Investing in SBIC’s: A Bank LP’s Perspective

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TD Bank has been investing in the SBIC asset class for more than a decade.

TD Bank has investments in all asset strategies – mezzanine, equity and debt funds within the Bank’s footprint from Maine to Florida.

35 investments in the New England market – MA, ME, NH, RI, CT and VT.
Bank Investment Considerations

• Permissible Bank investment under Dodd-Frank/ Volcker Rule – carve out for SBICs

• Evaluate strong investment managers with a dependable track record of delivering solid results in order to deliver solid economic returns for the Bank's shareholders.

• Potential for banking relationships to develop with the Fund, the Fund Manager, the General Partners and the Funds’ portfolio companies.

• Investment asset diversification.

• Qualifies for CRA investment test.
Due Diligence – Checklist

- Track Record
- Management
- Fund Investment Process
- Fund Partnership Terms
- References
- Document Checklist
- Portfolio Monitoring
Due Diligence – Track Record

• Evaluate investment track record of Fund managers
  – Assess prior returns – IRR, DPI (distributions to paid in capital), RVPI (residual value to paid in capital), TVPI
  – Contrast the team’s deal underwriting to its stated strategy
    ▪ are they consistent or does the team deviate from their stated underwriting approach e.g. investing in equity securities when their skill set is mezzanine lending?
Due Diligence – Management

- Team cohesiveness
  - How long has the team worked together and in what capacity
- Team departures
  - Understand why there are changes
- Conduct face-to-face meeting with team
- Perform Lexis-Nexis and OFAC background checks on senior professionals
- Understand how management communicates with its Limited Partners – e.g. do they provide quarterly LP updates
Due Diligence – Fund Investment Process

• What are the Fund’s key competitive differentiators
• Decision making process
• For all investments
  – What is the exit strategy thought process on the front end?
• Formal procedures for managing portfolio risk
• Valuation process & policies
• Lessons learned & measures taken to avoid future risks
Due Diligence – Partnership Terms

- Limited Partnership Terms
  - Investment period
  - Recycling of returned capital
  - Diversification

- Fund capitalization – private LP capital vs. SBA match

- How much are the general partners contributing to the Fund?

- Any preferred return to the limited partners?

- How are losses/gains distributed?

- Investment Committee/Advisory Board roles
Limited Partnership Structure

- Management Company
  - Firm name
  - Office equipment
  - Payroll system
  - Staff

- General Partner (LLC)
  - Capital repayment
  - Return on invested capital
  - Management fees
  - Carried Interest

- Limited Partners
  - A
  - B
  - C
  - 1% Investment
  - 99% Investment
  - Capital repayment
  - Return of invested capital

- Fund (Limited Partnership)
  - Management fees

- Portfolio Companies
  - A
  - B
  - C
  - D
  - E
Due Diligence – Background References

• Co-investors
• Other limited partners- talk with LPs who are not returning LPs
• Former partners
• Former employers
• Portfolio Company CEOs
• Senior lenders
Due Diligence – Document Checklist

• Limited Partnership Agreement
• Subscription Agreement
• Private Placement Memo
• Management Assessment Questionnaire (MAQ)
• Most Recent PowerPoint Presentation
• Audited Financial Statements, if available
Portfolio Monitoring – Best Practices

- Conduct annual in-person meeting and more frequent telephonic meetings with the investment team
- Review fund communications – quarterly & audited annual financial statements, K-1s, etc
- Obtain quarterly capital account statement
Risks

• Loss of capital – By far the greatest risk

• Fund Impairment
  – Fund is required to provide SBA with quarterly Capital Impairment Worksheet

• Timing of the “return of capital”
  – Understanding of when the SBA allows distributions of retained earnings available for distribution or “READ” as it is referred to commonly
Risk Mitigants

Mitigants:

– Meticulous due diligence process
– Underwriting experienced managers who have previously executed upon consistent strategy
– Shallower J Curve for mezzanine funds
Return on Investor Capital

Mezzanine Fund J-Curve

Returns

-10% -5% 0% 5% 10% 15%

Years from Vintage

-10% -5% 0% 5% 10% 15%

Return
Long-Run
10-Yr Average

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Conclusion

- SBA, OCC and FRB have a tremendous opportunity to educate the banking sector with this investment class
- Understand the SBIC program – talk with the SBA
- CRA credit for Fund investment – talk with your OCC examiner
- Perform your own due diligence – do not rely on others
- Comfort with Fund Management team & their past performance
- Patient capital