we believe there is an even greater need today. While the SBIC program has assisted many small business concerns since its creation, the program has yet to fulfill the potential envisaged for it by the Congress.

Studies of the industry have clearly demonstrated that larger SBICs are essential; that increased profitability is necessary to attract more private capital to the program; and that it would be desirable for SBICs to give greater emphasis to equity-type financing of small concerns.

Analysis of results under the program to date indicates that it is extremely difficult for a small SBIC to operate both properly and profitably. A disproportionate number of the violations of SBA regulations have been perpetrated by smaller SBICs. At the same time, the inability to generate sufficient revenue to support a professional full-time staff has made it virtually impossible for many of the smaller SBICs either to make the kind of comprehensive investigations prior to investment which are necessary for stable and profitable operations, or to provide continuing advisory services to portfolio concerns. Statistical data on the industry shows that, while the largest SBICs reported a 3.3 percent return on invested capital, the smallest size category reported a 2.3 percent loss on invested capital. We have concluded that profitability of SBICs is closely related to size; up to a level much larger than the average SBIC in today's industry, the larger the concern, the greater are the earnings on the dollars invested. We believe that at least $1,000,000 private capital is needed for successful operation.

It is essential that additional funds be attracted from the private sector into the SBIC program. While the proportion of Federal injection into the program has been somewhat less than that originally anticipated ($260,000,000 in Federal funds, compared to $475,000,000 in private capital), there is clearly a need for additional private investment, and there is reason to believe that those additional funds will not be forthcoming without major changes in the program. There have been very few public offerings of SBIC stock in the last several years, and most SBICs have considerable difficulty in attracting private loan or equity funds to increase the size of their operation. In order to attract increased investment, it is necessary not only to make the SBIC a more profitable operation, but to increase the leverage which is available to the SBIC itself. For the first time since the inception of the program, the industry as a whole showed a profit during the last reporting year. However, that profit is not adequate to make the SBIC an attractive investment, compared to alternative uses of investors' funds.

One of the most attractive forms of SBIC investment, from the point of view of the small business concern receiving the funds, is provision of equity capital. Yet, for a variety of reasons, SBICs have not engaged sufficiently vigorously in this form of investment: some 50 percent of SBIC investments are in the form of straight loans, about 33 percent in convertible debentures and loans coupled with options or warrants, and only about 17 percent in stock-purchase transactions. Our study indicates that the most profitable operations can be expected from SBICs which place at least 65 percent of their funds in investments other than straight loans, i.e., in equity or loans with equity features. To carry out adequately the purposes of the program, it is therefore essential that this form of investment be encouraged to the maximum extent feasible.

In order to achieve these aims of increased size, attracting more private capital and encouraging equity investments, legislation to amend the Small Business Investment Act is proposed concurrently, in a bill which would:

1. Establish a minimum SBIC private capital investment of $1 million;
2. Provide for Government loans on a two to one ratio to private capital, to a maximum of $7½ million; and
3. Provide additional leverage up to $2½ million to larger SBICs, as an incentive for greater investment in equity type financings.

This program legislation and the tax amendments form an integrated plan for remedying the major problems which have hampered the SBIC industry. Enactment of both bills is therefore vital to the future effectiveness of this promising Congressional vehicle for helping to supply the growth capital needs of small concerns.

TYPES OF FINANCING BY SBICS

A primary purpose of these tax proposals is to amend certain provisions of the Internal Revenue Code which operate to encourage SBICs to make straight loans rather than equity-type investments. In order to understand the effects of these provisions, it is helpful first to survey the methods which SBICs employ to provide funds to small concerns.

There are three basic financing techniques used by SBICs: (1) straight loans; (2) direct purchases of stock; and (3) debt transactions with equity features, including convertible debentures and stock purchase options or warrants.