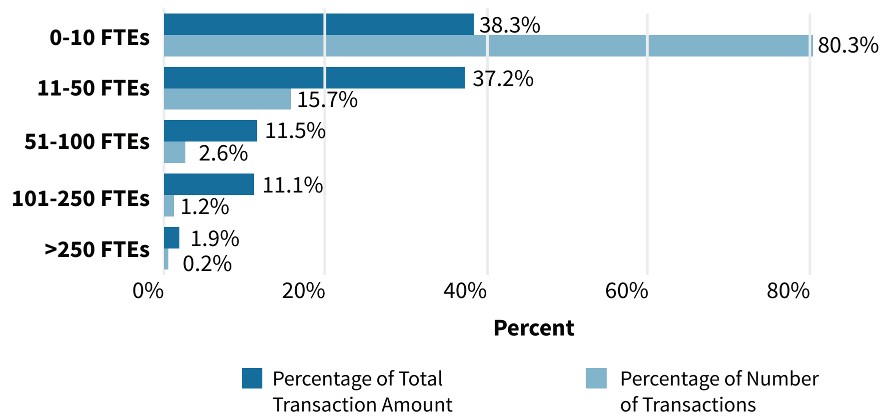
**Funds expended includes recycled funds and is shown as a percent of Allocation Volume.*
***Does not include Administrative Expenses.*

3B. Characteristics of Participating Small Businesses for Credit Support Programs

Business Size and Borrowing Need

One of the most compelling outcomes of SSBCI is its success supporting financing of very small businesses. Figure 3-3 shows that businesses with 10 or fewer employees accounted for 80 percent of SSBCI-supported loans and 38 percent of dollar volume (principal loan amount).

Figure 3-3: SSBCI Funds Loaned by Size of Business (FTEs) - Credit Support Programs



Business size varied by credit support program type, markedly for CAP loans, which reached very small borrowers with a median size of two FTES (see Figure 3-4). LPPs reached the largest businesses with a median business size of eight employees.

Figure 3-4: Typical Transactions by Credit Support Program Type

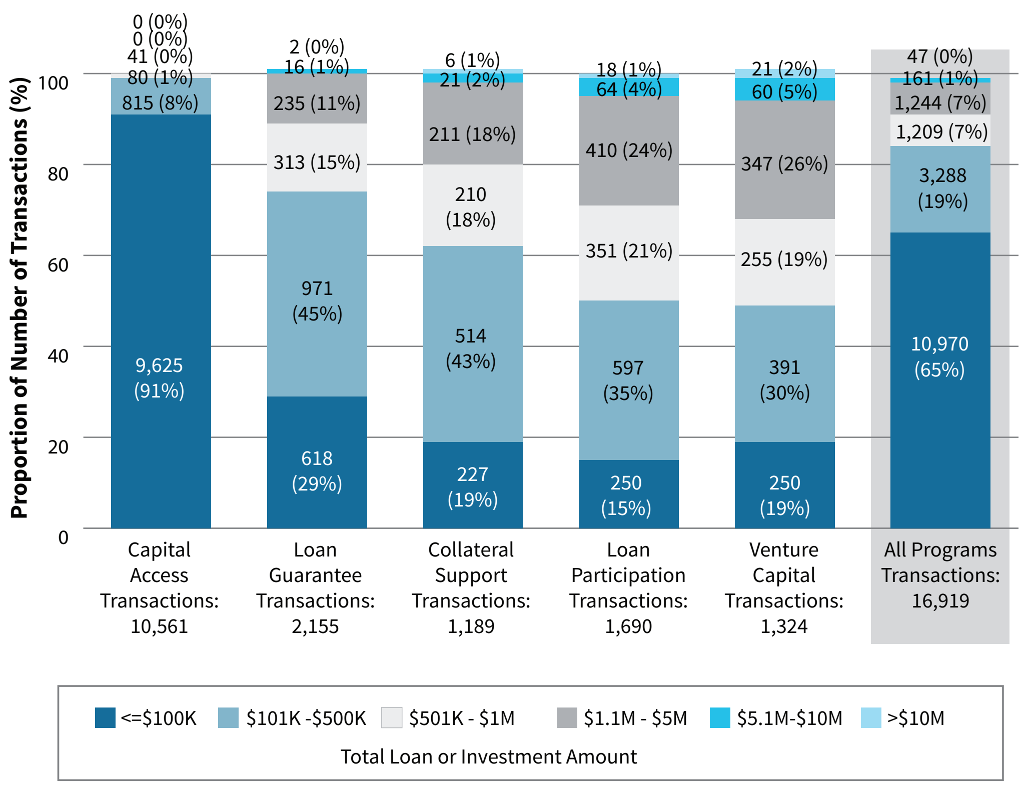
Program	Median Transaction Size (Principal Loan Amount)	Median SSBCI Support	Median Age of Business Supported	Median Size (FTEs) of Business Supported	Top 3 Industry Segments
Capital Access	$14,800	$700	5 years	2	Retail Trade Accommodation & Food Services Transportation & Warehousing
Loan Guarantee **Collateral Support** **Loan Participation**	$300,000	$62,500	6 years	7	Manufacturing Accommodation & Food Services Retail Trade

Participating businesses also had a range of borrowing needs. States supported lines of credit, equipment, owner-occupied real estate, and construction loans, among others. Figure 3-4 indicates the range of typical transactions by program type. The median CAP loan was approximately $14,800. LPPs supported the largest loans with a median of $495,000, followed by CSPs with a median of approximately $305,000, and LGPs with a median of $200,000. Overall, the median and average loan sizes for credit support programs were $30,000 and $274,069, respectively.

Figure 3-5 shows the distribution of transaction sizes in each program type. 91 percent of CAP loans were $100,000 or less. LGPs also had a high concentration of loans $100,000 or less (29 percent). In contrast, 15 percent of LPP loans were under $100,000 and half of LPP loans were over $500,000. Further research is needed to understand what accounts for the variety in distributions among credit support programs. Below are some observations that provide insight.

- The primary lending partners for CAPs in California and New York were CDFI micro-lenders. These two states accounted for 71 percent of all CAP loans.
- California and Georgia operated LGPs that supported a high volume of smaller lines of credit.
- LPPs in North Carolina, South Carolina, and other states supported a relatively high volume of owner-occupied real estate transactions, with higher transaction amounts.
- Loan participations also worked well for larger layered transactions involving multiple funding sources.
- SSBCI rules required states to target an average transaction size of $5 million or less.

Figure 3-5: Distribution of SSBCI Transaction Size by Program Type, cumulative through December 31, 2015



Industry

The top five industries by dollar amount of total financing for SSBCI credit support programs were Manufacturing (27 percent), Accommodation and Food Services (14 percent), Retail Trade (8 percent), Health Care and Social Assistance (8 percent), and Wholesale Trade (8 percent).

Industry concentrations by number of transactions are significantly different for CAPs compared to other credit support programs. As shown in Figure 3-6, CAP loans were concentrated in the top three industries: retail trades (21 percent), accommodation and food services (13 percent) and transportation and warehousing (11 percent). Non-CAP lending programs, in contrast, were more likely to support manufacturing businesses, which represented 17 percent of all transactions and the top three industries accounted for 40 percent of transactions.

Figure 3-6: Top 10 Industries to Receive SSBCI Loans by CAP versus non-CAP Credit Support Programs, cumulative through December 31, 2015

CAP		
Industries Assisted	**#**	**%**
Retail Trade	2264	21%
Accomodation and Food Services	1392	13%
Transportation and Warehousing	1133	11%
Manufacturing	898	9%
Other Services (except Public Administration)	977	9%
Construction	744	7%
Wholesale Trade	618	6%
Administrative Support and Waste Management	586	6%
Professional, Scientific, and Technical Services	543	5%
Health Care and Social Assistance	458	4%

non-CAP (LGP, CSP, and LPP)		
Industries Assisted	**#**	**%**
Manufacturing	858	17%
Accomodation and Food Services	591	12%
Retail Trade	555	11%
Health Care and Social Assistance	472	9%
Construction	470	9%
Professional, Scientific, and Technical Services	437	9%
Other Services (except Public Administration)	303	6%
Wholesale Trade	293	6%
Real Estate and Rental and Leasing	186	4%
Administrative Support and Waste Management	170	3%
Transportation and Warehousing	170	3%

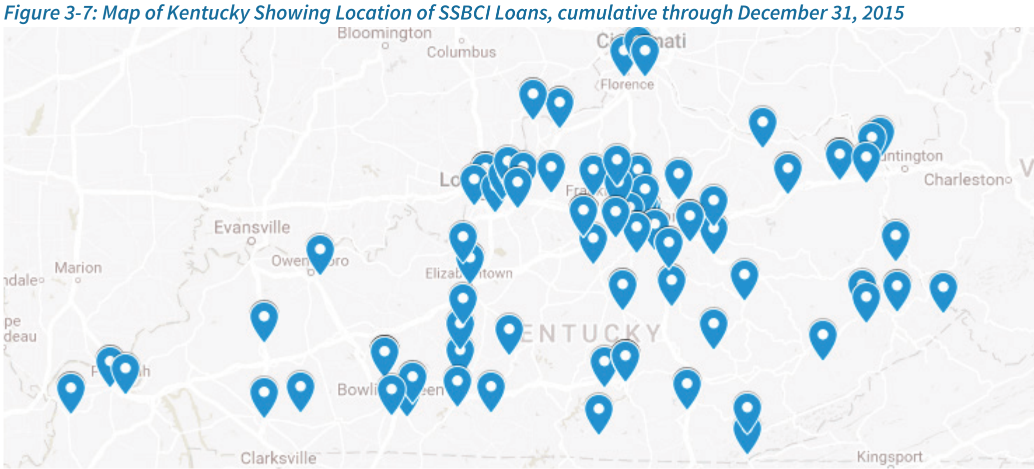
Location

As described in Chapter 2, states presented plans to target underserved communities as defined by the state. Treasury tracked activity using LMI census tracts as a proxy for underserved communities. Over four out of every 10 SSBCI loans were made to businesses in LMI areas.[12] Of the four credit support program types, CAP had the highest number of transactions in LMI areas – amounting to 47 percent of total transactions in LMI communities.

SSBCI loans financed businesses predominantly in urban areas (88 percent), but many states made a concerted effort to facilitate widespread geographic distribution of SSBCI loans within their states. For example, 47 percent of Kentucky's and 29 percent of Idaho's loans went to businesses in non-metro counties (see Figure 3-7).

No single approach to target underserved communities worked for all programs. Even so, focused marketing, especially through networks already connected to targeted communities, technical assistance and connections to mission-oriented intermediaries, and the identification of specific goals for targeted lending and investment all helped improve SSBCI performance in underserved communities.[13] For example, some states built on existing loan programs targeted to providing capital to minority, rural, or low-income communities in their states. Other states partnered with CDFIs or other mission-oriented local or regional economic development agencies to provide loans to selected industries or certain types of borrowers. For instance, West Virginia worked through their regional economic development network, and Pennsylvania and Washington selected CDFIs to manage some portion of their SSBCI allocation.[14]

Figure 3-7: Map of Kentucky Showing Location of SSBCI Loans, cumulative through December 31, 2015



	Non-Metro		LMI		All KY Transactions	
	Value	Percent	Value	Percent	Value	Percent
Number of Transactions	55	47%	97	83%	117	100%
SSBCI Amount ($ millions)	$3.9	40%	$5.9	60%	$9.8	100%
"Total Transaction Amount	$20.5	39%	$43.8	83%	$53.1	100%

12 Figure calculated from total number of loans or investments made in low- and moderate-income census tracts.

13 Op. cit., *Using the SSBCI Program to Improve Access to Capital in Underserved Communities.*

14 *Best Practices from Participating States: Partnering with Community Development Financial Institutions (CDFIs).* U.S. Department of the Treasury, State Small Business Credit Initiative. February 2015. Web accessed. (https://www.treasury.gov/resource-center/sb-programs/Documents/SSBCI%20CDFI%20Paper%202-27-15%20-%20final.pdf).

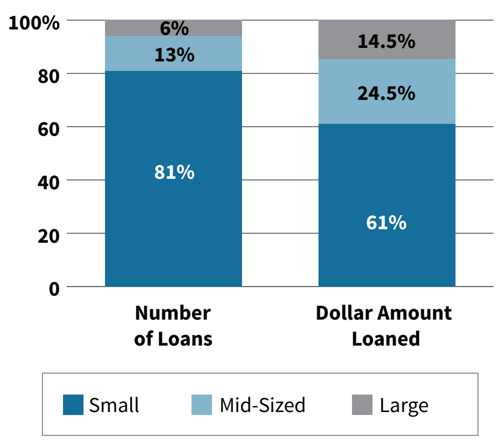
3C. Characteristics of Participating Lenders for Credit Support Programs

Small community banks, CDFIs, and credit unions[15] accounted for 81 percent of the total number of transactions and 61 percent of dollar volume (see Figure 3-8). CDFIs alone accounted for 51 percent of all transactions and 12 percent of the dollar volume.

Community banks and CDFIs rely on their expertise in the local community and long-term relationships with customers to inform credit decisions. They are less likely to rely on credit modelling to make lending decisions and flexible enough to incorporate credit support products like SSBCI.[16]

Credit unions participated in about 160 of 15,595 loan transactions. State program managers found that these institutions seldom have a commercial lending focus so few credit unions adopted SSBCI.

Figure 3-8: Percentage of SSBCI Loans by Lender Asset Size Class, cumulative through December 31, 2015



Large banks accounted for 6 percent of all SSBCI transactions, but several regional banks were among the most active individual lenders (see Figure 3-8). Large banks, especially those with a multi-state footprint, were less active because they have centralized underwriting and compliance processes and were less willing to operationalize multiple state SSBCI programs with different eligibility, compliance, and reporting requirements. Large banks were most active in collateral support programs where they accounted for 19 percent of all transactions.

Figure 3-9 shows the top lenders by number and dollar amount of loans. Several regional and national banks are among the highest dollar volume lenders. CDFIs represent 11 of the top 25 lenders in terms of the number of transactions.

15 This analysis uses the Community Reinvestment Act Asset-Size Thresholds to define small, mid-sized, and large banks where small banks have less than $1.22 billion in assets; mid-sized have assets totaling between $1.22 billion to $10 billion; and large banks have assets greater than $10 billion.

16 FDIC Community Banking Study. Federal Deposit Insurance Corporation. December 2012. Web accessed. (https://www.fdic.gov/regulations/resources/cbi/report/CBSI-1.pdf).

Figure 3-9: Top 25 SSBCI Lenders by Number of Transactions and Amount Loaned, cumulative through December 31, 2015

Top 25 Lenders by Amount Loaned

Lender	Lender Asset Size Class	States	Principal Amount Loaned ($ millions)
Fifth Third Bank	Large	FL, IL, KY, MI, OH	$116
Pacific Enterprise Bank	Small	CA	$92
Huntington National Bank	Large	IN, KY, MI, OH	$77
Yadkin Bank	Mid-sized	NC	$73
Opportunity Fund	CDFI	CA	$57
Wells Fargo Bank	Large	CA, NM, SD, VA	$47
Zions First National Bank	Large	ID, UT	$47
Craft3	CDFI	WA	$47
NewBridge Bank	Mid-sized	NC	$44
Columbia State Bank	Mid-sized	OR	$40
Bank of Guam	Mid-sized	CA, GU, MP	$39
ServisFirst Bank	Mid-sized	AL	$37
Washington Trust Bank	Mid-sized	CO, ID	$36
The Biltmore Bank of Arizona	Small	AZ	$35
Pacific Premier Bank	Mid-sized	CA	$35
Bridge Bank, N.A.	Mid-sized	CA	$32
TD Bank, N.A.	Large	NH, NJ, VT	$32
Trade Credit Guaranty Corp.	Small	GA	$31
Amarillo National Bank	Mid-sized	KS	$31
ACE	CDFI	GA	$30
South State Bank	Mid-sized	GA, SC	$30
AmericanWest Bank	Mid-sized	CA, UT	$28
mBank	Small	MI	$28
City National Bank	Large	CA	$27
Palmetto Bank	Small	SC	$27

Top 25 Lenders by Number of Transactions

Lender	Lender Asset Size Class	States	# of Transactions
Opportunity Fund	CDFI	CA	4700
Murphy Bank	Small	CA	510
ACCION San Diego	CDFI	CA	475
Renaissance EDC	CDFI	NY	371
Huntington National Bank	Large	IN, KY, MI, OH	345
Pacific Enterprise Bank	Small	CA	216
Trade Credit Guaranty Corp.	Small	GA	204
TMC Development Working Solutions	CDFI	CA	201
Center for Community Development	CDFI	NY	191
Chemical Bank	Mid-sized	MI	166
United Bank	Small	AL	143
BOC Capital Corporation	CDFI	NY	156
Pacific Premier Bank	Mid-sized	CA	154
ACCION East, Inc.	CDFI	FL, NY	125
Fresno CDFI	CDFI	CA	111
Fifth Third Bank	Large	FL, IL, KY, MI, OH	100
Yadkin Bank	Mid-sized	NC	95
OBDC Small Business Finance	CDFI	CA	93
Commercial Bank	Small	KY, MI	85
Independent Bank	Mid-sized	MI	82
Mutual Bank	Small	MA	80
FORGE, Inc.	CDFI	AR	80
Metropolitan Consortium of Community Developers	CDFI	MN	79
Small Business Credit Coop.	Small	GA	75
NewBridge Bank	Mid-sized	NC	74

The Role of CDFIs

CDFIs played a particularly important role in SSBCI. As of the end of 2015, they completed 50 percent of all lending transactions (7,889 loans). By dollar volume, CDFI participation was concentrated in CAPs so CDFI-led transactions utilized only $81 million in SSBCI funds (or 11 percent of the total SSBCI dollars expended). CDFIs generated a higher leverage ratio than non-CDFI transactions (8.31 compared with 6.98) and helped to create or retain 24 percent of all jobs supported (see Figure 3-10).

Figure 3-10: SSBCI Funds Expended, Leverage Ratio, and Jobs Generated by CDFI vs. Non-CDFI Lenders, cumulative through December 31, 2015

Type of Lender	Transactions (#)	SSBCI Expended ($ millions)	Leverage Ratio*	Jobs Supported (#)
CDFI	7,889	$81	8.31	41,234
Non-CDFI	7,706	$661	6.98	129,345
TOTAL	**15,595**	**$742**	**7.13**	**170,579**

**Does not include Administrative Expenses*

CDFIs made the smallest loans and served the smallest businesses. About 87 percent of CDFI transactions were loans enrolled in CAPs and 93 percent of the businesses that received loans through CDFIs had fewer than 10 employees. Furthermore, more than half (53 percent) of the businesses that CDFIs helped were located in LMI areas. The businesses receiving loans tended to be in retail and services, but a number of these small businesses were in manufacturing as well.

KEY TERM

CDFIs

Community Development Financial Institutions (CDFIs) are financial institutions that seek to expand economic opportunity through expanding access to financial products and services to businesses and residents in low-income communities. CDFIs can be banks, credit unions, loan funds, microloan funds, or venture capital providers. There are currently 1,000 CDFIs operating nationwide. These financial institutions gained certification as CDFIs by the CDFI Fund operated by the U.S. Department of the Treasury, which certifies, invests in, and provides assistance to CDFIs across the country.

3D. Profiles of Credit Support Programs

This section presents a detailed profile of each of the four types of credit support programs.

Capital Access Program

CAP – DEFINITION

Capital access programs (CAPs) provide a loan loss reserve to which the lender and borrower contribute a percentage of the loan value (up to 7 percent) the state matches on a dollar for dollar basis with SSBCI funds. In the event of a loss, any loan enrolled by a lender in a state's CAP can be charged off against that lender's CAP loan loss reserve.

CAP – Typical Transactions/Borrowers

Typical transactions include working capital loans, but CAPs are flexible and simple enough to use for a wide range of loan transactions. Primarily lenders used CAP loans to provide credit support for younger and smaller businesses or micro-enterprises, including start-ups, whose access to financing is limited because the costs associated with making the loan is relatively high given the anticipated earnings.

Businesses with a limited credit history and collateral availability benefited most from CAP loans. Banks generally find it difficult to lend to very young businesses, which, by definition, cannot provide historical financial statements to demonstrate that the business will have sufficient cash flow to service the debt. Banks that extend loans to start-ups often require higher levels of collateral and more liquid collateral than they would ask from an established borrower with a proven record of accomplishment. CAPs mitigate the higher risks associated with younger, smaller businesses and start-ups through the creation of the loan loss reserve pool.

CAPs also enabled some lenders to make loans to businesses with low credit scores and to offer small lines of working capital lines or credit to entrepreneurs. In general, CAPs require the lender to make a commitment to enroll multiple loans so that it can build a CAP reserve, unlike other lending programs (e.g., collateral support or loan participations) in which the credit enhancement is applied to each individual transaction.

CAPs – Key Statistics

Of the 15,595 SSBCI loans made through December 31, 2015, CAPs accounted for the greatest number of transactions at 10,561 (68 percent) (See Figure 3-11). California was responsible for making six of every 10 CAP loans enrolled nationally.

- Over two-thirds of all SSBCI loans were CAP loans, but states ultimately allocated only 3 percent of SSBCI funds to CAPs.
- CAPs had the lowest average principal loan size at $42,000 of all the SSBCI credit support programs. Enrolled loans ranged in size from $500 to $2.9 million. More than 8,900 of the 10,561 CAP loans were less than $50,000, but 41 were greater than $1 million.
- Among SSBCI program types, the leverage ratio for CAPs was the highest at 23 to 1.

- CAPs had the highest total among SSBCI program types for jobs supported (61,000 jobs) as reported by businesses (including both new jobs created and existing jobs retained).
- Borrowers financed by CAPs had a median of two full-time equivalent employees at the time of application.
- Fifty-five percent of all CAP loans went to businesses that were less than five years old, the highest percentage of any SSBCI loan program type.
- CAPs were also the most widely used program type to support businesses in LMI communities. About 47 percent of CAP loans provided funding to the businesses in LMI census tracts, the highest rate among the different program types.

Figure 3-11: Summary of Key SSBCI Metrics for CAPs, cumulative through December 31, 2015

SSBCI Metrics for Capital Access Programs	All States	California	All States Except California
Key Data:			
SSBCI Allocation ($ millions)	$45	$20	$25
SSBCI Allocation (% of Total Allocation)	3%	1%	2%
Transactions (#)	10,561	6,592	3,969
SSBCI Original Funds Expended ($ millions)	$22	$12	$10
SSBCI Program Funds Expended ($ millions)	$18	$10	$8
SSBCI Administrative Funds Expended ($ millions)	$4	$2	$2
SSBCI Recycled Funds Expended	$302,554	$275,147	$27,407
Average Principal Loan Size	$42,000	$35,000	$54,000
Program Outputs:			
Percent Expended	47%	62%	39%
**Total Leveraged Financing ($ millions)*	$507	$237	$270
***Leverage Ratio*	23.1:1	19.5:1	27.6:1
Program Outcomes:			
Total Jobs Supported	61,090	32,372	28,718
Jobs Created	11,202	3,341	7,861
Jobs Retained	49,888	29,031	20,857
SSBCI Loans in LMI Communities (% of total number of transactions)	47%	53%	36%
Top Three Industries Assisted (by number of transactions):	Retail Trade	Retail Trade	Retail Trade
	Accomodation and Food Services	Accomodation and Food Services	Accomodation and Food Services
	Transportation and Warehousing	Transportation and Warehousing	Other Services (except Public Administration)

**Includes financing leveraged with recycled SSBCI dollars*
***Includes administrative expenses*

CAP – Observations

Initially, the Act highlighted CAP as a standard for program design and resource allocation. Many states already had CAPs in place, and they had previously demonstrated promise in the decade before the recession. CAP had a less complicated application process compared with other program designs—an important consideration given the relatively short turn-around time for SSBCI applications and the option to modify programs after the original approval date. In addition, the CAP design readily lent itself to a reasonable expectation of at least a 10:1 leverage ratio. Large banks initially indicated a high interest in participating in CAPs. The standardization of pre-existing CAPs also made for a less intensive eligibility review by Treasury.

When SSBCI became operational, pre-existing CAPs in several states were among the quickest to begin deploying funds. However, with the notable exception of California, they were successful in deploying only small amounts. Lenders with pre-existing CAP reserves funded through a state program could not merge those reserves with SSBCI-funded CAP reserves, requiring the lender to create a new program, which was a disincentive. By 2013, states learned that the market acceptance for CAP dollars was limited. While several high volume CDFI micro-lenders (especially in California) made great use of CAP dollars, traditional bank lenders found the funds difficult to deploy.

While several high volume CDFI micro-lenders (especially in California) made great use of CAP dollars, traditional bank lenders found the funds difficult to deploy.

Many lenders cited borrowers' unwillingness to pay CAP fees as an obstacle to deployment. Further, bank lenders were reluctant to participate in CAPs because participation required enrolling a large volume of loans to build a sufficient loan loss reserve pool to fully offset the perceived higher risks of CAP loans. If loan losses are above normal, the loan loss reserve pool may not be adequate (as lenders learned from the losses they incurred during the 2008-2009 financial crisis). Lenders also perceived the level of public match funds available for SSBCI CAPs as too low compared with legacy state CAPs, which often matched private sector contributions on a $2 for $1 basis.

With little activity occurring in CAPs, some states responded by shifting their funding to other programs. CAP originally accounted for 20 percent (or $291 million) of all state allocations. As of December 31, 2015, CAP accounted for only 3 percent of state allocations, totaling $45 million spread across 24 programs, the lowest allocation of all the SSBCI program types. Even with this shift, CAPs still have the lowest deployment rate of all program types as well.

CAPITAL ACCESS PROGRAM EXAMPLE

California & the Opportunity Fund

The California Pollution Control Financing Authority (CPCFA), an independent agency chaired by the California State Treasurer, administered three of California's four credit support programs, including the Capital Access Program Loan Loss Reserve (CalCAP), a program created in 1994.

As of the end of 2015, CalCAP had provided $11 million in SSBCI contributions to loan loss reserves to provide credit enhancement for 6,592 transactions. These investments leveraged $237 million in loans, providing a leverage ratio of almost 20:1 and helping to create 3,341 jobs and retain 29,031 jobs according to business owners. CDFIs have accounted for 86 percent of all CalCAP transactions. The loans made by CDFIs, especially non-bank CDFIs, tended to be much smaller (representing only 43 percent of the total loan loss reserve contributions and about 31 percent of the total loan leveraged).

Opportunity Fund, a CDFI microlender, was the most prolific user of SSBCI CAP nationally, accounting for 4,700 transactions in California. Opportunity Fund was founded in 1994 to improve the economic well-being of low-wealth, under-capitalized entrepreneurs with offices in San Francisco and Los Angeles. It originates micro-loans typically for less than $10,000 although its loans have ranged from $500 to $107,560. It lends mostly to retail businesses from street vendors to family-run restaurants and dry cleaners. In 2015, Opportunity Fund was lending more than $2 million every month and helping people save over $1 million each year in micro-savings accounts. In 2015, Opportunity Fund originated more than 1,000 loans in a single year and 91 percent of the CDFI's borrowers were minorities.

CalCAP has been instrumental in helping Opportunity Fund fill two credit gaps. First, it allows Opportunity Fund to make loans that are too small for the local banking industry. Second, even though Opportunity Fund's default rate has been relatively low at less than 2 percent, CalCAP has been critical in helping Opportunity Fund shore up its loan loss reserves and sustain its growth.

Loan Guarantee Program

LGP – DEFINITION

Loan guarantee programs (LGPs) partially offset the risk associated with an individual loan by providing an assurance to the lender of partial repayment if a loan goes into default once the lender makes every reasonable effort to liquidate available collateral and collect on personal guarantees. This model involves providing a guarantee on only a portion of the loan (and always less than the total capital at risk for SSBCI) and reserves a portion of the amount guaranteed in a segregated cash account controlled by the state.

LGP – Typical Transactions/Borrowers

Typical transactions incorporating loan guarantees include lines of credit, asset purchases, and acquisition and construction of owner-occupied commercial real estate. Banks use LGP programs to finance established businesses or turn-around situations. Like a CAP, a LGP is flexible enough for use across a wide range of lending transactions; however, due to its mechanics, it is often not as amenable as CAP for use in loans of less than $50,000.

LGP – Key Statistics

- Loan guarantees accounted for the second largest number of transactions after CAP with 2,155, accounting for 13 percent of all SSBCI loans made through 2015 as shown in Figure 3-12.
- LGPs accounted for the fourth lowest dollar amount of allocations with 16 percent of total SSBCI funding.
- Loans originated through LGPs had the second lowest average principal loan size at $460,000. States have made guarantees on loans as small as $2,600 and as large as $11.9 million.
- The leverage ratio for LGPs was 7 to 1.
- LGPs were very effective and efficient at creating and retaining jobs with 48,568 jobs supported as reported by businesses, the second best performance of all SSBCI programs.
- Borrowers financed by LGPs had a median of six full-time equivalent employees at the time of application.
- Fifty-two percent of all LGP loans went to businesses that were less than five years old.
- LGPs provided 35 percent of their loans to businesses in LMI census tracts.

Figure 3-12: Summary of SSBCI Metrics for LGPs, cumulative through December 31, 2015

SSBCI Metrics for Loan Guarantee Programs	
Key Data:	
SSBCI Allocation ($ millions)	$232
SSBCI Allocation (% of Total Allocation)	16%
Transactions (#)	2,155
SSBCI Original Funds Expended ($ millions)	$158
SSBCI Program Funds Expended ($ millions)	$154
**SSBCI Administrative Funds Expended ($ millions)*	$4
SSBCI Recycled Funds Expended ($ millions)	$62
Average Principal Loan Size	$460,000
Program Outputs:	
Percent Expended	68%
***Total Leveraged Financing ($ millions)*	$1,098
****Leverage ratio*	7.0:1
Program Outcomes:	
Total Jobs Supported	48,568
Jobs Created	13,202
Jobs Retained	35,366
SSBCI Loans in LMI Communities (% of total number of transactions)	35%
Top Three Industries Assisted (by number of transactions):	Manufacturing Retail Trade Construction

* *Administrative expenses are weighted estimates prorated by proportion of program transactions to total OCSP transactions*

** *Includes financing leveraged with recycled SSBCI dollars*

*** *Includes weighted administrative expenses*

LGP – Observations

Nineteen states used SSBCI to support LGPs. LGPs proved reasonably easy to implement by states without pre-existing credit support programs. A guarantee percentage of 50 percent seemed to work well for new LGPs to ensure that lenders had enough “skin in the game” and minimize the amount of loan re-underwriting required by state program managers or their contractors. More established guarantee programs tended to set aside a lower percentage of each guarantee in the guarantee reserve fund than new programs.

A challenge to administering LGPs is that state program managers must be relatively experienced lenders. LGPs are not a “mechanical” or formula driven program like CAPs and some collateral support programs. Successful LGPs require state managers to exercise judgement, especially when a covered loan goes into default. Knowledgeable staffs gain the confidence of lenders if they can demonstrate an ability to “talk the talk” and facilitate deals that work for the borrower, the lender, and the state. This is particularly challenging for LGPs where the transaction size was less than half of that for CSPs and LPPs. This was due to three state programs (Alabama, California, and Georgia) that accounted for almost 80 percent of all national LGP transactions and provided guarantees for relatively small dollar transactions. The average transaction size for Alabama, California, and Georgia transactions was $360,000, whereas for all other states the average size was $803,000.

LOAN GUARANTEE PROGRAM EXAMPLE

Alabama Community Banks

With an SSBCI allocation of $31.2 million, Alabama created three new credit support programs administered by the Alabama Department of Economic and Community Affairs (ADECA). Ultimately, one of the three programs, the Alabama Loan Guarantee Program (ALGP), was actively adopted by the lending community and almost all of the state's SSBCI funds were re-allocated to AL-LGP. As of the end of 2015, ADECA has provided credit enhancements for 387 loans totaling $147 million through the guarantee program leveraging $28 million in SSBCI funding. More than 50 percent of SSBCI dollars supported retail and wholesale businesses, manufacturing, and other business and personal services.

Five community banks, including one that is a CDFI, (Southern States Bank, ServisFirst Bank, Peoples Bank of Alabama, South Point Bank, and United Bank) have expended more than $18 million in SSBCI guarantee funds, representing nearly two-thirds of program expenditures. United Bank, a CDFI, has accounted for 37 percent of the guarantee transactions.

Prior to SSBCI, Alabama had no pre-existing credit support programs targeting small business. In designing its SSBCI programs, Alabama relied heavily on input from community bankers. The five-person committee that designed the programs included the President of the Alabama Bankers Association as well as others with deep roots in the banking community. ADECA also surveyed local banks with the results guiding program design. ADECA enjoyed support from the Governor and Bank Superintendent, executive sponsorship that lent the program credibility. Another key factor in AL-LGP's success was the hiring of a former bank lender with more than 30 years of experience who could effectively communicate the value proposition of the program and who dedicated extensive time to sustained personal outreach.

The AL-LGP worked well for: (1) transactions originated by smaller community banks that do not participate in SBA programs; (2) transactions that required credit support, but did not justify the 75 percent SBA guarantee level; and (3) promising start-up businesses that usually did not meet established bank-lending standards. Lenders preferred the program because, from the banker's perspective, it is much easier and cheaper to use than SBA. Bank participants noted that the program is less cumbersome in terms of the paperwork required and less costly to the customers in terms of fees. Alabama markets AL-LGP providing credit support to businesses such as non-profits and start-ups that are prohibited from applying for SBA loans or have difficulty obtaining support through SBA programs.

Collateral Support Program

CSP – DEFINITION

Collateral support programs (CSPs) provide cash to lenders to boost the value of available collateral. CSPs are similar to subordinated loan participations in that they address shortfalls in collateral available to support a loan. In both cases, the borrower's cash flow typically meets the lender's underwriting standards, making the collateral shortfall an addressable barrier that would otherwise prevent the small business from qualifying for a loan.

CSP – Typical Transactions/Borrowers

Typical transactions incorporating CSP support include asset purchases and acquisition and construction of owner-occupied commercial real estate. States used the CSP to finance established, growing businesses, especially those in the manufacturing sector, which accounted for 17 percent of CSP transactions.

CSP – Key Statistics

- Allocations to CSPs increased by 58 percent above the initial allocations. CSPs recorded 1,189 transactions, the lowest amount of all the credit support programs as illustrated in Figure 3-13.
- CSPs received 18 percent of the $1.46 billion allocated to state SSBCI programs.
- CSPs had the second largest average principal loan size at $748,000.
- CSPs had the lowest leverage ratio of all credit support programs at 5.1 to 1.
- CSPs supported the creation and retention of 21,335 jobs.
- Borrowers financed by CSPs had a median of six full-time equivalent employees, the same as LGPs.
- Forty-six percent of all CSP loans went to businesses that were less than five years old.
- Among the SSBCI credit support programs, CSPs provided the lowest share of loans to businesses in LMI census tracts at 31 percent.

Figure 3-13: Summary of SSBCI Metrics for CSPs, cumulative through December 31, 2015

SSBCI Metrics for Collateral Support Programs	
Key Data:	
SSBCI Allocation ($ millions)	$261
SSBCI Allocation (% of Total Allocation)	18%
Transactions (#)	1,189
SSBCI Original Funds Expended ($ millions)	$210
SSBCI Program Funds Expended ($ millions)	$205
**SSBCI Administrative Funds Expended ($ millions)*	$5
SSBCI Recycled Funds Expended ($ millions)	$20
Average Principal Loan Size	$748,000
Program Outputs:	
Percent Expended	81%
***Total Leveraged Financing ($ millions)*	$1,079
****Leverage Ratio*	5.1:1
Program Outcomes:	
Total Jobs Supported	21,335
Jobs Created	10,062
Jobs Retained	11,273
SSBCI Loans in LMI Communities (% of total number of transactions)	31%
Top Three Industries Assisted (by number of transactions):	Manufacturing
	Accommodation and Food Services
	Health Care and Social Assistance

* *Administrative expenses are weighted estimates prorated by proportion of program transactions to total OCSP transactions*

** *Includes financing leveraged with recycled SSBCI dollars*

*** *Includes weighted administrative expenses*

CSP – Observations

CSP is a a mechanism to enhance the value of available collateral by pledging a cash deposit, held at the lending bank, as collateral. SSBCI featured many noteworthy experiments by state program managers, some of which were replicated in other states. CSP was perhaps the most notable example. Sixteen states created new CSPs based in part on the model established by the Michigan Economic Development Corporation. CSP loans were used to purchase machinery or finance the purchase or construction of commercial real estate. Several banks used CSPs to support their participation in the SBA's 504 program, helping certain SBA deals close. Under the 504 program, a bank generally finances 50 percent of an owner occupied real estate or equipment loan and the SBA finances 40 percent. The SBA's participation commences when the project is complete, which can be over a year from closing if the project includes construction. During the interim, lenders must finance up to 90 percent of total project costs, which exceeds most bank loan policies. Some banks utilize SSBCI to reduce their total exposure below their loan to value limits.

Collateral support and subordinated participation products had the added benefit of enabling a small business to retain and build its working capital, rather than having to invest it in a facility or equipment. These programs also enabled lenders to increase their support for equipment and accounts receivable financings, which lenders consider to be weak collateral.

Several lenders spoke about using SSBCI collateral support or subordinated participation products to finance specialty equipment or tenant improvements, purposes that often do not retain significant value in case of loan foreclosure and the liquidation of collateral.

CSPs have encountered more challenges than other SSBCI programs in generating recurring income streams to sustain program administration costs and to increase program capitalization. Revenues for CSPs are limited to fees charged upon application and closing and interest earned while the funds are held as collateral for loans. While held as collateral, SSBCI funds are generally invested in certificates of deposit and consequently do not generate much income in the current interest rate environment. A few states have addressed this issue by charging annual renewal fees to create an incentive for lenders to relinquish the SSBCI support once collateral values rise above the lender's loan-to-value ratio requirement. In addition, states began reducing the amount of cash that they would keep on deposit by re-evaluating the need for the cash deposit as the loan matured. This helped to recycle the funds more quickly.

COLLATERAL SUPPORT PROGRAM EXAMPLE

Michigan's Collateral Support Program

The Michigan Economic Development Corporation (MEDC) met the credit needs facing businesses with weak collateral but strong cash flow by creating a CSP in 2009, and provided the program with additional funding through SSBCI. Sixteen other states emulated this unique approach with their SSBCI funds. Michigan created its program to help businesses in a targeted set of "qualified" industries: mining, manufacturing, research and development, wholesale and trade, film and digital media productions, and office operations, among others. MEDC received high-level support for the program from the state banking association, the Governor, and other senior state officials, this executive sponsorship gave the program credibility.

The CSP has been the most active of Michigan's SSBCI lending programs, and approximately 29 percent of its funding has recycled as of December 31, 2015. The program allows for collateral support up to 49.9 percent of the loan amount with most requests in the 33 to 49.9 percent range. The program is easy to use because MEDC does not specifically "re-underwrite" the loan. Instead, MEDC relies on the partner financial institution's analysis and identified need for collateral support. By the end of 2015, Michigan had made 83 CSP loans from $44 million in SSBCI funding. These loans supported the creation of 3,472 new jobs and retention of 472 existing jobs as reported by business owners. Michigan's CSP achieved a 6.7 to 1 leverage ratio.

Michigan found that banks and credit unions of all asset sizes were interested in the program because of its unique abilities to address a specific lending gap. Banks participating in the program included regional banks such as Huntington and Fifth Third as well as large national banks such as Bank of America.

Loan Participation Program

LPP – DEFINITION

Loan participation programs (LPPs) involve purchases of a portion of a loan that a lender makes or the provision of a companion loan. LPPs can offer either subordinate or *pari-passu*[17] financing. Subordinate participations address shortfalls in collateral available to support a loan and enables an otherwise creditworthy small business to gain access to capital. If a program offers pari-passu financing it is often at a reduced interest rate, thus reducing interest expense. LPPs also enable lenders to adjust their overall exposure to a borrower and to offer loans larger than their institution's maximum loan amount. Typically, the lender services the entire LPP loan including the purchased portion. In some cases, the state purchases a portion of the loan at closing, and in others, states made a companion loan directly to the borrower in concert with a private lender. In some cases, states co-fund loans in partnership with CDFIs.

LPP – Typical Transactions/Borrowers

Typical LPP transactions include asset purchases and acquisition and construction of owner-occupied commercial real estate. LPPs are used to finance established businesses with a cash flow or collateral shortfall. LPPs also frequently provide fixed asset financing in larger amounts, extending the capacity of community banks that might not otherwise have been able to fund the loan.

LPP – Key Statistics

- LPPs recorded 1,690 transactions (see Figure 3-14), more than CSPs and VCPs, but less than CAPs and LGPs.
- Thirty-two percent of the $1.46 billion allocated to the state SSBCI programs was directed to LPPs (including direct loan programs), operated by 39 states in 44 active programs.
- LPPs had the highest average principal loan size at $1.2 million. SSBCI helped states to participate in loans ranging from $1,000 to $20 million.
- LPPs leveraged the largest dollar amount of total financing and a leverage ratio of about 7 to 1.
- LPPs are credited with creating 18,257 new jobs according to business owners, the most among SSBCI program types. LPPs supported 39,587 jobs overall (created or retained).
- Borrowers financed by LPPs had a median of eight full-time equivalent employees at the time of application.
- Forty-eight percent of all LPP loans went to businesses that were less than five years old.
- Among SSBCI credit support programs, LPPs provided the third largest share of loans to businesses in LMI census tracts at 33 percent.

17 Pari passu means that all lenders participating in a loan are of equal seniority with respect to payments and collateral.

Figure 3-14: Summary of SSBCI Metrics for LPPs, cumulative through December 31, 2015

SSBCI Metrics for Loan Participation Programs	
Key Data:	
SSBCI Allocation ($ millions)	$471
SSBCI Allocation (% of Total Allocation)	32%
Transactions (#)	1,690
SSBCI Original Funds Expended ($ millions)	$376
SSBCI Program Funds Expended ($ millions)	$366
**SSBCI Administrative Funds Expended ($ millions)*	$10
SSBCI Recycled Funds Expended ($ millions)	$36
Average Principal Loan Size ($ millions)	$1.2
Program Outputs:	
Percent Expended	80%
***Total Leveraged Financing ($ millions)*	$2,612
****Leverage Ratio*	7.0:1
Program Outcomes:	
Total Jobs Supported	39,587
Jobs Created	18,257
Jobs Retained	21,330
SSBCI Loans in LMI Communities (% of total number of transactions)	33%
Top Three Industries Assisted (by number of transactions):	Manufacturing Accommodation and Food Services Health Care and Social Assistance

* *Administrative expenses are weighted estimates prorated by proportion of program transactions to total OCSP transactions*

** *Includes subsequent private financing and financing leveraged with recycled SSBCI dollars*

*** *Includes weighted administrative expenses*

LPP – Observations

Generally, lenders participating in LPPs had to weigh the advantages of risk mitigation against the cost of lower outstanding balances. LPPs were valuable to smaller institutions that may not have the capital assets sufficient to handle a larger loan or want to spread the risks associated with a particular transaction. Subordinated loan participations also have the advantage of not only increasing the collateral value supporting the lender's share of a loan but also reducing the lender's overall exposure should the loan go into default. That, in turn, reduces the lender's delinquency ratio.

Lenders in the current market tended to prefer the collateral support model over subordinated loan participations if given the alternative. Even though LPPs offers similar benefits to CSPs, the LPP model requires sharing the loan with other partners at a time when lenders are seeking to retain the entirety of the customer relationship.

The preference for subordinated loan participations or collateral support program models also varied with lender financial strength. Lenders with strong liquidity and equity positions tended to prefer collateral support over loan participations because collateral support allowed the lenders to deploy more of their own funds, producing greater fee income and increasing interest income. Loan participations were particularly valuable in larger layered transactions involving multiple funding sources, especially for smaller community banks that may be approaching their legal lending limit on a particular transaction.

LOAN PARTICIPATION PROGRAM EXAMPLE

Advantage Illinois LPP

Illinois used subordinated loan participations to fill the gaps in complicated multi-layered transactions with minority-, women-, disabled- and veteran-owned and controlled businesses (MWDVs). The Illinois Department of Commerce and Employment Opportunity (DCEO), the designated SSBCI implementing organization, operates the Advantage Illinois (AI) LPP, a variant of its legacy loan participation program. AI LPP uses SSBCI funds to purchase a participation at the lower of 25 percent of project costs or 50 percent of the loan amount up to $2 million. The program prices loan participations at a below market interest rate and subordinates the participations to the lender's loan position, but receives a pro-rata share of payments.

Illinois targets MWDV businesses through incentives in program design, collaboration with stakeholders, and technical assistance. Over 70 percent of AI LPP loans in both dollar and number have been made to MWDV businesses.

The major advantages of the AI LPP include its flexibility, subordinate nature, and below market interest rate. Lenders indicated that they use SBA when possible for less complicated "plain vanilla" transactions, but on some projects SBA is either not enough or the transaction is ineligible (non-profit borrowers and refinancings). This is particularly true for transactions that often involve multiple lenders. This reflects Illinois' desired position to serve as a "but for" lender focusing on transactions that are not bankable conventionally or with standard credit enhancements.

As with other states, community banks have been the most active lenders in the AI LPP. As of the end of 2015, over 50 community banks, CDFIs, and regional loan funds have enrolled in AI lending programs. Village Bank, a subsidiary of WinTrust – a large community bank holding company, has been Illinois' most active LPP lender as measured by total loan amount.

At the end of 2015, Illinois had expended $49 million in SSBCI funds in 166 transactions leveraging $394 million in new small business lending, providing a leverage ratio of $8.11 in financing for each SSBCI dollar. These investments helped to create 1,883 new jobs and retain 1,064 jobs as reported by business owners. The AI LPP was the most actively used Illinois program accounting for 86 percent of the state's SSBCI funds expended through the end of 2015.

3E. Lessons Learned by State Program Managers

This section focuses on lessons learned based on interviews with program managers about the approaches they felt worked best. Those perspectives suggest that the most critical factor in implementing a successful program is simplicity in design and responsiveness to standard market practices. Four specific factors emerged as critical to SSBCI program success:

1. Program design and operations align with private sectors practices and market needs;
2. Effective, focused, and continuous marketing efforts;
3. Emphasis on long-term sustainability; and
4. Strong and well documented compliance practices.

The following describes how these factors influenced loan program deployment, leverage, and impact.

1) Program design and operations align with private sector practices and market needs

When bank representatives were actively involved in helping to design and champion the program, states reported better experiences getting their programs off to a quick and successful start. These representatives provided states with a better sense of market conditions, helped tailor programs to bank needs, identified addressable capital gaps, and served as a ready-made pool of potential program participants that were already familiar with the program when it launched. Many became repeat users.

Lenders and state SSBCI programs had the same interest in increasing the volume of quality credit available to small businesses in their state. State programs were most effective when their SSBCI program aligned with lenders' financial interests. For instance, banks were more willing to consider a loan to a business with weak collateral than one with weak cash flow. Collateral support and subordinated debt products directly mitigate banker risk with respect to collateral. At the same time, subordinated debt products were viewed favorably because they can help to improve the lender's collateral position relative to other types of credit enhancement. Lenders also preferred loan participations and collateral support that disbursed the credit enhancement directly to the lender at the loan closing rather simply promising pay in the event of default or placing a cash deposit in a reserve fund held elsewhere. In addition, lenders viewed SSBCI loan guarantees as easier to use when compared with other government-sponsored guarantee programs, which tend to have separate application and closing processes.

Many state SSBCI programs also tapped their lending partners to take on loan underwriting and servicing roles to reduce administrative overhead and to give lenders confidence in the loan approval and management process. Because lenders typically prefer to control the business relationship with the borrower, many states structured their lending programs with limited or no contact with the borrower. This approach helped to reduce paperwork burdens for businesses and lenders alike, areas in which lenders are often more experienced and efficient than state agencies.

Many states developed a simple master agreement describing terms of lender participation and permitting the use of a lenders' own application and closing documents. This eliminated the need for extensive SSBCI-related documentation at each loan closing and reduced the need for lenders to adapt to the use of non-conforming forms generated for SSBCI only. This allowed lenders to align the products with other customary bank offerings and customer expectations (i.e., minimizing fees and related costs to the borrower).

Several lenders noted that SSBCI programs typically engaged actively in reviewing liquidation plans and strategies in the event of a borrower default. While this protects SSBCI, lenders prefer to control the process to ensure they have to the flexibility to adapt to rapidly changing circumstances during a collections process. Lenders sought upfront master agreements with SSBCI programs that clearly defined liquidation rights and responsibilities in the event of a default rather than waiting to negotiate the issues at loan closing or at the time of a default.

2) Effective, focused, and continuous marketing efforts

Successful state SSBCI programs also had thoughtful, effectively implemented marketing plans. State program managers noted that continuous communication with lenders about their state's SSBCI programs needed to reinforce the benefits to the lender. The messages had to focus on what each lender was seeking from the program – the ability to help a client, the ability to overcome a collateral issue, the ease of use, and the ability to minimize risks. States successfully used their lender networks (including the state bankers' association) as well as economic development agency partners to share information about the program with potential program participants.

States frequently reinforced the credibility of their messages by providing examples of successful transactions to help lenders understand that their competitors were using the program effectively on behalf of their clients. Lenders also found that many states had employed staff with significant lending experience, and those staff helped to convey messages about the program's value.

The most effective marketing path varied based on who or which unit within a lenders' organization would drive the decision to participate. In some institutions, the CEO or chief credit officer was the key decision maker. In others, the SBA lending departments or individual loan officers active in small business lending influenced the lender's decision to participate. In short, each lender's culture affected how best to reach the business so state program managers had to try each of these avenues in their efforts to engage with potential new lending partners.

Common mechanisms for reaching new lenders included engaging them through their state banking association, reinforcing the reputation of the SSBCI managing entity through successes, and demonstrating how SSBCI funds would be available as a resource beyond the SSBCI program's sunset date.

3) Emphasis on long-term sustainability

For many state lending programs, the creation of an evergreen source of funding for their credit support program(s) was vital to building and maintaining the lending community's commitment to the program and to ensuring that funds would remain available to meet small business capital needs in the future. Since recycled funds remain under the control of the state, lenders were interested in longer term plans for SSBCI loan programs. Given the costs associated with learning and implementing a new program, lenders were less interested in participating in a state program with a finite term and limited capital availability.

States sought to leverage their limited resources by limiting the size of transactions, and therefore the dollar amount of credit support, and creating incentives for lenders to release SSBCI credit support once a loan had stabilized so the funds could be redeployed. In addition, states sought to maintain ongoing deal flow and collect loan fees and interest to generate new capital as a way to generate income to cover administrative costs. Through an aggressive loan monitoring process and by acting promptly on delinquent accounts as well as applying appropriate underwriting and collection practices, states mitigated the risk of losses.

4) Strong and well documented compliance practices

Ongoing compliance with federal SSBCI rules and regulations is a crucial part of operating a successful program. States noted that lenders and borrowers viewed some SSBCI certification and reporting requirements as bureaucratic and cumbersome, but clear communication from the outset helped to overcome reluctance to work with SSBCI. Program managers described several common themes about best practices to ensure consistent compliance.

First, compliance depended on states maintaining expertise in compliance and monitoring the most current version of the SSBCI program rules. Many states noted that their success in complying with Treasury guidance also depended on making lenders and borrowers aware of certification and assurance requirements at the outset as well as vigorously verifying their compliance.

Second, state program managers, lenders, and borrowers consistently expressed concern about certain program certification requirements, especially the congressionally mandated certification that no party in the transaction has ever been a sex offender against a minor, but they noted that these issues were overcome by clear and up-front communications about the requirements. Many states developed and used compliance checklists for staff and lenders, integrating those requirements into the entire process from loan application to repayment.

Third, a major early concern was that banking regulations might inhibit the willingness of lenders to participate. However, during the course of lender interviews, no lender identified any conflicts between SSBCI and banking regulations. States found that they benefited by establishing close working relationships with state and federal banking regulators, especially during the program design phase. In fact, several lenders reported that regulators had tended to view their bank's participation in the SSBCI program as a positive strategy in mitigating risk.

Finally, states that were most successful hired staff with compliance expertise. States also sought staff with experience managing SBA loans, preparing bank documentation, serving as paralegals, or related experience to ensure program compliance. States that contracted for program management noted that that they retained responsibility for program compliance and closely reviewed contractors' performance. In addition, states also often engaged experienced third parties to review compliance procedures and help with compliance audits. Many opted to cross-train staff at every level on compliance requirements and procedures as a way to integrate compliance as a part of the marketing and loan negotiation process. These states included conducting regular staff meetings on SSBCI program changes and compliance issues.

Chapter 4

Observations from Venture Capital Programs

Program Evaluation of the U.S. Department of Treasury State Small Business Credit Initiative

Center for Regional Economic Competitiveness & Cromwell Schmisseur

OCTOBER 2016

SSBCI

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Chapter 4:

Observations from Venture Capital Programs

More than two-thirds of states allocated SSBCI funds to 48 venture capital programs (VCPs) designed to stimulate private investments in small businesses with high-growth potential. The $448 million allocated to VCPs accounted for nearly one-third of total SSBCI funding.

This chapter summarizes why states undertook VCPs and the various types of VCPs states implemented using SSBCI funds. Furthermore, the chapter presents characteristics of small businesses attracting venture capital, and the variety of state objectives and business environments that influenced program strategies. The chapter ends with feedback from state program managers on lessons learned while designing and implementing VCPs.

Figure 4-1 illustrates that states made over 1,300 venture capital investments using $278 million in SSBCI funds. The investments leveraged nearly $1.7 billion in co-investment and more than $3 billion inclusive of subsequent private financing, for a leverage ratio of 11.1:1. These VCPs also supported the creation of almost 11,200 new jobs as projected by businesses at the time of investment.

For the purposes of this report, venture capital is broadly defined as financing for private businesses where an investment is made in return for an ownership interest (i.e., equity) in the business. With venture capital, investors share risk and rewards with other equity owners, such as the small business' founders, key employees, and other investors. In most cases, the business receiving equity investment does not provide investment security such as collateral or guaranties common to asset-based lending.

According to the State Science and Technology Institute (SSTI), three of the primary elements of an innovation or technology-based economy include intellectual infrastructure, an entrepreneurial culture, and investment capital.

Figure 4-1: Summary SSBCI Metrics for All VCPs, cumulative through December 31, 2015

SSBCI Metrics for All Venture Capital Programs	
Key Data:	
**Number of VC Programs*	48
SSBCI Allocation ($ millions)	$448
SSBCI Allocation (% of Total Allocation)	31%
Transactions (#)	1,324
SSBCI Original Funds Expended ($ millions)	$278
SSBCI Program Funds Expended ($ millions)	$271
***SSBCI Administrative Funds Expended ($ millions)*	$7
SSBCI Recycled Funds Expended	$707,923
Average Investment Size ($ millions)	$1.3
Program Outputs:	
Percent Expended	62%
****Total Leveraged Financing ($ millions)*	$3,081
*****Leverage Ratio*	11.1:1
Program Outcomes:	
Total Jobs Supported	19,821
Jobs Created	11,169
Jobs Retained	8,652
SSBCI Investments in LMI Communities (% of total number of transactions)	36%
Top 3 Industries Assisted (by number of transactions)	Professional, Scientific & Technical Services Information Manufacturing

* *There are 39 active VCPs, however some VCPs have transactions that are classified in more than one of the four program categories: Funds, State-Supported Entities (SSEs), State Agencies, and Co-Investment (see Section 4B for descriptions of the four program categories).*

** *Administrative expenses are weighted estimates prorated by proportion of program transactions to total OCSP transactions*

*** *Includes subsequent private financing and financing leveraged with recycled SSBCI dollars*

**** *Includes weighted administrative expenses*

Venture capital can be provided by a venture capital fund, an accredited intermediary organization, or an individual investor (e.g. an angel investor) at any stage of business development. Venture capital investors support small businesses in a wide range of business development phases, from formation through expansion, with venture capital commonly identified with supporting early-stage, high-growth potential businesses.

4A. Why States Support Venture Capital Investment Programs

SSBCI enabled states to create or expand VCPs. VCPs are part of a broader economic development strategy to promote entrepreneurial activity on the theory that innovation and entrepreneurship drive long-term economic growth and diversification. Many states design and implement "technology-based economic development" strategies to encourage entrepreneurial innovation and position their regions as global leaders in emerging industries.

According to the State Science and Technology Institute (SSTI), three of the primary elements of an innovation or technology-based economy include intellectual infrastructure, an entrepreneurial culture, and investment capital.[18] These elements foster more dynamic economies focused on new businesses creating high-wage jobs, generating local wealth, and anchoring the development of new industry clusters.

Research has shown that young, high-growth businesses contribute disproportionately to job growth and positive spillover effects for regional economies.[19] Economic developers aim to support these high-growth potential businesses, which often need equity financing to start, develop, and grow as the vehicle for commercial innovation.

An obstacle for supporting high-growth small businesses as a state economic development strategy is the supply of private sector equity investors, both in terms of the number of experienced venture investors and the amount of capital available for venture investments. Data shows that the supply and accessibility of privately managed venture capital is far more limited for small businesses located outside a small number of geographic regions. For example, since 2010, small businesses receiving 80 percent of the $166 billion of venture capital investments were headquartered in fewer than 1 percent of U.S. counties.[20]

Observers of equity capital markets have noted that the "virtuous cycle" of venture-backed businesses located close to funding sources has also created a "vicious cycle" for regions with few venture capital firms actively investing in local businesses.[21] As the profile of the venture capital industry has increased in the last 20 years, so has the geographic concentration of the industry's investments (see Figure 4-2). Economic development officials outside of traditional venture capital centers view this degree of investment concentration as a constraint on innovation development.

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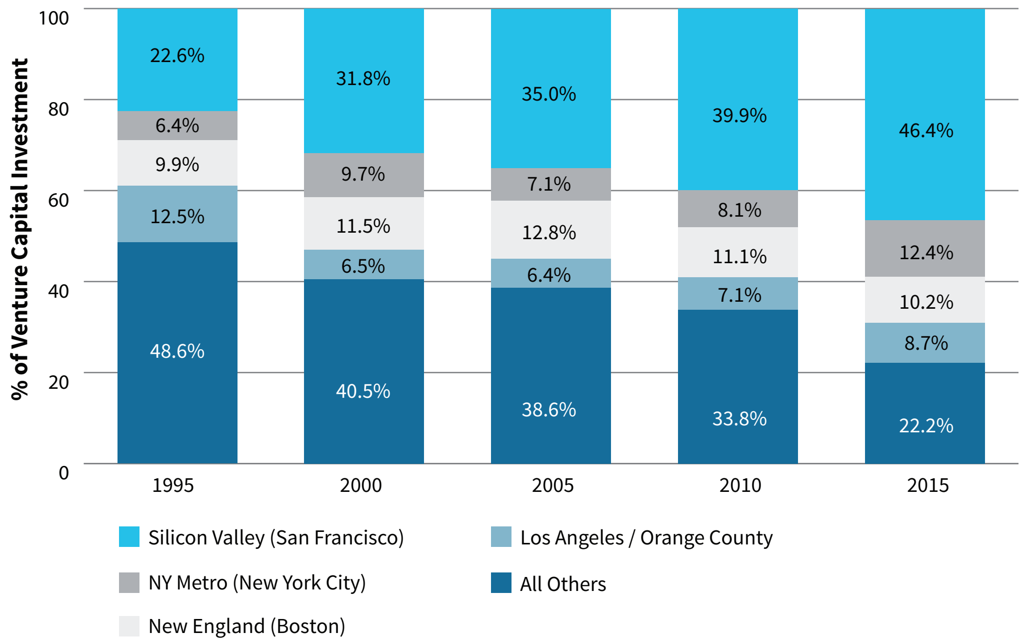
18 *A Resource Guide for Technology-based Economic Development*. State Science and Technology Institute. Prepared for the U.S. Department of Commerce, Economic Development Administration. August 2006. Web accessed. (http://ssti.org/sites/default/files/resourceguidefortbed.pdf).

19 Haltiwanger, John C.,Jarmin, Ron S., & Miranda, Javier. *Who Creates Jobs? Small Versus Large Versus Young.* National Bureau of Economic Research. Working paper 16300. August 2010, revised November 2012. Web accessed. (http://www.nber.org/papers/w16300.pdf).

20 Bowden, Adley. "The Geography of U.S. Venture Investments." PitchBook. 27 June 2014. Web accessed. (http://pitchbook.com/news/articles/thegeographyofu-s-ventureinvestments).

21 Lerner, Josh. "Geography, Venture Capital, and Public Policy." Harvard Kennedy School. Policy Briefs. March 2010. Web accessed. (https://www.hks.harvard.edu/index.php/content/download/68616/1247274/version/1/file/final_lerner_vc.pdf).

Figure 4-2: Increasing Rate of Geographic Concentration in Venture Capital Investments, 1995-2015[22]



Another challenge for economic developers relates to the relative scarcity of venture capital for small businesses at the earliest stages of development. Even though venture capital funds are commonly identified as the strategic investors behind early-stage businesses, the institutional investors that provide the capital to investment firms have increasingly migrated downstream by allocating capital to large investment funds (>$500 million) focused on growth-stage financing.[23] This increased concentration of capital for the later stages of enterprise development creates financing gaps along the capital continuum[24] and the need for public and private capital formation initiatives to support investment in young, promising businesses.

SSBCI provided an opportunity for many states to supplement existing VCPs, revitalize programs lacking sufficient state support, or create new programs where state managers perceived unmet needs in evolving entrepreneurial ecosystems. In particular, states with lower per capita rates of venture capital investment were more likely to allocate SSBCI capital to VCPs. As shown in Figure 4-3, states with small businesses that received just 20 percent of U.S. venture capital investments in 2014,[25] represented 84 percent of the $448 million of SSBCI VCP allocation.

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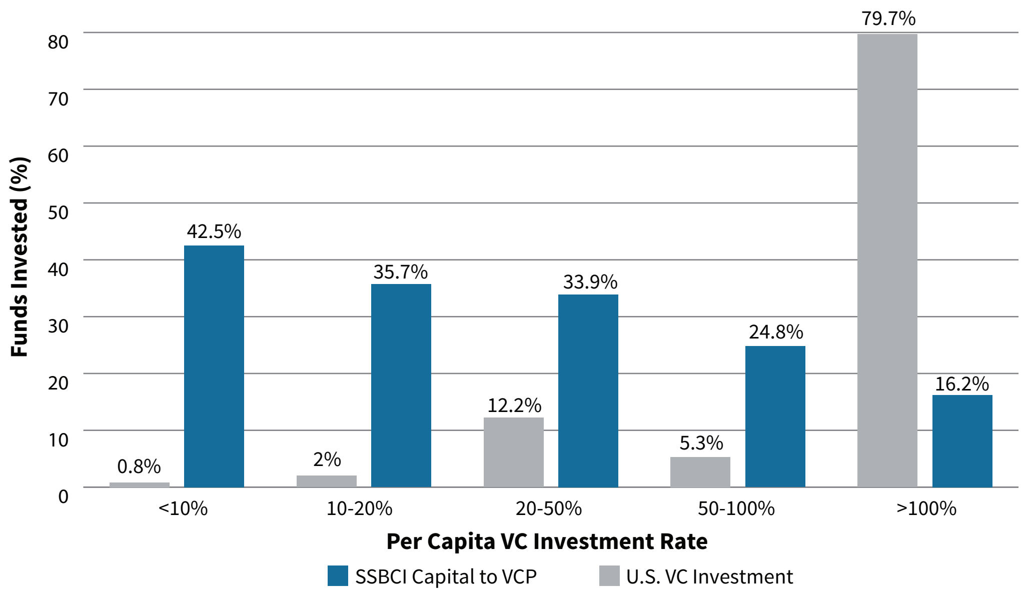
22 *Yearbook 2016.* National Venture Capital Association. March 2016. Web accessed. (http://nvca.org/research/stats-studies).

23 *2Q U.S. Venture Industry Report.* PitchBook. 16 April 2014. Web accessed. (http://pitchbook.com/news/reports/2q-2014-us-venture-industry-report).

24 *Policies for Seed and Early Stage Finance: Findings from the 2012 OECD Financing Questionnaire.* Organisation for Economic Co-operation and Development. Directorate for Science, Technology and Industry. Committee on Industry, Innovation and Entrepreneurship. 15 November 2013. (http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DSTI/IND(2013)5/FINAL&docLanguage=En).

25 Per capita percent is calculated as venture capital percent (the category of states' share of U.S. VC investments) divided by US % (the category of states' share of U.S. population). Data is aggregated from the following sources, numbers taken for 2014 as of 2015 reports.
"Population." U.S. Census Bureau. Web accessed. (http://www.census.gov/topics/population.html)
2015 Yearbook. National Venture Capital Association. 2015. Print.
"Allocations." U.S. Department of the Treasury, State Small Business Credit Initiative. Internal reports. Not publicly available.

Figure 4-3: State Per Capita Rates of Venture Capital Investment Compared to SSBCI VCP Allocations



States Categorized by Per Capita Rate of Venture Capital Investment	Per Capita VC%	% of U.S. Population	% of U.S. VC Investment	% of SSBCI Capital to VCP
CA, MA, DC, UT, NY, WA (6)	>100%	23.8%	79.7%	16.2%
CO, CT, RI, NH, IL (5)	50-100%	7.6%	5.3%	24.8%
MN, VT, MD, PA, VA, TX, GA, OR, FL, AZ, NJ, NC (12)	20-50%	37.5%	12.2%	33.9%
DE, MO, TN, OH, MI, NE, KS, NV (8)	10-20%	13.4%	2.0%	35.7%
WI, ME, ND, KY, LA, SC, IN, IA, AR, NM, SD, OK, AL, ID, WV, HI, MS, MT, AK, WY (20)	<10%	17.7%	0.8%	42.5%
U.S. Territories				19.6%
Totals		**100.0%**	**100.0%**	**31.1%**

Missouri is an example of a state that used its SSBCI allocation to address challenges to small businesses accessing venture capital. From 2005 to 2009, Missouri small businesses saw their market share of U.S. venture capital investments decline 75 percent.[26] The Missouri Technology Corporation (MTC), a state-sponsored non-profit, had previously struggled to secure consistent state government funding support for VCPs.

With its $26.9 million SSBCI allocation, Missouri allocated 89 percent, or $24 million, to the MTC to manage the Missouri IDEA Fund,[27] a VCP that could lead investment rounds in Missouri small businesses or co-invest alongside angel investors or venture capital funds. Missouri rapidly implemented the program with $7 million of SSBCI capital obligated for investments in 2011 and another $10 million obligated in 2012-13.[28]

Through December 31, 2015, Missouri's total of $21 million in VCP investments had been matched more than 10 to 1 by $289 million of new capital investment. The program's success and regional impact led to a substantial increase in the state's budget for MTC to continue its investment and venture capital development programs.[29]

26 Op. cit., 2016 Yearbook. National Venture Capital Association.

27 "Commercialization Programs." Missouri Technology Corporation. Web accessed. (http://www.missouritechnology.com/commercialization-programs).

28 "Quarterly Reports." U.S. Department of the Treasury, State Small Business Credit Initiative. Not publicly available.

29 Altman, Maria. "Nixon celebrated funding for Missouri Technology Corporation." St. Louis Public Radio. 20 May 2015. Web accessed. (HYPERLINK "http://news.stlpublicradio.org/post/nixon-celebrates-funding-missouri-technology-corporation" \l "stream/0" http://news.stlpublicradio.org/post/nixon-celebrates-funding-missouri-technology-corporation#stream/0). (In May 2015, the Missouri Legislature approved $16 million for MTC for the following year's budget). (http://news.stlpublicradio.org/post/nixon-celebrates-funding-missouri-technology-corporation#stream/0)

4B. Classifications of SSBCI Venture Capital Programs

For this report, SSBCI categorized state VCPs primarily by how the state engaged with the investment process, resulting in four program categories: Funds, State-Supported Entities (SSEs), State Agencies, and Co-Investment (see Figure 4-4).

Figure 4-4: Classifications of SSBCI Venture Capital Programs

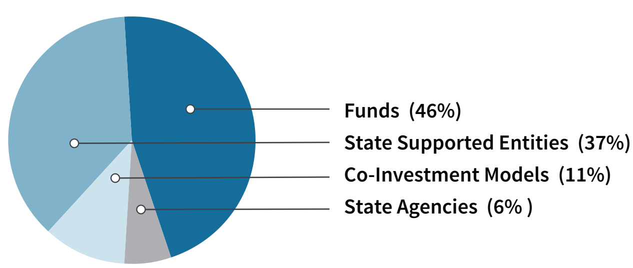
VCP Category	Investment Management	Investment Terms	ROI Measures
State Agencies	Staff at state agency or a contractor, often with an external investment committee.	States directly engage in transactions and receive returns based on the investment contract.	Financial ROI and other economic development considerations.
Co-Investment Models	Eligible investors or funds identify qualifying investments for state participation on a formulaic basis.	States invest directly or through an intermediary. Principal and proceeds on individual investments are returned to the state or intermediary.	Financial ROI and other economic development consideration.
State-Supported Entities	State supported entities aligned with public benefit (private non-profit corporation, quasi-state entity).	State-funded intermediaries invest in companies. Investment principal and gains return to the intermediary to be reinvested.	Financial ROI and other economic development considerations.
Funds	The general partner or staff at the fund.	Funds invest in companies. Investment principal and gains on the investment portfolio return to state minus fees and carried interest.	Financial ROI.

In Figure 4-5, the SSBCI allocation amounts are shown for each VCP category.

The following sections provide a detailed description of the categories used in this report to categorize VCPs. We have included state implementation examples from each category and the primary metrics used to measure performance.

Figure 4-5: SSBCI Allocations by VCP Category

VCP Category	SSBCI Allocation ($ millions)
State Agencies	$27.5
Co-Investment Models	$48.2
State Supported Entities	$166.4
Funds	$205.3
TOTAL	**$ 448.1**



Funds

Programs in the Funds category empower private investment fund managers to manage SSBCI funds – they perform due diligence, make investment recommendations and/or decisions, and monitor investment portfolios. Investment managers in the Funds category are not otherwise associated with state governments or engaged to manage economic development functions of the state. Managers seek to maximize financial returns from investments within the parameters of the program, as financial returns on invested capital is the predominant measure by which private investors, pension funds and endowments measure venture fund performance.

To engage private fund managers, states selected funds through a competitive review and selection process managed either internally by a state agency or by a contracted private entity serving as the fund-of-funds manager. States engaged the private funds in one of the two ways listed below.

1. States engaged more than one investment fund manager to administer the state's allocation (VCPs in Alaska-Anchorage, Arkansas, Hawaii, Louisiana, North Carolina, New Jersey, New York, Texas, and Wisconsin), commonly referred to as a "Fund-of-Funds" program; and
2. States contracted with a single investment fund manager to administer the state's allocation (VCPs in Florida, Michigan, New Hampshire, North Dakota-Carrington, Rhode Island, Washington, and Wyoming-Laramie).

Figure 4-6: SSBCI Metrics for the Funds VCP Category, cumulative through December 31, 2015

SSBCI Metrics for VCPs with Funds Strategy	
Key Data:	
Number of VCPs w/Funds Strategy	16
SSBCI Allocation ($ millions)	$205
SSBCI Allocation (% of Total Allocation)	46%
Transactions (#)	661
SSBCI Original Funds Expended ($ millions)	$122
SSBCI Program Funds Expended ($ millions)	$119
**SSBCI Administrative Funds Expended ($ millions)*	$4
SSBCI Recycled Funds Expended	$0
Average SSBCI Support	$179,500
Average Investment Size ($ millions)	$1.3
Program Outputs:	
Percent Expended	60%
***Total Leveraged Financing ($ millions)*	$1,425
****Leverage Ratio*	8.5:1
Program Outcomes:	
Total Jobs Supported	7,628
Jobs Created	3,950
Jobs Retained	3,678
SSBCI Investments in LMI Communities (% of total number of transactions)	33%
Top 3 Industries Assisted (by number of transactions)	Information Professional, Scientific & Technical Services Manufacturing

* *Administrative expenses are weighted estimates prorated by proportion of program transactions to total VCP transactions*

** *Includes subsequent private financing*

*** *Includes weighted administrative expenses*

Investments managed by funds can span the full spectrum of development stages from pre-seed to mezzanine financings. In aggregate, investments managed by funds recorded a slightly higher leverage ratio as funds managed a greater proportion of later stage and debt/mezzanine investments across the SSBCI portfolio. See Figure 4-6 for SSBCI program metrics for VCPs that used the Funds strategy. The following state program summaries provide examples of various approaches taken by programs in the Funds category:

- **New Hampshire** – To stimulate institutional capital investment in an in-state venture capital fund investing in seed and early stage technology businesses, the state implemented a variation of a "first-loss" program in which the state VCP participates *pari passu* on fund profits but agrees to absorb the first 15 percent of fund losses via an adverse liquidation preference. Analogous to many lending programs, the goal was to lower the risk of loss for pension funds and university endowments that might otherwise perceive greater performance risk by investing in a venture capital fund limited to investing in New Hampshire small businesses.

- **Washington** – The creation of the $19 million "W Fund" was anchored by $5 million of SSBCI capital. The structure facilitated seed and early stage investments in technology businesses developed from intellectual property licensed from in-state universities.

- **Texas** – The second phase of the "Jobs 4 Texas" program supported the development of new venture capital funds developed by angel investor groups or first-time fund managers. The innovative program agreements restricted SSBCI capital to in-state investments while enabling the state to profit from out-of-state investments that deliver returns to fund co-investors, and granted above-market profits interests to fund managers in exchange for no management fees on SSBCI capital and priority distributions to accelerate the return of principal to the VCP.

State-Supported Entities (SSEs)

SSEs are non-profit or quasi-governmental entities that serve as the primary investment agents to manage SSBCI funds – they perform due diligence, make investment recommendations and/or decisions, and monitor investment portfolios. Entities in this category managing SSBCI capital under contracts with state programs include development finance authorities and venture development organizations that have public benefit missions aligned with state economic development interests. See Figure 4-7 for SSBCI program metrics for VCPs that used the SSE strategy.

Figure 4-7: SSBCI Metrics for the State-Supported Entities VCP Category, cumulative through December 31, 2015

SSBCI Metrics for VCPs with State-Supported Strategy	
Key Data:	
Number of VCPs w/SSE Strategy	23
SSBCI Allocation ($ millions)	$166
SSBCI Allocation (% of Total Allocation)	37%
Transactions (#)	482
SSBCI Original Funds Expended ($ millions)	$99
SSBCI Program Funds Expended ($ millions)	$96
**SSBCI Administrative Funds Expended ($ millions)*	$3
SSBCI Recycled Funds Expended	$707,923
Average SSBCI Support	$199,600
Average Investment Size ($ millions)	$1.1
Program Outputs:	
Percent Expended	57%
***Total Leveraged Financing ($ millions)*	$1,260
****Leverage Ratio*	12.7:1
Program Outcomes:	
Total Jobs Supported	8,538
Jobs Created	5,374
Jobs Retained	3,164
SSBCI Investments in LMI Communities (% of total number of transactions)	41%
Top 3 Industries Assisted (by number of transactions):	Professional, Scientific & Technical Services Manufacturing Information

* *Administrative expenses are weighted estimates prorated by proportion of program transactions to total VCP transactions*

** *Includes subsequent private financing*

*** *Includes weighted administrative expenses*

Deals managed by SSEs also run the full spectrum of the small business development stages. SSE-managed programs included VCPs in Arkansas, Indiana, Maine, Maryland, Missouri, Nebraska, Nevada, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, Virginia, West Virginia, and Wisconsin. The following state program summaries provide a snapshot of the SSE program category:

- **Oklahoma** – i2E (innovation to Enterprise) is a state-created and state-sponsored 501(c)(3) organization responsible for managing Oklahoma's entire SSBCI allocation via a contract with the Oklahoma Department of Commerce. Aligned with existing state-funded initiatives, i2E created the Accelerate Oklahoma! Fund with SSBCI funding to support technology businesses at multiple stages of development through mentoring services, leading investment rounds and supporting the syndication of investments from angel investors or out-of-state funds. i2E identified three gaps to address with SSBCI support: 1) post proof-of-concept "accelerator" investments ranging from $100,000 to $250,000 2) growth stage investments in established businesses needing greater than $1 million in new capital to expand product offerings or acquire new customers, and 3) "any stage" investments up to $500,000 designed to enhance angel investment activity in Oklahoma.

- **Pennsylvania** – Pennsylvania's Department of Community and Economic Development allocated $5 million of the state's $29.2 million allocation to a VCP. Seven state-supported non-profit organizations served as contracting entities for investing the funds: four regional Ben Franklin Technology Partners (BFTP) nonprofit organizations and three regionally-focused Life Science Greenhouses. These established programs have been leading seed and early stage equity investments in Pennsylvania small businesses for more than 32 years and 14 years, respectively. With SSBCI capital, the new program focused on supporting follow-on rounds in existing portfolio businesses that have achieved early milestones and need private capital to continue their development.

- **Virginia** – The CIT GAP Fund is a program managed by the Center for Innovation Technology (CIT), a state-sponsored non-profit organization. The Virginia Small Business Financing Authority (VSBFA) contracted with CIT to manage the $3 million CIT Gap Fund. The CIT GAP Fund invests in science- and technology-based startups with high-growth potential, and in many cases, CIT will lead or co-lead small equity investment rounds in seed stage businesses with the potential to develop and raise much larger follow-on investment rounds.

State Agencies

A small number of states engage directly in transactions in the State Agency category– they rely on state agency staff or contractors to source deals, perform due diligence, and recommend investment transactions. They typically make investment decisions based on input from an investment committee that includes private sector representatives. The model has nearly disappeared, partly due to concerns that government agencies may not meet the SEC's technical definition of an "accredited investor," which could potentially impose regulatory burdens on private businesses with state agencies as investors.

In addition, state agencies are more likely to face constitutional limitations on private equity participation, often creating investment scenarios where the state program cannot benefit from successful investments while accepting downside risk of investments. See Figure 4-8 for SSBCI program metrics for VCPs that used the state agencies strategy.

Figure 4-8: SSBCI Metrics for the State Agencies VCP Category, cumulative through December 31, 2015

SSBCI Metrics for VCPs with State Agencies	
Key Data:	
Number of VCPs w/State Agency Strategy	4
SSBCI Allocation ($ millions)	$28
SSBCI Allocation (% of Total Allocation)	6%
Transactions (#)	58
SSBCI Original Funds Expended ($ millions)	$22
SSBCI Program Funds Expended ($ millions)	$22
**SSBCI Administrative Funds Expended*	$331,700
SSBCI Recycled Funds Expended	$0
Average SSBCI Support	$380,900
Average Investment Size ($ millions)	$1.5
Program Outputs:	
Percent Expended	81%
***Total Leveraged Financing ($ millions)*	$157
****Leverage Ratio*	7.0:1
Program Outcomes:	
Total Jobs Supported	1,227
Jobs Created	794
Jobs Retained	433
SSBCI Investments in LMI Communities (% of total number of transactions)	21%
Top 3 Industries Assisted (by number of transactions):	Professional, Scientific & Technical Services Manufacturing Information

* *Administrative expenses are weighted estimates prorated by proportion of program transactions to total VCP transactions*

** *Includes subsequent private financing*

*** *Includes weighted administrative expenses*

States initially implementing a VCP managed by a state agency but then modifying their program strategy included Maryland, Illinois, Iowa, Ohio, and Alaska-Anchorage. Of these, Maryland subsequently transferred program responsibility to a SSE; Illinois deactivated its VCP when the program manager left for a private sector opportunity; Iowa engaged a for-profit venture advisory firm to effectively manage program operations; Ohio deactivated its VCP in favor of an established lending program; and Alaska-Anchorage shifted its allocated capital to an approved fund-of-funds program.[30]

30 The Municipality of Anchorage approved only one investment transaction through its State Agency program model.

Co-Investment Model

Co-Investment states set defined criteria for eligible investments and automatically match eligible private investments on a formulaic basis. These programs do not commit SSBCI funds to any entity for managing the investment process, a distinguishing feature from Funds and State-Supported Entities, where the state has entered into a contract with one or more entities to actively manage investment processes. See Figure 4-8 for SSBCI program metrics for VCPs that used the co-investment strategy.

Figure 4-9: SSBCI Metrics for the Fixed Ratio Co-Investment VCP Category, cumulative through December 31, 2015

SSBCI Metrics for VCPs with Co-Investment Models	
Key Data:	
Number of VCPs w/Co-Investment Strategy	5
SSBCI Allocation ($ millions)	$49
SSBCI Allocation (% of Total Allocation)	11%
Transactions (#)	123
SSBCI Original Funds Expended ($ millions)	$35
SSBCI Program Funds Expended ($ millions)	$34
**SSBCI Administrative Funds Expended*	$703,500
SSBCI Recycled Funds Expended	$0
Average SSBCI Support	$277,800
Average Investment Size ($ millions)	$1.7
Program Outputs:	
Percent Expended	71%
***Total Leveraged Financing ($ millions)*	$239
****Leverage Ratio*	6.7:1
Program Outcomes:	
Total Jobs Supported	2,428
Jobs Created	1,052
Jobs Retained	1,376
SSBCI Investments in LMI Communities (% of total number of transactions)	37%
Top 3 Industries Assisted (by number of transactions):	Information Manufacturing Professional, Scientific & Technical Services

* *Administrative expenses are weighted estimates prorated by proportion of program transactions to total VCP transactions*

** *Includes subsequent private financing*

*** *Includes weighted administrative expenses*

Co-Investment programs create an opportunity for more passive investment of SSBCI funds alongside private capital investors whether they use state agencies or state-supported entities as legal intermediaries. Co-Investment programs establish a process to define and approve the qualifications of small businesses or investors that are eligible to participate and apply for co-investment. A subjective review by the state program manager may or may not be part of the investment decision process as outlined below:

1. States implementing a Co-Investment VCP without subjective review include Tennessee, Indiana, and the District of Columbia.
2. States implementing a Co-Investment VCP with subjective review include Kansas and Minnesota.

4C. SSBCI Venture Capital Program Investment Activities and Characteristics

This section highlights observations about SSBCI venture capital investment activities from aggregate investment data reported by state program managers. Readers should note these observations relate to the SSBCI VCPs in aggregate and do not necessarily reflect the unique characteristics of each investment strategy implemented by states because of the variability in program design and local business environments. Primary observations include:

- VCPs deployed (expended or obligated) 69 percent of allocated capital through 2015.
- VCPs provided capital to small businesses in various stages of development, but particularly early-stage.
- VCPs supported small, young businesses.
- VCPs facilitated private investment leverage at time of initial and subsequent financings.
- VCP investments were concentrated in a small number of industry sectors.
- VCP investments were focused in urban areas.

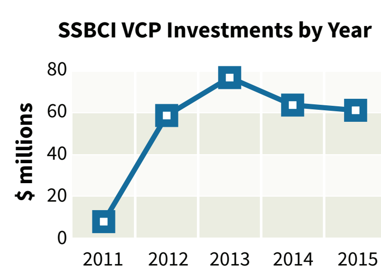
VCPs deployed more than two-thirds of allocated SSBCI capital between 2011 and 2015

Through December 31, 2015, VCPs had expended $266.7 million and obligated another $61.4 million either to small businesses or to venture capital funds obligated to invest the committed funds in small businesses. The VCPs started investing in 2011 and ramped up investing as approved programs established partnerships, sourced deals, and facilitated private investment (see Figure 4-10).

Figure 4-10: VCP Investment Activity by Year

SSBCI VC Investments	Number of Investments	*SSBCI Funds Expended ($ millions)
2011	25	$8.0
2012	215	$58.3
2013	339	$78.7
2014	383	$65.6
2015	362	$60.5
TOTAL	**1,324**	**$271.1**

*Does not include administrative expenses

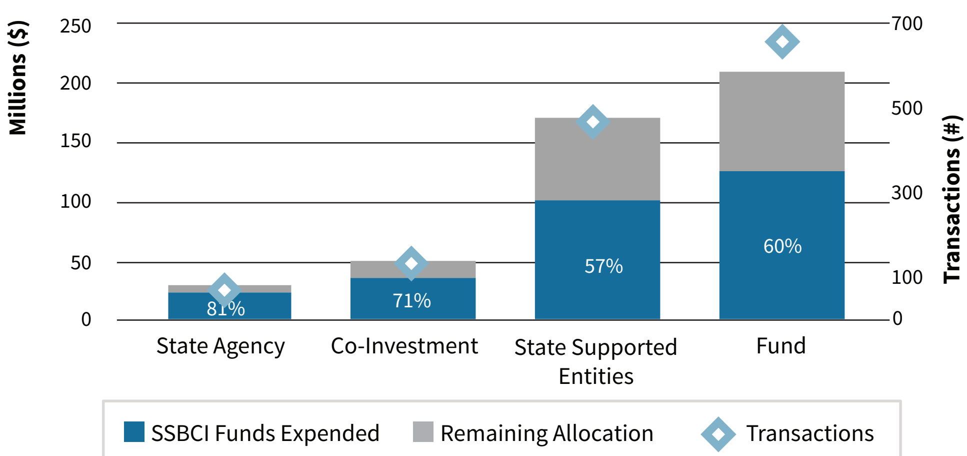


Co-Investment and State Agency programs expended a higher percent of VCP allocations than Fund and State-Supported Entities through 2015 (see figure 4-11). One possible factor contributing to this observation is simply the lower allocation amounts states made to these program categories (17 percent of the total VCP allocation). Also, the requirements to create legal structures to execute certain fund investment strategies impacted the speed of capital deployment.

The structural characteristics of certain types of investment strategies can influence how quickly capital can be deployed to small businesses. One objective of states implementing the Funds strategy was to establish new investment funds with a local presence to support small business capital needs. However, the process to raise a new fund and secure capital commitments is long, creating a timing obstacle between states providing support to new funds and those funds disbursing capital to small businesses. In addition, many Funds programs legally obligate capital to investment funds through contractual agreements prior to the funds expending capital via investments in small businesses. The legal obligation occurs when the funds are contractually engaged to manage committed capital, and expenditures occur typically over a 3- to 4-year investment period, with some funds held in reserve for follow-on investment rounds in the fund's portfolio businesses. Furthermore, the time required of states to manage the fund selection and contracting process, as well as the time required for new investment funds to "close" on capital commitments, can result in funds deploying more slowly.

In the case of SSEs, the SSEs may obligate capital to small businesses in advance of closing an investment round (expending the funds) for the purpose of enabling the small businesses to raise private capital co-investments. The time allowed between SSE commitment and required completion of the investment round varies by program from 90 days to one year.

Figure 4-11: SSBCI Investment Activity by VCP Category



VCP Category	Number of Investments	SSBCI Funds Expended ($ millions)	Allocation	Percent of Allocation Expended
State Agency	58	$22	$28	81%
Co-Investment	123	$35	$49	71%
SSE	482	$99	$166	57%
Fund	661	$122	$205	60%
TOTAL	**1,324**	**$278**	**$448**	**62%**

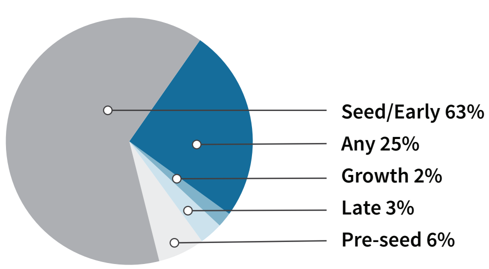
VCPs supported small businesses in various stages of development, particularly early-stage

SSBCI managers described their VCP investment strategies as focusing on small businesses in specific stages of development (although several made clear their intentions to invest in businesses at "any stage"), with the potential to generate financial and economic development returns.

The venture capital industry commonly uses terms such as "seed," "early," "growth" and "later" to describe the development stages of small businesses receiving venture capital investments;[31] however, stages of small business development are not always easily defined. State program managers used a wider range of investment stage definitions to characterize VCP strategies in their SSBCI applications. Typical small business investments reported by state VCPs vary primarily by these stages of business development rather than a characteristic of the program model, but information on stage of investment was not collected at the transaction level.

As illustrated in Figure 4-12, SSBCI VCPs developed strategies to support small businesses in various stages of development and particularly seed- and early-stage businesses, which represented 63 percent of proposed activities. By comparison, the NVCA reports that just 36 percent of venture capital investments are invested in seed and early stage businesses.[32]

*Figure 4-12: VCP Investment Transactions by Stage of Business/Investee**



Readers should note that SSBCI transaction data systems did not require states to report the development stage of small businesses, so data is not available to make precise statements about the development stages of businesses supported by SSBCI investments. However, the age of small businesses at the time of an investment, on a portfolio basis, serves as a reasonable proxy for concluding that state forecasts in their applications generally correlated to the actual small business investment activities. The following summaries of stage-based investments intended to be general descriptions of typical investments to help readers understand the diversity of investees.

Pre-seed or "proof of concept" investments

Prior to forming a business or at the time of business formation, many inventors seek small investments to prove technical concepts that demonstrate the potential value of their intellectual property. Also, "accelerator" programs may offer small capital investments, alongside mentoring and technical assistance services, to idea-stage entrepreneurs to help develop their business plans and working prototypes that may attract future investors.

Investments in **pre-seed stage** small businesses were most often from accelerators co-investing less than $50,000 or from angel investors. The risk of failure at this stage is high, so many small businesses struggle to find private capital to match the program's investment. With small businesses launched through accelerator programs, the value of the SSBCI capital investment and the private capital co-investment was often standardized for all program participants. With seed stage investments, the business value determination is sometimes deferred until a future

31 Op. cit., 2016 Yearbook. National Venture Capital Association.

32 Ibid. Page 13.

"institutional" investment round through the use of a convertible note structure, in which the loan value can be converted to equity with the same terms as the other investors.

Seed stage and early stage investments

Small businesses that have the founding team working to develop product prototypes or business model concepts are generally described as "seed stage" businesses. "Early stage" businesses are developing ventures with a strengthened management team and a proven concept or product ready for market introduction, but early-stage businesses are typically not generating positive cash flows from operating activities.

The terms of **early stage** investment transactions will vary by region. Small businesses raising early stage capital in regions with significant venture capital industry activity are far more likely to raise investment rounds of $1 million to $5 million. The vast majority of SSBCI VCP capital was invested outside these regions, so the typical early stage investment deal was less than $1 million.

State program managers confirmed that angel investors were important co-investors in early stage SSBCI investments and that SSBCI funds generally accounted for a higher percentage of each round, resulting in lower private capital match ratios than later stage investments. The convertible note structure is also used in early stage investments, but transactions were more likely to be structured as priced equity rounds, typically as preferred stock rather than the common stock held by founders and employees of the small businesses. The valuation of the business is determined by the amount of capital invested and related percentage of ownership purchased by the investors.

The median number of full-time equivalent employees at a business receiving SSBCI VCP investment was four, and more than 75 percent of the businesses supported were less than five years old.

Growth stage investments

Small businesses that have already received one or more rounds of equity investment and are generating significant revenues from one or more products are described as "growth stage," implying that their products or services are proven to have market viability and that invested capital will help them scale their business.

Many VCPs targeting seed and early stage investments had the flexibility to participate opportunistically in **growth stage** investment rounds, where the small businesses raised investment rounds of greater than $1 million after having achieved certain development milestones with capital from pre-SSBCI seed and early stage investors. Again, the size of rounds in this investment stage for many SSBCI investments is significantly lower than in regions with substantial VC activity, where growth stage investment rounds are often greater than $5 million.

Many SSEs used SSBCI capital to invest in follow-on rounds in small businesses in which they had invested in seed or early stage rounds with pre-SSBCI state capital. The terms of growth stage investments typically provide investors with preferred stock at specified valuations. The initial private capital ratios are higher for growth stage investments.

Late stage investments

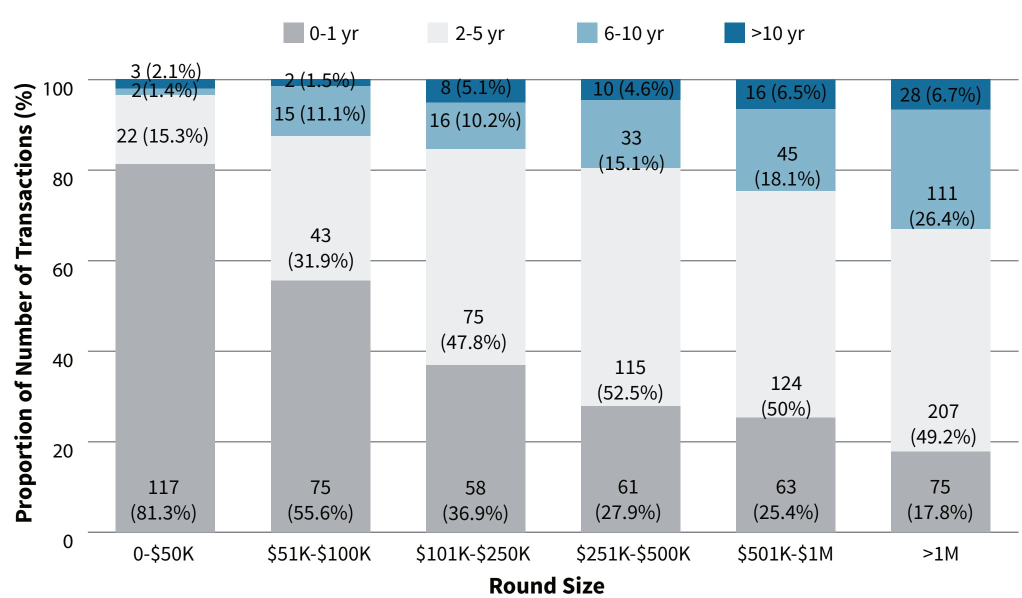
"Later stage" businesses have proven scalability during the growth stage and need capital to gain additional market share, diversify product lines, and prepare for a "liquidity event" that will enable equity investors to realize returns on invested capital. They include maturing small businesses with cash flows to service debt but other risk factors that disqualify them for bank loans, such as not having sufficient collateral or a track record of generating positive cash flows for a sufficient length of time. Note that while mezzanine and debt investments are excluded from the venture capital investment data reported by Thomson Reuters and published by PwC Moneytree and the National Venture Capital Association, these types of investments were reported as VCPs for SSBCI as they generally included equity components, such as warrants, to supplement the returns of the loans. States that opted for VCPs in this category appeared to place greater emphasis on near-term job creation than the majority of VCPs stimulating private capital investments in seed and early stage small businesses.

A small number of VCPs focused on **later stage** equity investments or **debt/mezzanine** investments in small businesses that were entering growth phases but not positioned to access debt markets. The typical size of a later stage or debt/mezzanine investment was greater than $5 million. VCPs typically structured later stage equity investments as preferred stock at specified valuations. Debt/mezzanine investments were typically structured as loans with stock warrants or royalties based on revenues.

VCPs supported small, young businesses with equity investment support

As shown in Figure 4-13, SSBCI VCPs reached small, young businesses. The median number of full-time equivalent employees at a business receiving SSBCI VCP investment was four, and more than 75 percent of the businesses supported were less than five years old. Furthermore, 92 percent of all VCP investment transactions involved businesses with 50 employees or less.

Figure 4-13: Business Age by SSBCI Investment Round Size

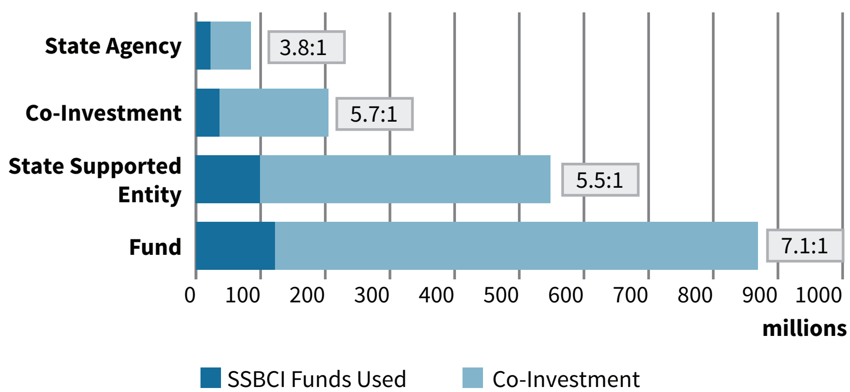


VCPs facilitated investment at the time of initial and subsequent financings

The ability of state VCPs to attract significant amounts of investment helped states implementing VCPs, and SSBCI overall, work to achieve the target private leverage goal of 10 to 1 across all approved programs. With few exceptions, SSBCI VCPs required at least a 50 percent co-investment from private investors on investment terms generally driven by the usual and customary terms of private investors.

The different VCP strategies demonstrated variability in the amount of private leverage generated from private co-investment, but all VCP categories attracted average private leverage of at least twice the SSBCI funding (see Figure 4-14).

Figure 4-14: SSBCI Investment and Direct Leveraged Financing by VCP Category

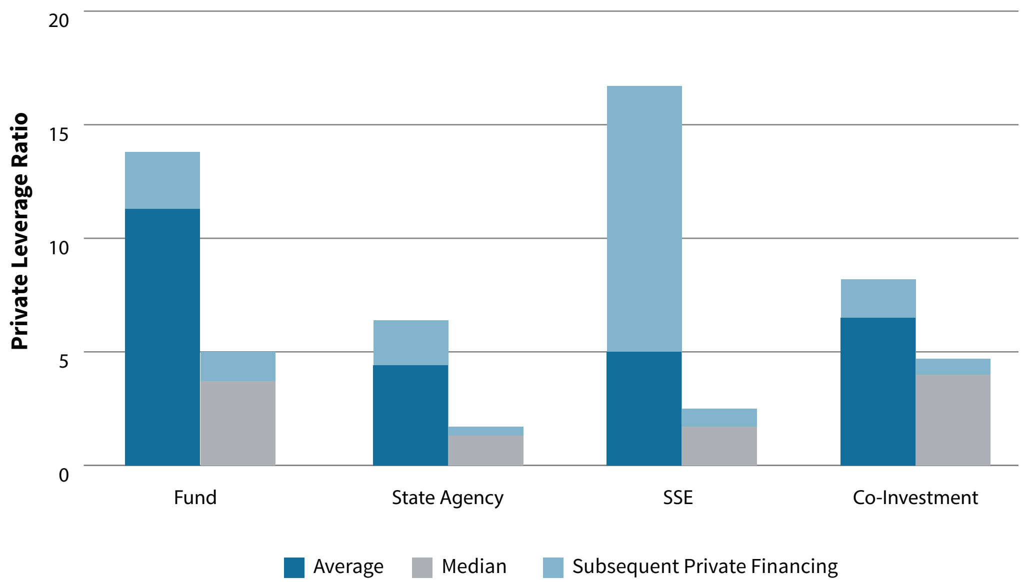


Direct Leveraged Financing does include financing leveraged with recycled SSBCI dollars, but does not include subsequent private financing

At the time of the initial investment transaction, Fund and Co-Investment strategies generated the highest private investment leverage at nearly double the private leverage amount achieved by the other program categories (see Figure 4-15). A likely reason for this outcome is the way states designed Co-Investment strategies to exclusively match private investment from qualified funds (e.g., minimum fund size in Tennessee). By defining eligibility criteria for qualified co-investors to include investment funds and exclude individual investors, Co-Investment transactions were similar to Fund transactions. Furthermore, with a more prescriptive approach to defining eligible transactions, including required ratios of private investment to SSBCI support, Co-Investment generated the highest median private investment leverage. State Agency and SSE strategies were more likely to attract investment leverage from individual investors, resulting in lower initial leverage calculations.

It is a customary practice for private investors leading seed or early stage investment rounds to reserve capital and plan to participate in future financing rounds as small businesses achieve milestones and require additional capital to continue developing. Many private investors also leverage personal networks to identify new investors managing larger pools of capital to lead follow-on rounds. All models have the potential to support investments that attract significant private investment across multiple financing events. This potential is reflected in the high maximum private leverage ratios across all program, with the SSE category having the highest overall leverage.

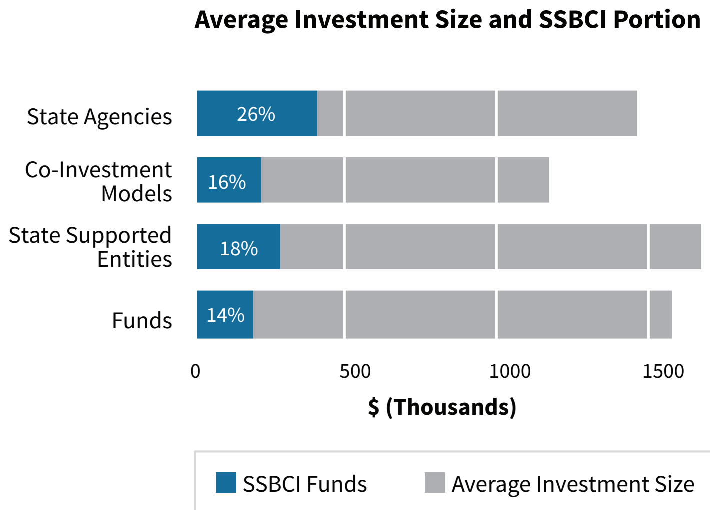
Figure 4-15: Private Investment Leverage for Initial and Subsequent Financings



Contracted private investment managers in the Funds category tend to invest in larger rounds of financing. Factors contributing to this observation include the ability of venture capital funds to attract other investors to co-invest in deals, and the tendency for funds to focus on growth-oriented investments.

The nearly 1,300 investment transactions across the SSBCI VCP portfolio indicate that that average SSBCI support was approximately 15 percent of the average investment round (see Figure 4-16). However, there was variation among program categories that reflects the differences in investment strategies, activities, and sources of private co-investment. SSEs and State Agencies tended to invest SSBCI funds at a higher proportion to private investment. Possible contributing factors include the focus of SSEs on earlier-stage businesses raising smaller investment rounds from angel investors and seed funds. States implementing Funds and Co-Investment strategies tended to support larger investment rounds requiring less SSBCI support in each transaction.

Figure 4-16: SSBCI Support as Proportion of Average Investment



VCP Category	Average Investment Size ($ in millions)	Average SSBCI Support	SSBCI as % of Investment
State Agencies	$1.5	$380,900	26%
Co-Investment Models	$1.7	$277,800	16%
State Supported Entities	$1.1	$199,600	18%
Funds	$1.3	$179,500	14%

Investments were concentrated in a small number of industry segments

In varying order, all VCP categories supported small business investments in the same top three industries of Professional, Scientific & Technical Services, Information, and Manufacturing. Figure 4-17 shows the top three industries assisted by SSBCI VCPs account for 80 percent of all investment transactions. These industries are increasingly driven by technology development and adoption, making them likely industry classifications for small businesses seeking equity investment. For small businesses in these categories, risk capital is often needed to perform the early work of identifying market opportunities and developing products or services before revenue can be generated.

The more detailed breakdown of industry sector distribution of SSBCI provided in Figure 4-18, which illustrates investments in technology-driven sectors accounting for the majority of VCP transactions.

Figure 4-17: Top Three Industries Assisted by SSBCI VC Programs

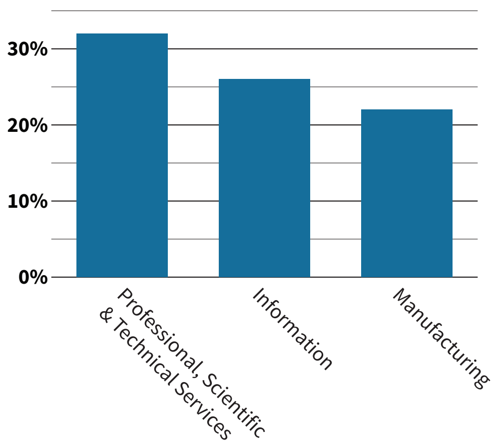
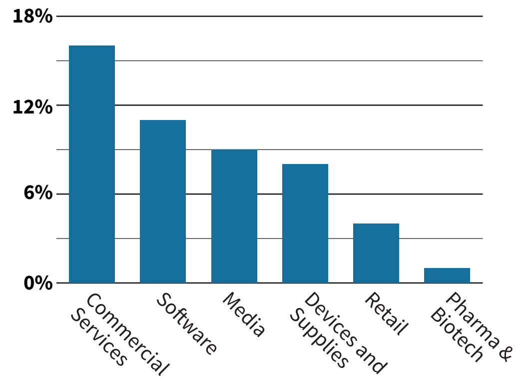


Figure 4-18: Industry Sectors Most Supported by SSBCI VC Programs



VCP transactions were primarily in urban areas

VCPs distributed investments across 33 diverse states; however, the investing environment for the full portfolio of SSBCI VCPs was mostly urban. Approximately 94 percent of all SSBCI venture capital investment transactions are made in urban areas.

State efforts to increase the availability and accessibility of risk capital often benefit metropolitan areas, where some level of concentration of entrepreneurial talent, academic institutions, corporate headquarters, and professional service resources exists. Developing small businesses, especially in the seed and early stages, are more likely to hire contractors and rent specialized equipment or facilities that serve multiple small businesses, so locating in urban areas is more efficient while they focus on achieving development milestones. Furthermore, sources of private capital required to match equity investments are more likely to be located in and around urban areas.

One objective of VCPs is to improve regional entrepreneurial and investment ecosystems so that they can better compete in attracting resources of talent and capital. Of the SSBCI VCP program categories, the Co-Investment strategy was most active in supporting non-metro investments, accounting for approximately 15 percent of the total co-investment transactions and 26 percent of the total non-metro investments made across all state VCPs. This observation driven by the geography of states and employing Co-Investment programs and the flexibility of Co-Investment programs to match investment from qualified investors wherever the investor identifies an eligible investment.

4D. State Goals and Business Environments Influenced SSBCI VCP Strategies

States employed a range of strategies to invest SSBCI funds through state VCPs, with each state's unique objectives influenced by the demand for equity financing and the presence of private investors. Program managers viewed these venture capital "demand" and "supply" considerations as critically important to achieving the expected outcomes of different VCP strategies. Regional business environments vary greatly – both between states and also within states – in their preparedness to attract private investment, so states worked to inventory the necessary components of their entrepreneur and investment ecosystems to implement the right corresponding strategy or combination of strategies.

On the investment demand-side of the equation, states worked to identify a realistic baseline of the estimated amount of venture capital investment resident businesses could attract if capital accessibility was improved. For example, states collected information from investment solicitation filings by businesses with the Securities and Exchange Commission, from interviews with small business founders/executives about fundraising needs, and by working with venture development organizations that assist small businesses with attracting risk capital investment. Based on this information and other data points, such as sponsored research expenditures and patent filings, states estimated how much capital the entrepreneurial ecosystem could absorb.

State VCPs worked to identify and support private investors in two primary classes: institutional venture capital funds and individual "angel" investors.

On the investment supply-side, states examined the availability and accessibility of equity-based capital from different types of investors in their target markets. With SSBCI requiring private investment match alongside the federal funding, taking inventory of the likely sources of private investment was viewed as a high priority by state program managers. Importantly, the types of private investors and the amount of capital available in states is not uniform. In mature investment ecosystems, the different but complementary investor classes are present and engaged at different points along the capital continuum. State VCPs worked to identify and support private investors in two primary classes: institutional venture capital funds and individual "angel" investors.

Venture capital funds with a presence in a state, whether resident to the state or serving the state through a branch office, are essential partners for supporting high-potential small businesses from early through growth stages of development. Because venture capital funds are concentrated geographically, states with more developed investment ecosystems were more likely to implement a program that contracted with a third party investment manager (the Funds model) or a Co-Investment program targeting qualified fund investors. States with few to no active venture capital funds located in their regions were less likely to implement a Funds model, opting instead for different strategy.

Individual "angel" investors can be found in most regions across the country. Angel investors are critically important in the start-up and early stages and in regions with few active venture capital firms. Angel investors supported over 7,000 deals contributing to more than $41 billion in investment in 2015.[33] In many cases, state VCPs looked to angel investors as the primary co-investors with SSBCI funding.

In some markets, angel investors actively collaborated through a network approach, often relying upon "lead investors" to conduct due diligence for the group or even contract with staff to manage the investment process with the members participating individually. In several states, SSBCI capital facilitated the formation of angel funds that allow individual angel investors to commit capital to a fund for more active investment management and portfolio diversification.

A large number of states have well-established state-sponsored organizations chartered with the mission to support the development of technology businesses for economic development purposes. Many of these entities, commonly referred to as Technology-Based Economic Development (TBED) or Venture Development Organizations (VDOs), have managed successful pre-seed, seed and early stage business investment programs for many years pre-dating SSBCI. Furthermore, these economic development entities not only make equity investments by managing VCPs, but also offer technical assistance to small businesses to help stimulate demand for investment. For example, i2E, a venture development organization in Oklahoma, uses a team of advisors to help entrepreneurs identify product/market fit for new concepts, develop business plans and investor presentations, and access non-dilutive and other sources of capital as appropriate. The organization has even authored its own book as a guide to entrepreneurial growth.[34]

In summary, states designed investment strategies and selected implementation partners based on each program manager's fundamental understandings of the entrepreneurial culture, supply of innovation, and maturity of small business investment ecosystems in each state.

4E. Return on Investment Measures Varied Across Venture Capital Programs

Beyond designing program structures to best fit the unique market environments of their states, state VCP managers also made an important determination in the program design phase – whether the VCP would strive to maximize financial returns from investments or prioritize other economic development metrics ahead of, but balanced with, financial return expectations.

Some VCPs prioritized financial returns on investment (ROI) as a leading performance metric and outcome necessary to build sustainable investment capacity. Proponents of this "ROI" approach recognized that profitable investments on the portfolio as a whole would eventually replenish the VCP's capital and enable it to continue investing on an "evergreen" basis, thereby furthering the reach of its economic development mission. The most cited benefit

33 *2015 Annual HALO Report.* Willamette University, Angel Resource Institute. 2015. Web accessed. (http://www.angelresourceinstitute.org/Research/Halo-Report/Halo-Report.aspx).

34 *The Entrepreneur's Path: A Handbook for High-growth Companies.* I2E, Inc. 2010. Web accessed. (http://i2e.org/publication/the-entrepreneurs-path/).

for prioritizing financial returns is the alignment of priorities with the private sector investors. However, because of the long time horizon of realizing profits from equity-based investments that will exceed the life of SSBCI, it is not possible to calculate, or even estimate, the financial return on investment of the VCPs.

Other VCPs invested with an expectation of financial returns from each transaction but also with the realization that the portfolio of equity investments in pre-seed, seed, and early stage small businesses may be challenged to generate a profit on invested capital. VCP managers with this perspective on financial returns viewed their programs as focusing resources on investments that could remove risk factors for follow-on investors. By choosing not to reserve VCP capital for participation in follow-on investments, managers of these programs willingly sacrificed the prospects for greater profits in order to provide more capital for small businesses needing assistance at the earliest development stages.

An important determination in the program design phases was whether the VCP would strive to maximize financial returns from investments or prioritize other economic development metrics ahead of, but balanced with, financial return expectations.

SSEs were most likely to consider other economic development considerations when making investment decisions, including but not limited to geographic or demographic diversity, leveraging intellectual property developed in universities, and complementary state economic development priorities. As a state-supported entity with a more than 30-year history, the Ben Franklin Technology Partners (BFTP) of Pennsylvania provides an interesting look into the strategies, considerations, and impacts of these venture development organizations.[35] When assessing their own performance, BFTP takes account of financial return as well as state tax receipts and jobs to be created.

With few exceptions, SSBCI VCPs were managed as state assets expected to generate financial returns in addition to stimulating private sector investments and related economic impacts. None of the VCPs granted capital to small businesses or their investors, although several VCPs provided various financial incentives to participating investors in the form of above-market carried interest or non-standard risk mitigation, such as accepting an adverse liquidation preference.

4F. SSBCI Impacts on State Entrepreneurial Ecosystems

Interviews with program managers yielded a number of common themes about the positive externalities of higher levels of venture investing due in part to SSBCI. Venture development

35 "Executive Summary: Achievement in Uncertain Times: The Economic Impact of Ben Franklin Technology Partners [2007-2011]." Pennsylvania Economy League. *A Continuing Record of Achievement.* 2013. Web accessed. (http://nep.benfranklin.org/wp-content/uploads/2013/06/BF_exec-summary_rvsd052313.pdf).

and human capital development were supported through the investment process of state VCPs. VCPs and their statewide partners address an important need in providing aspiring entrepreneurs with access to mentoring and connections to potential investors.

Furthermore, quasi-state and nonprofit organizations managed many of these small business investment programs, frequently with the help of private sector professionals. These organizations promote entrepreneurship programs, support technology transfer programs at research universities, host pitch competitions and angel investor conferences, mentor entrepreneurs, lead small investment rounds in early-stage businesses, and syndicate investment rounds with local and regional investors. It is not uncommon for these organizations to review 500 or more business plans for every 15 to 20 investments made. With each plan reviewed, the organization is helping to educate entrepreneurs in ways that improve business plans or refocus efforts toward more viable new ventures.

SSBCI helped revitalize state venture development efforts

A common theme highlighted by VCP managers was the timeliness of SSBCI allocations given the cutbacks or indefinite program deferrals that resulted from state budget cutbacks in 2010. In the broad scope of economic development programs, VCPs take a comparatively long period of time to result in tangible job creation, and the state fiscal environment created uncertainty in numerous programs, including long-standing efforts in states like Arkansas, West Virginia, Oklahoma, Missouri and Rhode Island. With the SSBCI capital infusion, these states and others were able to reinvigorate these programs, helping them retain or grow their capacity and create a larger pool of capital for future small business investments.

Venture Capital Programs support long-term job creation and economic growth

★ ★ ★ ★ ★

VENTURE CAPITAL SUPPORTS

Economic Growth

Innovation Development

Job Creation

★ ★ ★ ★ ★

Venture capital is commonly cited as a significant driver of economic growth, innovation development, and job creation. For example, data from a recent academic study shows that 38 percent of the 8.1 million employees in public companies founded in the past 40 years were employed by companies that received venture capital investments during their early development stages. Venture-backed firms represented 43 percent of similarly aged public companies and accounted for 58 percent of the market capitalization and 83 percent of R&D expenditures by their peer group.[36]

Many state VCPs had these ultimate outcomes in mind when they projected substantial job creation data for their programs – 49,000 jobs by 2016 from the $366 million of capital allocated to VCPs at the SSBCI program's outset. But, it is important to note that job creation is the most difficult outcome to forecast from venture capital investments, especially when the portfolio is comprised mostly of seed and early stage investments. States with substantial experience managing state-sponsored VCPs were typically more conservative in their job creation projections.

States report the number of full-time equivalent employees at small businesses at the time

36 Gornall, Will, & Strebulaev, Ilya .A. *The Economic Impact of Venture Capital: Evidence from Public Companies.* Stanford University Graduate School of Business Research. Paper number 15-55. 1 November 2015. Page 6, Table 3. Web accessed. (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2681841).

of the SSBCI investment and the small business owners' projections about the number of jobs expected to be created within two years of the investment. Most early-stage businesses attracting venture capital do not have sufficient track record nor enough information about their future markets to truly know what the impact will be on their employment needs. Furthermore, even if the businesses could make a reliable projection, it is highly uncertain which businesses will actually be successful and create the jobs they estimated and which businesses will survive to the next phase of their development.

Taking into consideration modifications that increased the total VCP allocation to $448 million, investees reported jobs created or retained through December 31, 2015, as 19,191, or 39 percent of the cumulative projections. With few exceptions, state managers view VCPs as a long-term strategy to create jobs.

4G. SSBCI Addressed a Gap in Federal Programs for Equity-Support of Innovation

The federal government provides support for technology-based economic development in a variety of ways. Federal support for innovation infrastructure is provided through competitive grants to research institutions from federal agencies such as the National Science Foundation ($7.5 billion annual budget[37]) and the National Institutes of Health ($32 billion annual budget[38]). Innovation development support is provided through Small Business Innovation Research (SBIR) grants from eleven federal agencies that foster technology commercialization partnerships with small businesses ($2.2 billion[39]). To provide financial support for small business, the federal government supports subsidized growth capital through the SBA Small Business Investment Company (SBIC) debentures program that loans capital to qualified investment managers with matching private investment.[40] Credit enhancement programs are administered by more than one federal agency, including a portfolio of SBA loan programs[41] and the Department of Agriculture.[42]

In addition to providing capital for small business investment through the SBIR and SBIC programs, the federal government also invests in building regional entrepreneurial capacity by supporting venture development organizations and related initiatives. For example, regional entrepreneurial development is encouraged through regional innovation grants from the Economic Development Administration (EDA) within the Department of Commerce. The EDA's Regional Innovation Strategies Program,[43] authorized through the America COMPETES Act of 2010 and appropriated funding in 2014, offers grant funding opportunities to strengthen regional communities and provide technical assistance for developing plans for seed investment funds.

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37 "NSF at a Glance." National Science Foundation. Web accessed. (http://www.nsf.gov/about/glance.jsp).

38 "Budget." National Institutes of Health. Web accessed. (http://www.nih.gov/about-nih/what-we-do/budget).

39 "About SBIR." U.S. Small Business Administration, Small Business Innovation Research Program. Web accessed. (https://www.sbir.gov/about/about-sbir).

40 "SBIC." U.S. Small Business Administration, Small Business Investment Corporation. Web accessed. (https://www.sba.gov/sbic/general-information/program-overview).

41 "Loans & Grants." U.S. Small Business Administration, Small Business Investment Corporation. Web accessed. (https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs).

42 "Programs & Services." U.S. Department of Agriculture, Rural Development. Web accessed. (http://www.rd.usda.gov/programs-services).

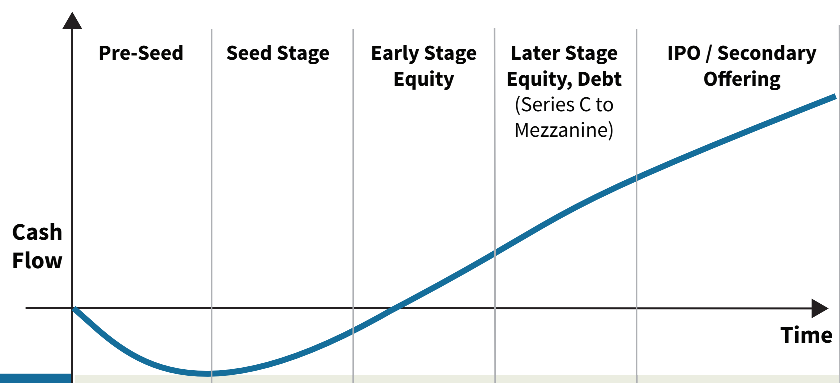
43 "Regional Innovation Strategies Program (RIS)." U.S. Department of Commerce, Economic Development Administration. Web accessed. (https://www.eda.gov/oie/ris/).

To a much lesser degree, the federal government has supported equity investments in small businesses. The SBIC Participating Securities program that encouraged equity-oriented investing ended in 2004,[44] with SBICs since that time structured to support later-stage investments. The more recent efforts by the SBA to encourage early-stage investing through "Early Stage" SBICs[45] is an important program, with five licensed funds, but the program's loan repayment terms remain a challenge to supporting early-stage business investment opportunities due to the long-term, illiquid nature of early stage investing.

In contrast, more robust capital formation experiments with equity support initiatives have been conducted at the state level, with some states allocating funds to equity finance programs nearly continuously for more than 30 years.[46] Other states have experimented intermittently with various venture development and equity support programs.[47]

As shown in Figure 4-19, while innovation and venture development are supported nationally by federal programs – SBIR grant funding to small businesses for innovation development at the seed stage and SBIC funding support for growth-stage financing – a critical gap exists for federal support along the capital continuum for early-stage equity investment. It is at this critical early stage equity financing gap that many states used SSBCI funds to support state VCPs designed to stimulate private financing in high-growth potential small businesses.

Figure 4-19: Equity-based Capital Continuum for High-Growth Businesses



Private Sources of Capital	Angel Investors, Accelerator and Seed Funds		Venture Capital Funds		Public Markets
Direct Federal Support (Equity)	SSBCI				– –
				SBA SBIC USDA RBIC	
Other Federal Support (Grants)	SBIR / STTR, Commerce EDA		Commerce EDA, SBA		– –

44 Dahlstrom, Timothy R. "The Rise and Fall of the Participating Securities SBIC Program: Lessons in Public Venture Capital Management." Perspectives in Public Affairs. Vol. 6, No. 1. Pages 64-83. Arizona State University. 26 May 2009. Web accessed. (http://www.academia.edu/8114631/The_Rise_and_Fall_of_the_Participating_Securities_SBIC_Program_Lessons_in_Public_Venture_Capital_Management_-_Perspectives_in_Public_Affairs_Vol._6_No._1_pp._51-68_Spring_2009).

45 "Office of Investment and Innovation: SBIC Early Stage Innovation Program." U.S. Small Business Administration, Office of Investment and Innovation. January 2016. Web accessed. (https://www.sba.gov/sites/default/files/articles/OII_Early_Stage_Slide_Deck_January_2016.pdf).

46 "About." Ben Franklin Technology Partners. Web accessed. (http://cnp.benfranklin.org/about/).

47 "Resources." Economic Development Partnership of North Carolina. Web accessed. (http://www.thrivenc.com/businessservices/financing-and-capital).

4H. Program Manager Commentary on VCP Challenges and Lessons Learned

This section summarizes reflections from state program managers about the challenges and lessons learned during the implementation of SSBCI. State managers had the flexibility to create their own programs, but they had to fit within federal rules and guidelines that did not always align with common publicly supported venture management practices. As a result, some SSBCI requirements resulted in states needing to adjust investment processes that were already in place for existing programs. The basic realities of equity financings – subjective investment decisions, pooling of capital into fund partnerships from multiple sources, extended timeframes for fundraising, investment and liquidations – create unique challenges and risks for managers of equity support programs.

State program managers raised a variety of issues for states to consider when designing and implementing VCPs.

- **Program managers recommended defining conflicts of interest policies at the outset of any federal or state program**. During the implementation of SSBCI, the federal rules on conflicts of interest evolved to better align with the standard operating procedures of venture capital investors.[48] However, changes during the program created uncertainty and disrupted the pace of deployment as some states adjusted their processes.
- **Program managers recommended setting realistic expectations on the amount of time required to establish new VCPs.** This advice is especially relevant for a Fund strategy that uses third party contractors for managing the investment process and might be dependent on raising capital from outside sources. In some states, like New York, the process to competitively select and engage private investment managers (i.e., finalize partnership agreements) took longer than originally estimated and delayed the starting point for investing SSBCI funds. In other states, like Washington and New Hampshire, the amount of time needed for the selected fund managers to raise the target amount of private capital and "close" the investment funds took longer than anticipated.
- **When accepting federal funds to support small business financing programs, states accepted the responsibility to account for the federal funds at all times.** Accounting for SSBCI funds in VCPs was generally viewed as straightforward for the program categories of State-Supported Entity, State Agency, and Co-Investment programs. However, some Fund state VCPs opted to invest SSBCI funds as a "Limited Partner" in fund partnerships, having an ownership position in the total fund and not restricted to the in-state investments. States investing in the full partnership created new challenges to track and account for the flow of SSBCI funds once the capital became fungible alongside other funding. By comparison, other Fund state VCPs established isolated "side car" funds for investment managers to use for in-state investments.

48 Initially, SSBCI conflicts of interest rules prohibited investments in businesses controlled by an SSBCI insider (e.g., someone involved in the investment decision or relatives of that person) Treasury guidance referred to definitions in Banking Regulation O. However, applying Regulation O definitions for "control" and "insider" to VCPs created serious implementation challenges for state program managers. First, and most importantly, using the banking regulation definitions created the unintended consequence of prohibiting follow-on investments by SSBCI-funded VC programs, which is a standard, beneficial practice in equity-based financing. Second, the process of determining control was overly complicated and burdensome for program managers and program contractors.

- **Sufficient staff capacity to sustainably manage VCPs was viewed by states as a critical success factor, a challenge made more difficult by the cap on allowable administration fees.** State VCPs often faced competing priorities for attention from program managers, as well as turnover by key staff. This was documented for all program categories, with State Agency and State-Supported Entity categories being most impacted by staff capacity issues. Furthermore, with VCPs, states assume significant program management responsibilities after the initial investment, because equity investments can be held for many years before a liquidation event.

- **State program managers reflected on the importance of designing flexibility into state program rules in accordance with the federal requirements.** In other words, establishing small business investment parameters at the state level that are overly prospective or confining can delay fund deployment to small businesses. States can balance flexibility in setting appropriate investment parameters with both federal policy mandates and state program objectives (e.g., supporting early-stage businesses). Furthermore, states considered how to creatively manage VCPs when the federal requirements resulted in management obstacles. For example, the administration fee structure allowed by SSBCI did not align with market expectations of private investment fund managers. Most states implementing Fund programs had to design alternative compensation agreements to engage investment managers, such as increasing the profit share in exchange for lower annual administration fees charged.

Chapter 5

Concluding Comments

Program Evaluation of the U.S. Department of Treasury State Small Business Credit Initiative

Center for Regional Economic Competitiveness & Cromwell Schmisseur

OCTOBER 2016

SSBCI

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Chapter 5:

Concluding Comments

In implementing SSBCI, states experimented with different program models and various terms and conditions to address barriers small business owners and entrepreneurs face in obtaining capital to start and grow their businesses. SSBCI provided state program managers with broad discretion in deciding how to deploy capital to small businesses and leverage private capital.

While SSBCI defined rules in areas such as administrative cost limits, use of proceeds, and conflict of interest policies, states were otherwise encouraged to either support existing successful programs or innovate to address small business capital needs with new programs.

This chapter summarizes the consultants' conclusions and general observations about what SSBCI has accomplished and what lessons it offers in informing future federal or state small business financing programs.

5A. Key Program Outcomes

- **SSBCI implemented a federal-state-private economic development collaboration that state leaders described as an effective model.** States gained greatest attention from lenders and investors by building on their capacity to understand local markets and by remaining flexible in providing state-specific solutions.

- **SSBCI provided states with the flexibility to design customized small business capital support programs for meeting unique business financing needs.** States are better positioned than the federal government to identify local capital needs, create an integrated businesses assistance system, and manage programs with local partners.

- **Most states received all of their funds from Treasury and expect to deploy them by before the Allocation Agreements expire in 2017.** Out of 57 participants, 55 received their second disbursements and 46 received their third and final disbursements by December 31, 2015. The states that deployed their SSBCI funds quickly were more likely to have developed products that capital markets valued and that met the needs of small businesses. Many also had pre-existing relationships with lenders and investors that helped to adapt the products to market needs.

- **States were able to expend their funds more rapidly if they had existing management capacity to implement financing programs and adapt to market needs.** States that implemented programs accepted readily by the market tended to have experienced staff in place. For other states, the process of identifying personnel and formulating program guidelines delayed initial progress. Even so, many states that created new programs were also effective because they were able to attract experienced staff.

- **Treasury's role as a convener was instrumental in promoting state-defined best practices and sharing new state program models.** SSBCI created a large collection of state experiments in both lending and equity-based capital formation that provides the opportunity to share information on evolving state program models, program principles, and best practices. State leaders have limited resources available to them when considering capital program options, and this information should be viewed as a resource and made easily accessible for review in the future.

5B. Lessons Learned from Credit Support Programs

Program Design

- **States endeavored to design credit support programs that addressed specific local credit gaps and responded to local market needs.** The program designs reflected economic realities, adapted to local capital needs and state banking practices, and used flexible program designs and terms. For example, several states implemented CSPs in response to declining business asset values that are typically used as collateral for loans. Throughout the country, community banks and CDFIs used SSBCI to address unique borrower needs and to finance start-ups and nonprofits.

- **The most widely used programs incorporated input from local banking and non-bank financial institutions in the design process.** Lender input during both the design and implementation stages tended to influence key program features and increase lender interest in the program. States most commonly engaged community banks and CDFIs. Financial institutions with an identified commercial lending core were most active. CDFIs were particularly important in supporting investment in low- and moderate-income areas.

- **Objectives changed in response to evolving economic conditions.** Successful states designed multiple programs to meet a spectrum of small business credit needs as they evolved in the aftermath of the recession. For example, some states designed programs to support businesses of varying sizes, at different stages of development, or serving specific industries. Many states reallocated funds as new capital gaps emerged or market conditions changed. Even as the economy recovered, states continued actively using SSBCI, suggesting that states sought to fill important structural capital needs beyond those required for stimulus.

- **Credit support programs that subordinated the state's position on collateral to the lender achieved faster market acceptance than pari-passu programs.** Lenders appreciate programs that focus on filling the collateral gap in small business lending because it allowed them to honor financing commitments even if a collateral appraisal is lower than expected; this was a particular challenge immediately after the recession when collateral values were unusually depressed. Even so, successful programs ensured that lenders were sufficiently at risk to maintain the full integrity of their underwriting process.

- **Expectations for private leverage shifted.** Many states struggled with achieving the overall 10:1 leverage ratio when measured only through initial deployment of funds. Aside from CAPs, the other program models relied on recycled funds to achieve their targets. SSBCI's authors envisioned CAPs as an important part of the program and leverage ratios above 20:1 were relatively common for CAP. However, ultimately that program type did not appeal in the marketplace and many states had to rely on alternative credit enhancement programs that were more likely to leverage new lending at a rate of 6:1 or 7:1. New programs designed to meet current market needs often had even lower leverage ratios. This information provides a good benchmark for future lending and investment program support that reflects what banks and other lenders require to address the credit gaps associated with otherwise creditworthy borrowers.

Operations and Compliance

- **The choice of administrative agent impacted performance.** States had the option to select partners to help implement their SSBCI financing programs. States with legacy credit programs had a head start in identifying partners, but states that created new programs experimented with new types of partners and delivery systems. For example, several large states with dispersed populations and those with no legacy programs chose to work with or through statewide non-bank CDFIs and BDCs. Even so, states with quasi-public agencies already in place were the most active in deploying funds rapidly while also adapting their programs quickly.

- **Continuous and consistent marketing drove success.** All programs, but especially states without legacy programs, benefited from reaching out to active small business lenders in their market on a continuous basis using a broad range of means including through state bankers' associations, small business development centers, regulatory agencies, websites, newsletters, and others.

- **Reaching underserved communities required a robust program, network of partner lenders, and consistent marketing.** No single approach to targeting underserved communities worked for all programs. Focused marketing, especially through networks already connected to targeted communities, technical assistance to mission-oriented intermediaries, and the identification of specific goals for targeted lending and investment helped to improve SSBCI performance in underserved communities.

- **State programs sought to incorporate design elements aligned with market practices.** State programs that adapted their processes and procedures to local capital market needs and state banking practices appealed to lenders. Market-responsive processes, provisions, and terms helped programs to fulfill their objectives of leveraging private capital for small business lending, especially in low- and moderate-income areas. Successful programs reduced paperwork by allowing lenders to use their own forms and closing documents, minimized the need for re-underwriting of credit decisions, and reduced the time for processing loan applications made through lending partners.

- **Small banks and CDFIs originated the largest share of loans under SSBCI.** Although there were hundreds of CDFIs and small banks that participated in the program, "power users" accounted for a significant number and dollar volume of SSBCI transactions. Engaging these committed lenders drove the program's success providing capital to small businesses. CDFIs tended to represent smaller loans and had high leverage ratios, especially because they engaged with CAPs, particularly and the California CAP which represented nearly three-quarters of all CDFI loan transactions nationwide. While small lenders made more loans, large banks had difficulty adjusting their products, credit underwriting, and compliance programs to state specific SSBCI requirements.

5C. Lessons Learned from Venture Capital Programs

Program Design

- **Many states customized SSBCI VCPs to work within local market conditions for equity investors, which can vary significantly from state to state and region to region.** The success of VCPs depended on the ability of state program managers to accurately identify and address risk capital financing gaps within the unique entrepreneurial and investment ecosystems of their particular state. States vary greatly in terms of both entrepreneurial capacity (which creates demand for equity financing) and private investment capacity (which provides the local supply of capital), creating the need for customized VCP strategies.

- **States often worked to develop a portfolio or "continuum" of state small business finance programs to address capital needs across the investment/development stages of high-growth potential businesses.** States that developed a complementary portfolio of small business finance programs communicated the need to support businesses from the early-stage through the growth stages to increase the likelihood of success and keeping the business in state.

- **Establishing a base of local investors, specifically local venture capital funds, was a critical success factor for supporting high-growth entrepreneurship, innovation development, and regional economic diversification.** SSBCI helped stimulate investment from different types of private investors, with many states intentionally supporting the formation of new investment funds or local offices for existing out-of-state investment funds.

- **State program managers shared experiences and collaborated on developing best practices for designing and operating VCPs.** Equity support programs are an emerging field of practice in economic development, and SSBCI has contributed valuable program experiments, data and lessons learned that improve understandings at the state and federal levels. This national network of experienced venture capital program managers as well as state agency and state-sponsored nonprofit leaders designing and implementing capital programs not only helped make SSBCI successful but also improved this field of economic development by making more information available on the processes, practices and structures of state VCPs that will benefit future programs.

- **Equity investors welcomed states and SSBCI resources as partners.** State engagement not only helped to increase capital available for equity financing, but it was also seen as critical in developing the entrepreneurial ecosystem. Investors considered it important that state staff learn about local venture capital networks, local ecosystems that could serve the small business equity market, and potential private-sector partners within their states.

Operations and Compliance

- **States vary widely in their available institutional infrastructure to design, manage and/or oversee equity investment programs.** While some states operated small business investment programs consistently or continuously for many years prior to SSBCI, many states either had no preexisting programs or had funded them inconsistently. The federal government is better positioned to address economic challenges if states maintain a base level of small business investment programs and are prepared to deploy capital to small business development ecosystems. The right infrastructure – legal entities, personnel, and processes – is necessary to efficiently and effectively implement VCPs.

- **For VCPs, effective marketing and outreach strategies varied by the type of program.** In State Agency and Co-Investment programs, the state maintained primary responsibility for communicating the benefits of program participation to both potential funding recipients and private co-investors. With models using third party entities – non-profit or for-profit – to manage the program's investment process, the external investment manager maintained the responsibility for effectively attracting investees with support from the state administrator. Many states actively marketed their programs through regional and statewide economic development partners, with an online informational resource guide and contact point to make it easy for interested parties to learn more and apply for funding.

- **States were often challenged to clarify expectations about what outcomes should be achieved and when, including how to measure and report results at different points during program duration.** While job creation is a traditional economic development measure, equity investments typically require many years before businesses begin their longer-term employment growth phase that generates financial and economic returns. Instead, the private investment leverage ratio is a more relevant metric in monitoring impacts within the control of program managers. Also, equity program managers should emphasize measuring outcomes on a portfolio basis, understanding that many individual businesses will ultimately fail and a small number of highly successful small businesses will be responsible for the vast majority of economic development returns.

- **A valuable byproduct of SSBCI was the creation of a national network of practitioners interested in documenting and sharing detailed information on capital formation program experiments.** This network consists of experienced venture capital program managers as well as state agency and state-sponsored nonprofit leaders designing and implementing first-time capital programs. Creating this network of practitioners not only helped make SSBCI successful but also improved this niche field of economic development by making more information available on the processes, practices, and structures of state VCPs that will benefit future programs.

PROGRAM EVALUATION OF THE US DEPARTMENT OF TREASURY
STATE SMALL BUSINESS CREDIT INITIATIVE

OCTOBER 2016

PREPARED BY

CENTER FOR REGIONAL ECONOMIC COMPETITIVENESS

CROMWELL SCHMISSEUR