



## The Best of All Worlds:

### *How to help Small Businesses, Investors, and the Economy*

On March 26, 2009, the House Small Business Committee—Subcommittee on Investigations and Oversight held a hearing “Expanding Equity Investment in Small Business”. A panel of investment industry experts was invited to discuss increasing *access to capital* for small businesses. This has been the buzz word of late—from loans, to taxes, to investments, we are told that small businesses need “access to capital.” Oddly absent from this panel however was a single representative of the small business community, who might present the actual needs of small businesses. This absence reflects a confusion regarding the scope of the House Small Business Committee’s oversight, namely the interests of small businesses. To be clear, **what small businesses most need today is *business***. The question is how best can we implement policies to accomplish *that* goal.

Patrick Dalton speaking on behalf of Business Development Centers (BDCs) spoke of two transactions which he described as “typical of the type of loans that we, and indeed the BDC industry at large, provide to small and mid-sized businesses.”<sup>1</sup> According to his testimony these businesses had “over 550 employees” in the first case, and “over 2,000 workers” in the second, neither of which satisfies the definition of small business. While the efforts of BDCs are worthy of consideration, they are out of place for a committee tasked with oversight of small businesses. Companies with fewer than 500 employees account for nearly 80% of all new jobs.<sup>2</sup> Nearly 95% of these have fewer than 100 employees, accounting for half of all private employment in the country.<sup>3</sup> Surely, **there is enough work for the committee without expanding its jurisdiction to include larger companies**.

Failing to include small business representatives at hearings creates a false dichotomy between entrepreneurs and investors. Both sides need equal standing at the table. Truth is, we have complementary though not entirely overlapping interests. Entrepreneurs and small businesses at times need the influx of capital and business expertise that investors provide; and investors need the ideas, the know-how, and the commitment that entrepreneurs offer, to create the businesses that produce the profits that they seek. To ensure the greatest benefit for the greatest number, **it is essential to support innovation and business creation at all stages: conception, development and growth**.

The **Small Business Innovation Research (SBIR) program** was established by Congress in 1982 to provide seed funding from the earliest stages.<sup>4</sup> Currently 11 federal agencies have extramural research budgets in excess of \$100 million per annum, the threshold for involvement in SBIR. With no impact on overall expenditures, the program assigns a percentage of existing budgets (currently 2.5%) for open competition among small businesses. **Phase I supports feasibility studies** for novel approaches to unsolved problems. As such, Phase I projects are typically untested and unproven at their outset, but have the potential to save money, save lives, and revolutionize their fields.

According to John May, on behalf of the Angel Capital Association:<sup>5</sup>

[A]ngels invest in start-up and early stage companies, while VCs provide “growth capital” for companies that are further along in their development.

1 <http://www.house.gov/smbiz/hearings/hearing-3-26-09-expanding-equity-investment/Dalton.pdf>

2 <http://www.sba.gov/advo/stats/sbfaq.pdf>

3 <http://www.census.gov/epcd/www/smallbus.html>

4 [http://www.sbircoach.com/files/Roland\\_Tibbetts\\_On\\_SBIR\\_.pdf](http://www.sbircoach.com/files/Roland_Tibbetts_On_SBIR_.pdf)

5 <http://www.house.gov/smbiz/hearings/hearing-3-26-09-expanding-equity-investment/May.pdf>

He noted that:

Individual angels are investing \$10,000 to \$200,000 per company, with angel groups making average investments of \$281,000 per company in 2008.<sup>6</sup> This compares to average VC investment of more than \$7 million for the last several years.<sup>7</sup>

The typical SBIR Phase I award currently falls in the range of \$100,000 for six months to develop proof that a project is worthy of further support, and that it shows promise for commercialization. A Phase II award, contingent upon such proof, falls in the range of \$750,000 for 2 years, overlapping the support from Angels. Currently, the rules on eligibility to compete for these awards have essentially three points: 1. The firm must employ fewer than 500 employees; 2. It must be American-based; 3. It must be at least 51 percent owned by individuals.<sup>8</sup> **The SBIR program as it stands provides an injection of capital into small businesses at a stage only partly served by Angel Investors, and all but ignored by Venture Capital.**

The greatest needs for small innovative businesses today are funding the startup costs to develop proofs-of-concept and bridging the gap between prototype and commercialization, the point at which Venture Capital is most likely to take an interest. The first of these is currently served by SBIR under existing regulations. **The need to fund the conception stage of business development is severely underserved** elsewhere in our economy. According to the testimony of P. Sherrill Neff, on behalf of the National Venture Capital Association (NVCA):<sup>9</sup>

We do not fund basic research but rather search for concepts that have been vetted through the basic research process and show promise for the broader public marketplace.

By this light, it would seem remarkable if any company majority-owned by a member of the NVCA would support a feasibility study. If not, then what benefit is to be gained by permitting them “to fully participate” in SBIR?<sup>10</sup> Such participation would necessitate changes not only to the rules regarding eligibility but to the nature of the program itself, reducing or removing support for feasibility studies, thus eliminating the incentives for novel approaches to long-established problems. The three-phase structure of SBIR has more than a quarter-century of proven success.<sup>11</sup> In the words of SBA Administrator-designee Karen Mills, the SBIR program in its current form is an “extraordinarily successful program”.<sup>12</sup>

There has been a push however to alter SBA rules to accommodate Venture Capital majority-owned companies in the earliest stages of SBIR. But **what interest would a firm having invested “more than \$7 million” have in obtaining a grant for \$100,000 to conduct a feasibility study?** The investment community is already welcome to benefit from and support the innovations and growth of small businesses. If there is a willingness on their part to invest in early-stage companies before proof of concept, many would welcome their involvement. So long as they take a minority stake in the firm it retains its eligibility to compete for SBIRs. The trade off is simple: they must either invest lower amounts in a greater number of companies; or value the companies they invest in more highly to maintain their ownership below 49%. **SBIR support permits more of these companies the chance to mature to a point where Angel or VC investments would be appropriate. That seems like a win all around.**

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6 May's citation: Angel Capital Association, ACA Angel Group Confidence Report, 2008.

7 May's citation: PricewaterhouseCoopers MoneyTree Survey, 2006-2009.

8 The rules can be found at <http://www.zyn.com/sbir/sbres/sba-pd/sba-pd-02.pdf>

9 <http://www.house.gov/smbiz/hearings/hearing-3-26-09-expanding-equity-investment/Neff.pdf>

10 These were the words used by Rep. Nydia Velázquez, Chairwoman of the House Small Business Committee in a [letter dated March 11, 2009](#), which she sent to the Chairman of the House Budget Committee.

11 [An Assessment of the SBIR Program](#) (2008), Charles W. Wessner, Editor, National Research Council.

12 [Confirmation Hearing](#) of Karen Gordon Mills as Administrator of the Small Business Administration before the Senate Committee on Small Business & Entrepreneurship, April 1, 2009.