An Overview of Small Business Investment Company Funds

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Summary of Commerce Street Capital

Commerce Street Capital, LLC, is a premier investment banking firm serving financial institutions and middle-market companies. We value collaboration with our client partners and enjoy building long term relationships established on a foundation of mutual respect, common goals, and uncommon integrity. Led by veterans of the financial services industry, Commerce Street Capital's practice includes:

- Mergers & Acquisitions
- Recapitalizations
- Private Placement of Debt & Equity
- Regulatory Advisory
- Valuations & Fairness Opinions
- Community Bank Capital Markets Services
- SBIC Fund Raising
- Corporate & Real Estate Finance
- Due Diligence Services

What is the Value Proposition for a Bank to Invest in an SBIC Fund?

• Banks invest in Small Business Investment Company ("SBIC") funds for three key reasons:

- Returns – The returns for banks on their investments in SBIC funds should be compared to other CRA-eligible investments. Many banks' CRA investment portfolios consist solely of mortgage-backed securities ("MBS") which are often federally insured and finance single-family homes in the bank's Assessment Area. However, some banks approach CRA investing by setting aside a portfolio of their CRA investment portfolios for SBICs and other non-MBS investments.

- CRA Credit – Banks receive CRA credit (under the Community Development Test or the Investment Test, under the Intermediate Small Bank and Large Bank CRA exams, respectively) for investments in SBIC funds that actively market to companies in the bank's Assessment Area. The fund's activity is often evidenced by a CRA Side Letter between bank investors and the SBIC Fund.

What is the Value Proposition for a Bank to Invest in an SBIC Fund? (continued)

- Banks invest in Small Business Investment Company ("SBIC") funds for three key reasons:

    - Cross-sell opportunities – Banks are able to benefit from their investments in SBIC funds through:
        - Banking Services for the Fund's Portfolio Companies – As SBIC funds identify loan and investment relationships with companies, those businesses often need banking relationships for cash management, lines of credit, and letters of credit.
        - Refinancing – SBIC funds often exit their loan positions through refinancing by a bank; the Principals of a fund often make these opportunities available to the fund's bank investors.
        - Referrals – Funds often identify companies that are better suited for bank financing (based on the company's proposed Sources & Uses of funds and the company's financial projections); these referral opportunities arise through the relationship between a bank's C&I lending team and the Principals of an SBIC fund.

What are Key Risks for Banks in Investing in SBICs?

• Risk: Liquidity – The secondary market for an investments in SBIC Funds is illiquid. However, if an investor intends to sell its investment in a fund, that investor would be able to offer its share pro-rata to the fund's other investors. This would likely be done at a discount to the carrying value of the investment. As banks review potential SBIC fund investments, they will note that the fund's projected returns compensate investors for the illiquid nature of the investment.

• Risk: Control – Investors in SBIC funds are Limited Partners and cede decision-making rights over the fund's loans, investments, and management to the fund's General Partners (i.e. its Principals). This risk is typically mitigated by the Principals' professional experience and track record in managing prior funds. Additionally, SBIC funds typically communicate regularly with their investors via quarterly financial reporting (which typically includes valuations of portfolio companies) and maintain a dialogue with bank investors to discuss trends in the bank's local market.

What are Key Risks for Banks in Investing in SBICs?

• Risk: Credit – SBIC funds often provide financing that is more aggressive than banks would provide. To compensate for the increased risk, SBIC funds often charge their portfolio companies higher interest rates on loans and are also compensated through warrants, other equity instruments, and payment-in-kind arrangements.

Investors can mitigate the additional credit risk by understanding an SBIC fund's risk management policies (incl. loan covenants typically included in agreements with borrowers, the fund's loan loss reserve provision, and procedures for monitoring troubled credits). Additionally, bank investors gain comfort in understanding the results from the Principals' prior funds, what led to losses in a portfolio, and how the Principals managed those loans and investments to ensure the best outcomes for the fund's own investors.

How do Banks Evaluate Potential SBIC Investments?

- Target Market:
  - Does the fund include the Bank's assessment areas in its target market? Is there an opportunity to provide banking services to portfolio companies?
- Management:
  - Who is on the Investment Committee? How long have they worked together? How much is team investing personally?
- Track Record:
  - How have the principals' prior funds performed? Can they replicate the returns based on the proposed strategy? How does the fund's strategy compare to the Principals' prior funds' investment strategies?
- Process:
  - How are investment opportunities sourced? What is the process for investment decisions?
- Monitoring / Portfolio Management:
  - Is the fund staffed to deal with troubled loans and investments? How have they handled investments that did not perform? What type of reporting can investors expect?
- Legal:
  - What are the basic terms of the fund? Bank investors should review the fund's Private Placement Memorandum, Limited Partnership Agreement, Subscription Agreement and past audits.

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