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McDAVID, Jr., John Edwin, 1934-  
CONTRIBUTIONS OTHER THAN CAPITAL FUNDS OF THE  
SMALL BUSINESS INVESTMENT COMPANIES TO SMALL  
BUSINESS.

The Ohio State University, Ph.D., 1966  
Economics, commerce-business

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CONTRIBUTIONS OTHER THAN CAPITAL FUNDS OF THE SMALL  
BUSINESS INVESTMENT COMPANIES TO SMALL BUSINESS

DISSERTATION

Presented in Partial Fulfillment of the Requirements for  
the Degree Doctor of Philosophy in the Graduate  
School of The Ohio State University

By

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\* \* \* \* \*

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## ACKNOWLEDGMENTS

The writer would like to express his thanks to his wife, Eileen, for her support and encouragement, without which completion would never have been possible, and to his children, Steve, Cathy and Johnny, for their understanding and cooperation while he was working. The writer would also like to express his thanks to his chairman, Dr. Charles B. Hicks, for his guidance and assistance. Thanks are given the other members of the committee, Dr. W. Arthur Cullman, Dr. John K. Pfahl, and Dr. James A. Black for their help in developing this dissertation. Thanks are also due to Walter B. Stults, Executive Director of the National Association of Small Business Investment Companies, and to Alvin H. Hartman, Vice President of Narragansett Capital Corporation for their help in obtaining information. Appreciation is expressed to Dr. Charles Wheeler of Xavier for his help in editing the work. The writer would also like to express his thanks to Gloria Wolfson for typing this dissertation.

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## CHAPTER I

### INTRODUCTION

During the past few years interest in the importance of Small Business Investment Companies (referred to hereafter as investment companies) has increased. These had their beginning when they were provided for under the Small Business Investment Act of 1958 (referred to hereafter as The Act). They were set up to provide a source of equity financing and long-term credit to small business to fill a financing gap. The Act also provided that the investment companies should render management assistance to small business as well. This study is concerned with these management services.

Congressional hearings provided data pertaining to the inadequacy of financing for small business. A study, conducted by the Federal Reserve Board, to supply information for these hearings showed that an adequate supply of short-term credit was then available, but that long-term credit and equity financing for small business were lacking. As a result of the hearings Congress passed The Act.

Two studies which cover the services of investment companies have been conducted. They make it clear that investment companies can provide management assistance in a number of ways. The Act allows the investment companies to provide management assistance, because it was seen that such assistance could be very helpful to small business. There is disagreement today as to whether the investment companies are providing these services.

In the seven years of its existence the investment company program has grown until in September, 1965, there were over 700 licensees. These licensees have lent over \$800 million to small businesses.

#### Statement of the Problem

The ultimate objective of this study is to supply information to the investment companies so they can provide the management assistance necessary to enable small businesses to fulfill the role available to them in the economy. This will be accomplished by an evaluation of the services now offered by the investment companies.

Evaluation of the services currently provided will allow the investment companies to determine what ones are being utilized. This will permit emphasis to be placed on these useful services. As a result, small businessmen may receive more of the services they require. It may also point out to the investment companies not now offering

services that certain ones are important.

The evaluation turned up additional services which would be of benefit to the small businessmen, and which are not provided at this time. The investment companies can determine if it is feasible to provide these additional services.

The specific objectives of this dissertation are -

1. to determine the intent of Congress with respect to the providing of services by the investment companies.
2. to determine how well the investment companies are implementing The Act -
  - a. as viewed by the investment companies.
  - b. as viewed by small businessmen.
3. to make recommendations for improvement in The Act and/or in the investment company's performance.

#### Importance of the Study

This analysis can benefit the investment company industry and the small business community. Small business is important to the economy, but many times it has difficulty surviving because of competition. The importance of small business will be treated first, followed by a discussion of survival problems and how this study may relieve them.

Importance of small business in the economy

Small business is the backbone of the economy. More than 99 percent of the 4.3 million business firms in the United States at the end of 1957 were classified as small. According to the House Select Committee on Small Business report, Problems of Small Business Financing, 95 percent of all businesses had twenty or fewer employees.<sup>1</sup> The report suggests that the total number of businesses tends to follow the economy as a whole and that:

The total business and total human population move in remarkable consonance with each other. In 1957, there were about 25 business firms for every 1,000 persons, the comparable figure for 1928 was 24.9. Even in the depths of the great depression, the ratio fell only to 23.2.<sup>2</sup>

The total number of business firms has increased over the years, though this has not been true of all industries. From 1953 to 1957, the number of wholesale firms remained relatively constant while the number of manufacturers decreased.<sup>3</sup> The largest growth has been in the areas of retail trade, construction, and service industries.

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<sup>1</sup>U. S. Congress, House Select Committee on Small Business, Problems of Small Business Financing, 85th Congress, 2nd. Sess., 1958, p. 5.

<sup>2</sup>Ibid., p. 7.

<sup>3</sup>Ibid., p. 10.

A large segment of the population in the United States is directly affected by the prosperity of small business. Approximately thirty million people earn a livelihood in such business firms.<sup>4</sup> This amounts to about half of the total working force.

Small business contributes to the economy by keeping it competitive. It strives constantly to grow and obtain a larger share of the market, and it thus keeps the advantages of a competitive market open to the customer.<sup>5</sup> Big business likewise depends on small business since it is imperative that small businesses exist if big business is to remain under private auspices. If the latter absorbs too many small businesses, or otherwise causes them to fail, the government will break up or will nationalize the large concerns.<sup>6</sup>

Small business enterprises have been the least adaptable to centralized control of all the economic element. It is difficult to visualize a vigorous middle class as a strong group of independent voters without the small business element. In serving its own interests, it acts as a social and political stabilizer, its very numbers serving as a safeguard against concentration of power in any one group.<sup>7</sup>

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<sup>4</sup>Ibid., p. 10

<sup>5</sup>A.D.H. Kaplan, Small Business: Its Place and Problems (New York: McGraw-Hill Book Company, Inc., 1948), p.6.

<sup>6</sup>Ibid., p. 4.

<sup>7</sup>Ibid., p. 3.

These considerations indicate that it is in the public interest to look at present economic and legal policy and practice affecting small business to assure that all entrants have a reasonable chance of success. The small business owner should be warned of all the pitfalls and the necessary financial and personal resources, but no "wet blanket" should be thrown on his ambitions. Small business provides the hired man with an opportunity to become his own boss.

Many individuals tire of working for someone else and long to enter business for themselves. Small business affords them this opportunity. Many of them have limited financial resources and thus must enter business on a small scale. If it were not for small business, these men would be relegated to working lifetimes for someone else. Small business provides the hired man with the opportunity to enter business and to determine if he has the ability to become a manager. This is important in our free enterprise system.

From the foregoing analysis it is evident that small business is important in the economy. It may be assumed that what is good for small business is good for the economy.

William Francis, Past President of National Association of Small Business Investment Companies, gives some indication of the important contributions made to the economy by the small businessman. The following is a portion of his remarks to the Southwestern Region in Houston on August 10, 1964:

Let me seriously ask a strange question: as a vital, strong, basic element in our economic and social structure, is small business here to stay? Most of us would unhesitatingly affirm this proposition. Before answering too quickly it may be worth considering some little-recognized trends in small business.

To cite merely one statistic: in terms of affluence. The 1950 Federal census discloses that small business owners - excluding farmers - were 23% of the top 5% income earning groups. By 1960 - in only 10 years - small business owners constituted 13% of this group. What a deterioration in profitability! Would this not call for your drastic action if it occurred in one of your portfolio companies?

In recent years small business has served as a frontier. It provides opportunity for the frustrated and the visionary to move out on their own. It provides opportunity for the energetic and creative to build from their own design. It affords everyone in this country--for the taking--the chance to improve his position through hard work and diligence.

Thus, we clearly see small business as a frontier furthering freedom, nurturing economic creativeness and productivity, and most important--aiding the development of our national character.

Just as that western frontier was closed, consider the crucial question here and now: is the small business frontier closing, also? Undoubtedly, that is the direction of our movement.

From Francis' remarks it is evident that small business did and still does make a contribution to the economy.

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<sup>8</sup>"The President's Message," NASBIC News, Vol. 6, No. 8, August, 1964, p. 2.

Its importance is also evidenced by the Federal Government's concern for it. It formed the Small Business Administration and Small Business Committee in both Houses of Congress. These Committees are set up to aid small business with its problems and to offer it assistance. The U. S. Department of Agriculture also has numerous facilities to aid farmers, many of whom are small operators.

The Small Business Administration provides management assistance as well as funds. Such assistance comes through counseling, administrative management courses, conferences, research on small business management, and publications. These aids are designed specifically for small businessmen and are readily available. Assistance is given in a number of forms--individual counseling and advice as well as one-day conferences covering some phase of small business management. Research is undertaken with its main objective that of providing small businessmen with information to aid them in managing, financing, and operating small enterprises. Congress has made it clear that the primary area in which information is to be developed is that of management. The primary objective of official publications is to inform small businessmen about effective methods of management.

#### Survival problems of small business

Small business often needs financial and management assistance if it is to survive. The investment companies



are set up by law to provide both types of assistance. This study is concerned primarily with providing management assistance. Survival problems are more often concerned with management deficiencies.

All small businesses have problems. Many arise from the lack of the following qualities on the part of the small businessman: (1) the sense of humility -- realization that not all people are qualified to run a company; (2) the sense of values -- realization that he must not overestimate the value of the product or service produced; (3) the sense of urgency -- realization that he must not put off problems until it is too late to do anything about them; (4) the sense of direction -- realization that he does not know what the company is going to do in the future or where it is going; (5) the sense of organization -- realization that the company has a need for more than a one-man organization -- (6) the sense of planning -- realization that he must consider long-range plans, budgets and forecasts. If the small businessman had adequate judgment in all of these areas, many of his problems would be alleviated. He needs management help, and investment companies can aid him in all the ways mentioned above.

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<sup>9</sup> Joseph W. Powell, "Don't Go Short on the Future of SBICs," The Commercial and Financial Chronicle. Vol. 196, No. 6224 (December 17, 1962), p. 17.

How to bring essential management guidance to small businessmen on terms that they can afford and through media to which they will respond is a problem. There is need for an overall management counselor who can, to some extent, provide advice about production, distribution, and finance. This counselor need not be completely competent in all fields, but he can give general guidance in such matters as market research, financial analysis, inventory control, quality control, cost control, record control, production control, and technological progress. Many sources of help, such as state universities, governments, banks, trade associations, and suppliers, are available to small businessmen. The problem is not the availability of such advice but in inducing small businessmen to seek and use it.

Finance is but one of the problems of small business. Others involve production, management, and marketing. Finance, however, generally attracts the most attention since problems in any of the other areas usually cause financial difficulties. As a result the company becomes financially embarrassed, and people feel that the problem is financial. Although money has become a problem at this stage, it is really the result of some other weakness. The lack of skill in running a business is the major factor

in failure and difficulty, and only rarely is the lack of capital a cause.<sup>10</sup>

Small businessmen do not have the advantage of staff specialists to aid them in their work. This prevents their specializing in the area that they themselves perform best or even from working in their own specialty. They are forced to do many things for their business that other people are far better qualified to do. The individual may be an excellent salesman, but when he runs a business, he must concern himself with production and finance as well.

The Small Business Administration reports that small businessmen fail to realize that what they don't know can hurt them. They appear to suffer a consistent lack of basic training. In one of its studies, the Administration found that 39 percent of the managers, 35 percent of the full-time bookkeepers, and 60 percent of the part-time bookkeepers in small businesses had never taken a course in accounting or finance.<sup>11</sup> These findings point up a serious deficiency. Many small businessmen do not use the data they themselves generate. As long as revenues exceed expenses they do not see the need for ratio analysis. They do not realize the significance of return on investment, inventory

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<sup>10</sup> A.D.H. Kaplan, See pages 27-30 of this study.

<sup>11</sup> "Small Business Pays Penalty of Ignorance," Business Week, No. 1661 (August 5, 1961), p. 107.

turnover, and trends in expense ratios. This in turn damages their companies' relationships with banks and other financial institutions. The latter become reluctant to lend to unsophisticated managers because the risk involved is too great. By providing assistance in financial analysis, investment companies could help small businessmen.

Problems, for example, ordinarily arise when a salesman attempts to start a production operation. In this situation the individual may know very little about production or finance. He falls short in such areas as production scheduling, plant layout, motion study, and quality control. He feels that so long as he can sell the item, everything else will be all right. Often he has little trouble selling the product, but problems arise when production fails to support sales. The company may begin to expand without concern for efficiency of operations, for costs of production, or for overhead. Over-expansion puts more companies into bankruptcy than under-expansion.<sup>12</sup>

Small businessmen have the problem of obtaining competent outside advice. Advisers are needed in several areas. An attorney who can be consulted for legal advice before commitments are made is a necessity. An accountant is also needed to analyze the company's financial position,

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<sup>12</sup>L. Charles Burlage, The Small Business Man and His Problems (New York, The Vintage Press, 1958), p. 50.

to prepare profit and loss statements as well as tax returns, and to compute breakeven charts and ratios with trends for management. He should not merely prepare these items but should point out the meaning and the important aspects of figures. The banker should be very close to the small businessman because he can advise on loan limits and pending obligations of the company. The latter should deal honestly and frankly with the banker and accommodate him in every way possible. The small businessman also needs an outside person whose advice can be trusted.<sup>13</sup> The investment company may be able to fill this latter requirement satisfactorily.

To be a competent manager of a small business, an individual must have knowledge and skill in a number of areas. He must be able to judge the people whom he hires. He must be a good credit analyst. He must be able to make decisions concerning the operations of the business since these directly affect his profit and loss position. He must be well read in his field and attend meetings of his trade association to keep himself informed of the latest developments in his area. This latter activity will allow him to benefit from the experiences of others and to learn what his competition is doing.<sup>14</sup>

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<sup>13</sup> Ibid., p. 25.

<sup>14</sup> Ibid., p. 16.

From the foregoing it is obvious that the small businessman must cover many areas. Deficiencies in any one area can create survival problems for the company. Help in solving these problems, however, is available. It is the major premise of this study that the investment companies can provide help, and, if they are accepted as partners, can be of great assistance.

#### How this study can help survival

It has been pointed out that small business needs management assistance. Under The Act the investment companies are allowed to provide it. The present study will examine the types of assistance being offered by investment companies and being used by small businesses. This investigation aims to show if the needed services are available. If they are not, the study will point out the need for these services by small business.

Indicating the need for specific services to small business suggests what steps can be taken to ensure they are provided. Such steps can be taken by the investment companies themselves or by the Small Business Administration. Ensuring that these services are available for small businessmen is a step in the process of aiding survival. If the services are utilized, they can help small businessmen solve management problems and thus reduce the number of failures.

## Method of Research

### Secondary research

A survey of pertinent literature was undertaken to obtain information relevant to investment companies. The material included information pertaining to their importance and to their formation as well as testimony from Congressional Hearings.

The same research also provided information used to develop a philosophy of the services which the investment companies should render. Books and articles which treat the kind of management assistance which outside advisers can render to small businesses were located. Two studies which contain information concerning services offered to small businesses by investment companies were also found. From this literature a list of services already available to small businesses by investment companies and others was developed.

This research also developed insight on how these various services can benefit small businessmen and permitted analysis of their value and their necessity.

Reports of Congressional Hearings pertaining to the passage of The Act were read. This was done to obtain insight into the need for a source of long-term loans, equity capital and management services by small businesses. The primary purpose was to find if Congress recognized the need for management assistance by small business and how the investment companies could provide it.

### Primary research

Two questionnaires were prepared to determine what services are available from investment companies for small business. The first questionnaire, included in Appendix A, was sent to the investment companies and requested information relative to the types of financing and the services which the investment companies provide. The questionnaire obtained information concerning services offered in six major areas: (1) management assistance, (2) obtaining additional financing, (3) helping to locate additional business, (4) underwriting connections, (5) other services offered, and (6) consulting services. A second questionnaire, included in Appendix B, was then sent to a group of companies which have borrowed from investment companies. This inquiry covered the six areas listed above and attempted to determine the extent to which available services are used by the small businesses.

Discussions with representatives of 18 investment companies and the Executive Director of the National Association of Small Business Investment Companies (referred to hereafter as The Association) followed and covered the same areas as did the questionnaires. The objective was to obtain depth information beyond that derived from the questionnaires. Such information would allow further interpretation of certain answers. Case studies were conducted in these interviews to show how investment companies have



provided services to small businesses. Interviews include visits with investment companies in Illinois, Indiana, Ohio and the Northeastern United States.

## Limitations

### Limitations of secondary research

Secondary research covered government publications, books, periodicals, and similar resources. It was undertaken to locate any additional material published on investment companies and on their services. The major portion of the material which was eventually located covered finance and did not deal with the aspect of service. Some material covering services offered by investment companies was located. This was of a general nature and considered services which board members and consultants might render.

This research was extensive but not exhaustive as some material could have been overlooked. Since it is possible that material may have been overlooked, it is also possible that an important viewpoint may have been missed.

### Survey limitations

The survey of investment companies consisted of those which were members of The Association in 1964. This included 325 of the 723 licensed investment companies at that time. The survey covered all of the large investment

companies and a larger percentage of the medium-sized investment companies than of the small ones<sup>15</sup> -- because this is the makeup of the membership of The Association. The returns showed that 47 percent of the large, 16.6 percent of the medium and 9.7 percent of the small companies responded.

The fact that only companies which are members of The Association were included may have introduced some bias. These investment companies are generally the most active and progressive. It is felt that these were the ones which should be included since they could provide better information on services offered.

The makeup of the sample may also tend to introduce some bias in the results. This is because of the heavy weighing of large investment companies. These firms can afford full-time management, and it is likely that they would provide more services than do small investment companies.

Questionnaires were sent to 153 small businesses, whose names were supplied by the responding investment companies. Some investment companies supplied several names while others provided none. The returns included 52 small businesses which had borrowed from large investment companies, 36 from medium ones, and 11 from small ones. This tends, of course, to weigh the returns in favor of the companies which borrowed from large investment companies.

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<sup>15</sup> For a discussion of size determination see page 46.

The method of obtaining names of small businesses to survey may also have introduced some bias into the results. The investment companies were asked to supply names of portfolio companies they would be willing to have surveyed. These companies had borrowed funds from the investment companies. This was the only method possible to obtain names of portfolio companies since the Small Business Administration will not provide this information. But it could have resulted in a list of companies which are happy with their investment companies' relationships. Such, however, was not the case, for several companies voiced bitterness. The heavy weighing of companies borrowing from large investment companies could also possibly bias the results. There is no reason to believe, however, that either of these factors actually does create bias, because in most cases there is no significant difference between the answers given by the various portfolio companies.

#### Definition of Terms

This section gives definitions which in some cases provide merely the essentials of the full definition stated in Appendix C.

Small business concern for the purpose of financial and other assistance: one which is not dominant in its field, employs less than 250 employees if engaged in manu-

facturing, and has sales of less than \$5,000,000 if it is a wholesale establishment, or sales of less than \$2,000,000 if it is engaged primarily in retail operations.

Small business firm for the purpose of receiving assistance from an investment company: in order to receive assistance, the business concern must qualify under the preceding paragraphs or not have assets in excess of \$5,000,000, net worth in excess of \$2,500,000, or average net income after taxes for the past two years in excess of \$250,000.

Small business investment company: a corporation duly organized and licensed to operate under The Act of 1958.

Licensee: a corporation chartered by the Small Business Administration to conduct the business designated for an investment company within its operating territory.

Operating territory: the area in which investment companies are authorized to carry on their operations of providing equity capital, long-term financing, and consulting and advisory services to small business.

Types of investment company loans: an investment company is authorized to provide funds to small businesses under Sections 304 and 305 of The Act. Section 304 loans provide equity capital to the small business through the purchase of debenture bonds which shall be callable and convertible into stock of the small business. Section 305

loans provide long-term loans which are not convertible.

### Organization of Thesis

Chapter II discusses briefly the Congressional investigations leading up to passage of The Act. A discussion of reasons for failures of small businesses follows. The sections of The Act which pertain to this study are then covered and are followed by a section reviewing research subsequent to The Act.

Chapter III reports the results of the surveys. It includes a discussion of the makeup of the questionnaire. A discussion of the services provided by the investment companies and of how these services can benefit small businesses follows. This chapter then examines the results of the surveys and points out the services offered and their use.

The interviews are covered in Chapter IV. They bring out additional information on the services offered and suggest what additional services are needed. They also present cases to illustrate how management assistance rendered by an investment company has benefited a portfolio company.

Chapter V presents the findings and the conclusions of the study. Recommendations that indicate what action needs to be taken for the investment companies to better serve small business complete the study.

## CHAPTER II

### PREVIOUS RESEARCH ON SMALL BUSINESS

This chapter will review 1) the Congressional investigation and other investigations that led to the enactment of The Act, 2) The Act itself, and 3) subsequent research. The Congressional investigations revealed primarily the need for equity financing and long-term credit for small business. They pointed out the lack of such financing and the need for an institution to provide it on an equity basis. If it were provided, the institution lending the funds would be interested in the operations of the small business and would offer management assistance. The second section will report on investigations that sought to determine why small businesses fail. The third part cites the provisions of The Act which are pertinent to this study. These sections treat the methods of providing funds and management assistance. The final section considers research since enactment of The Act. This research will reflect some uses being made of the management assistance provision.

## Congressional Investigation

In the period between 1935 and 1950 several studies to determine the extent of financing problems faced by small businesses were made. All of them reached the same conclusions, namely that adequate short-term funds were available but that a source of long-term funds and equity capital was needed. A bill was introduced in the Senate in 1950 to provide for establishment of private national investment companies. These were to furnish long-term credit and equity capital to small businesses. The bill failed to pass.<sup>1</sup>

In 1957 Congressional Committees again began to investigate the need for long-term credit and equity capital for small businesses.<sup>2,3</sup> Numerous individuals testified before the House and Senate Committees as to the need for funds and the sources of available funds. At the same time

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<sup>1</sup>Andrew P. Murphy, Jr. and Charles H. Netter, "The Small Business Investment Act of 1958, Various Bills to Amend The Small Business Investment Act of 1953 and the Small Business Investment Act of 1958" (Washington, D. C., U. S. Government Printing Office, 1959), pp. 569-70.

<sup>2</sup>U. S. Congress, House Select Committee on Small Business, Problems of Small Business Financing, 85th Cong., 2nd. Sess., 1958.

<sup>3</sup>U. S. Congress, Senate Subcommittee of the Committee on Banking and Currency, Credit Needs of Small Business, 85th Congress, 1st. Sess., 1957.

the Federal Reserve undertook a study to determine the availability of long-term credit to small businesses. The conclusion reached was that private investment companies were needed to provide funds.

Senator Johnson (now President Johnson) wrote to the Senate Subcommittee that small business can normally find short-term credit but that the need for long-term credit and equity financing was not being met. He further stated that a private source was needed to supply this type of financing because commercial banks are not capitalized, or set up, or equipped to provide equity capital. He proposed that investment companies which would provide it through the purchase of convertible debentures be chartered.<sup>4</sup>

In the House report, Problems of Small Business Financing, the advantages of equity capital are discussed.<sup>5</sup> One of the six advantages cited is that it introduces the experience of several owners with their varying backgrounds to small business. This is the only reference in the Congressional Reports to providing management assistance to

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<sup>4</sup>U. S. Congress, Senate, Subcommittee of the Committee on Banking and Currency, Financing Small Business, 85th. Cong. 2nd. Sess., 1958, p. 359-60.

<sup>5</sup>U. S. Congress, House Select Committee on Small Business, 85th. Cong., 2nd. Sess., op. cit., pp. 372-81.



small businessmen. If the new investment companies were to provide equity capital, however, they would also influence management.

In April, 1958, the Federal Reserve System presented its report on small business financing.<sup>6</sup> It again showed that short-term credit was available for small business but that long-term credit was not. The need for long-term financing for small businesses simply was not being met.

It is interesting that nothing is found in the hearings to indicate that Congress was concerned with the lack of management ability in small businessmen. Since nothing is mentioned in the reports, Walter Stults, Executive Director of The Association, was queried about this subject. Mr. Stults, formerly with the House Committee on Small Business, states that between 1950 and 1958 the ability and desirability of investment companies' providing management assistance for small business was discussed but never formalized. On the other hand, Congress did have continuing concern about the obvious lack of competent management skills found in many small businessmen. The Dun & Bradstreet Failure Record, which attributes over 90 percent of all failures of business to managerial shortcomings, was often

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<sup>6</sup>"Member Banks Lending to Small Businesses, 1955-57, "Federal Reserve Bulletin", XLIV (April, 1958), p. 393-406.

quoted. Mr. Stults further stated that some of those who worked closely with Senator Sparkman for passage of The Act did understand that investment companies which took equity positions in small businesses would have strong motivation for providing counsel and aid. This, of course, is not formal data, but is the only evidence available. It does indicate that those drafting The Act were at least thinking of trying to provide some assistance and thus reduce the failure rate caused by ignorance of management principles.

#### Other Investigations Before The Act

This section will present material relating to the reasons for the failures of many small businesses and will indicate that the major reason for them is the lack of managerial ability. Since investment companies can provide assistance through management services, they should be able to reduce the frequency of failures.

The Dun & Bradstreet Failure Record shows that 91.9 percent of the underlying causes of business failures in 1964 were caused by management shortcomings.<sup>7</sup> The figure

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<sup>7</sup>"The failure Record Through 1964," Dun & Bradstreet, Inc. Industries Studies Division (New York), pp. 12-13.

points to four factors:

8.8%	Lack of experience in the line
20.9	Lack of managerial experience
19.7	Unbalanced experience*
<u>42.5</u>	Incompetence
91.9%	Total

\*Experience not well rounded in sales, finance, purchasing, and production on the part of management.

These underlying causes were revealed by the owners' ability to eliminate conditions which result in inadequate sales, heavy operating expenses, receivables' difficulties, inventory difficulties, excessive fixed assets, poor location, competitive weakness, and the like. This fact indicates the definite need for training in management for small businessmen to be successful.

Admittedly, the Dun & Bradstreet study of failures covers all businesses, large and small. Since 99 percent of businesses are classified as small ones, however, the figures should accurately represent their situation.

Some comments by A.D.H. Kaplan in his book Small Business, Its Place and Problems are significant though somewhat dated. Most failures of a small business, he says, are really caused by managerial inability although the most frequently cited cause is the lack of working capital. Bankruptcy essentially is the inability to muster sufficient current assets to meet current obligations. But lack of capital is the result of failure--not its cause.

Of all the causes of failures, only a small portion can be attributed to outside conditions. Some 80-90 percent are traceable to the human element.<sup>8</sup> This recalls the problems discussed in the previous section. Small businessmen need assistance in their affairs because they seldom can rely entirely on their own ability and experience.

According to Kaplan, 50.1 percent of business failures can be traced to inept management.<sup>9</sup> Only 6.5 percent was due to capital causes, 12.1 percent to overhead, 7.0 percent to inexperience, and 6.3 percent to general incompetence. Environmental conditions accounted for 27.4 percent of the failures, family affairs for 8.8 percent, personal characteristics for 2.0 percent, speculation for 7.3 percent, and miscellaneous factors for 3.3 percent. These figures indicate how important management ability, or the lack of it, is in the life of a business.

Kaplan lists the following reasons for small business failures as determined from formal studies (references not given), and he comments:

1. Deficiencies in management supply the underlying cause of failure in the majority of cases, usually with unfavorable external conditions to make the failure decisive.

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<sup>8</sup>A.D.H. Kaplan, Small Business: Its Place & Problems (New York: McGraw-Hill Book Co., Inc., 1948), p. 65.

<sup>9</sup>Ibid., p. 67.

2. Most failures are in the very young enterprises, reflecting a lack of preparation. As important as the business inexperience of the enterpriser is his failure to lay the groundwork for determining the scope of the enterprise, the character of its market, and the kind of equipment--personal and physical--it requires.

3. The prevailing weaknesses of management fall within the area of financial management. They range from a complete absence of record-keeping and loose credit-granting to a lack of regard for the necessary relationship between available funds and their appropriate uses.

4. The small enterpriser tends to be tied up in the immediate operations of purchase, sales, or craftsmanship without taking time for analysis of his position either by himself or by outside counsel. Insolvency thus often comes as a shock to the enterpriser.

5. Personality difficulties that doom small proprietorships include a lack of alertness to meet changing situations, inability to maintain friendly relations with help and customers, and, to a lesser extent, shiftlessness, neglect and personal involvements in questionable outside activities.

6. The advent of severe competition often marks the turning point in the life of the business, determining whether it will meet the challenge with a re-examination of the enterprise and fresh grip on its problems or go under for lack of inherent strength.

7. External factors, like economic changes, unfavorable legislation, and "acts of God," occasionally wipe out a well-managed business, but these are of comparatively minor importance in the total.<sup>10</sup>

These comments show that man is the most important factor in the success or failure of a business. In an attempt

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<sup>10</sup> Ibid., pp. 66-68.

to remedy managerial inadequacy, The Act made provisions for the investment companies to provide management assistance to small business. Congress hoped that competent management guidance could be forthcoming and that the small businesses would use it.

### The Act

Controversy raged over whether small business needed such assistance through companies that the government chartered to provide long-term and equity financing. Many were outspoken on both sides. Some felt small business did not need government assistance. Others declared that small business would suffer unless better financing was made available. Thomas Graham, for instance, suggested in 1958 that three things were needed to assure adequate small business financing:

1. Make equity capital more available to small business.
2. Provide an instrumentality by which small business may have more readily available good management and good management services.
3. Assist in promoting the liquidity of the common stock of small companies in the area served.<sup>11</sup>

On April 21, 1958, Senator Johnson speaking for himself and for several other senators, among them Fulbright,

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<sup>11</sup>Thomas Graham, "Small Business Will Disappear Unless Financing is Obtained," The Commercial & Financial Chronicle, Vol. CLXXXVII (May 8, 1958), p. 2084.

Sparkman, Proxmire, and Humphrey, introduced S. 3651 which provided for the establishment of a Small Business Administration as a separate Government agency. This bill, titled, "Small Business Investment Administration Act of 1958," authorized the chartering of investment companies in various sections of the country to advance equity capital to small business. On the same day H. R. 12182, which would amend the Small Business Act to provide long-term loans in increased amounts to small business, was introduced. The House bill provided for administration of the loans by the Small Business Administration. S. 3651 was amended on June 9, 1958, to authorize a new Small Business Administration division to administer The Act. The bill was then sent to the House Committee on Banking and Currency for consideration.<sup>12</sup> Congress passed original S. 3651 as amended as Public Law 85-699 on August 21, 1958. The bill provided for long-term credit, equity financing, and management assistance for small business.

#### Provisions of The Act

The Act has undergone numerous modifications since its passage. Its provisions will be discussed here as they stand in February, 1966. The rules were issued by the

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<sup>12</sup>U. S. Congress, House Select Committee on Small Business, op. cit., p. 80-105.

Small Business Administration December 10, 1964, as amended.<sup>13</sup>

Formation requirements<sup>14</sup>

Applicants for licensing as Investment Companies must submit a proposal to the Small Business Administration which gives information about (a) plans of operation, (b) experience of the operators, and (c) financial data on the officers, directors, and the 10 percent stockholders. The Small Business Administration, after reviewing the proposal, will notify the proponent to proceed, to furnish additional information, or to consider the application rejected. If notice to proceed is issued, the applicant can then obtain its state charter and organize under state laws. After its state charter is in order, the corporation may apply for a license under The Act. When submitting its application, the corporation must show evidence that it has paid-in capital and surplus equal to at least \$300,000 in cash or in Government securities. Only after issuance of the license is the corporation authorized to operate as an investment company.

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<sup>13</sup> Small Business Administration, Part 107, Rules and Regulations Issued Under the Small Business Investment Act of 1958, as Amended (Washington, D. C.: U. S. Government Printing Office, 1964).

<sup>14</sup> Ibid., Sections 107.1 & 107.2.



Capital requirements<sup>15</sup>

As noted in the preceding section, the operator must have paid-in capital and surplus of at least \$300,000. At least one-half of this amount, or \$150,000, must be from private sources. If the remaining amount is not available from such sources, the applicant may request the Small Business Administration to purchase subordinated debentures for the difference. The Small Business Administration will purchase these from the investment companies in an amount equal to the paid-in capital from private sources up to \$700,000. These debentures are for a term of twenty years and bear interest at the rate of 5 percent per annum. The funds provided under Section 302a of The Act are considered as part of the paid-in capital and surplus.

Equity capital and loans provided by investment companies<sup>16</sup>

Equity Capital (under Section 304 of The Act) is provided to incorporated small business concerns under Section 107.501 of the Regulations as follows:

A. Each Licensee shall constitute a source of Equity Capital for incorporated small business concerns, which capital shall be supplied in a manner and under terms consistent with regulations of the Administration.

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<sup>15</sup>Ibid., Sections 107.3 & 107.4.

<sup>16</sup>Ibid., Sections 107.501 and 107.601.

B. "Equity Capital" funds received by an incorporated small business concern from a Licensee as the consideration for the issuance of Equity Securities by such concern to such Licensee.

C. "Equity Securities" means:

1. Certificates of stock of any class: Provided, however, that whenever any such stock contains a right to convert to another class of stock or contains rights or privileges therein in the nature of stock warrants or options, no further stock purchase warrants, options or conversion rights shall be issued in connection therewith and

2. Instruments which evidence a debt and which provide a right or privilege to convert all or any portion of the debt instruments into stock of the small business concern, or provided nondetachable or detachable stock purchase warrants or options, or provide both a right or privilege to convert all or any part of the debt instrument into stock and also detachable stock purchase warrants or options: Provided, however, that no further stock purchase warrants, options or conversion rights shall be issued in connection therewith.

The debentures must have maturities of not less than five years but no more than twenty years. Interest on them is set with the approval of the Small Business Administration but may not exceed that allowed under state usury laws.

Debentures are callable on any interest date by giving three months' notice. If they are called, the investment company must decide whether it wishes to convert to common stock in the small business concern or to receive its investment in cash. The rules allow for a premium to be placed on the value of the debenture in the event of a call.

Nevertheless the investment companies are concerned lest the small business call the loan before sufficient time has elapsed to determine whether conversion is desirable.<sup>17</sup>

In addition to equity loans, investment companies are allowed to make long-term loans under Section 107.601 of the Regulation in accordance with Section 305 of The Act. Such loans may be made to either incorporated or non-incorporated small business concerns as follows:

Each Licensee shall constitute also a source of funds for long-term loans for the sound financing of the operations, expansion and modernization of small business concerns. Such loans shall not provide any right in a Licensee to acquire any stock or other proprietary interest in the borrower, except through the medium of collateral security.

The same terms apply to this loan as to equity financing.

Either equity capital or loans may be provided with maturities of less than five years when this is necessary to protect the previous position of the Licensee. This arrangement may be made only if the purpose of such short-term funds is not to meet normal short-term requirements of the small business.

Before purchasing a debenture or making a loan, investment companies may require the borrower to incur no

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<sup>17</sup> Donald Earl Vaughn, Development of the Small Business Investment Company Program (unpublished Ph. D. thesis, Austin, The University of Texas, 1961), p. 55.

further liabilities other than trade credit. This means that if any further borrowing is attempted, the investment companies must agree to such action and either make the loan or assist the small business in arranging it. This condition permits the investment company to serve as an advisor on future financing and is one phase of the services provided by it.

Consulting and advisory services  
provided by investment companies<sup>18</sup>

The consulting and advisory services which investment companies may provide to the small business concern are defined in Section 107.705 of the Regulations as follows:

A. Consulting and advisory services shall consist only of advice with respect to the financial, management and operational activities of a small business concern; and shall not include performance by the Licensee of any financial, management or operating activity of the small business concern.

B. Consulting and advisory services may be provided by a Licensee to only (1) those small business concerns which meet the eligibility requirements under The Act and the regulations thereunder; and (2) another Licensee in connection with the financing of a small business concern with which the latter Licensee proposed to negotiate forthwith or is then in process of negotiation for financing.

C. A Licensee may render consulting and advisory services to small business concerns for whom the Licensee does not provide financing: Provided, however, that such services shall not

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<sup>18</sup>Small Business Administration, op. cit., Section 107.705 and 107.706.

constitute a major source of income of a Licensee (including as part of Licensee's income the net income, before Federal income taxes, of said Licensee's subsidiary corporation under Section 107.706).

Section 107.706 provides that a Licensee may organize and establish a subsidiary corporation, chartered for the purpose of providing consulting and advisory services to small business. This section provides further that the subsidiary must be wholly owned by the Licensee and must have the same officers and directors.

This section was designed to provide small businesses with assistance not available under other conditions. It is the section of the Regulation with which this paper is chiefly concerned.

The writers of The Act felt that the small business concern needed more than a source of funds. If management skills to complement those of the small businessman are provided by investment companies, he can concentrate on the area or areas of business in which he excels and can receive expert assistance in those in which he is weak. This aid would strengthen small businessmen especially in growing business situations.

The literature on the subject discloses that investment companies do render services in a number of ways. Primary among these is management assistance. Consulting services allowed under The Act are also offered. Aid in

obtaining additional funds when they are needed is likewise given. Assistance in obtaining additional business is authorized. Such matters are covered in the following chapter.

#### Scope of the program

From its beginning in 1958 the investment company program has grown until in June, 1965, there were 720 licensees.

#### Growth of the investment company program

The first investment companies were licensed in 1959; sixty-one firms received licenses in that year. The peak year for licensing, 1963, saw 273 new companies formed. Of those holding licenses as of this writing (February, 1966), 45 are publicly held.<sup>19</sup> Over one-half of the investment companies are small, privately held firms with capital and surplus of less than \$325,000.

The earliest figures available on loans were for September 30, 1960, and are shown in Table 1. A total of 643 loans involving \$30,190,354 had been made. These funds were disbursed to companies in 39 states. None of the investment companies had been in operation much in excess

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<sup>19</sup>"Freeze to End; Squeeze to Remain," NASBIC News Vol. 6, No. 9 (September, 1964), p. 4.

of one year and 52 had been in operation less than six months.<sup>20</sup> The investment company industry at this time was young, and the types of financing provided were new to the business community. The role they were to play was being established.

The latest figures available on comparable data were for four years later, September 30, 1964. There were then 664 investment companies. The 540 additional firms give some indication of the rate of growth of the industry. There have been considerably fewer Section 304 than Section 305 loans, but approximately the same amount of dollars is involved in each category. As time progressed, the investment companies have put more money into equity capital, and for that reason they should be willing to provide management assistance. Most of the public issues in investment companies' stock were sold during the period (1960-1964) and the large investment companies have provided equity financing. Funds have been provided to companies in all fifty states and three possessions: Puerto Rico, Guam, and the Virgin Islands.

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<sup>20</sup>"Small Business Investment Company Loan & Equity Financing Transactions--By Industry, Cumulative Through September 30, 1960," Washington, Small Business Administration (December 16, 1960).

TABLE 1  
 QUANTITY AND AMOUNT OF LOANS MADE BY INVESTMENT COMPANIES  
 SEPTEMBER 30, 1960 AND SEPTEMBER 30, 1964

(In Thousands)

Date	Number of SBICs	Number of Loans	304 Loans		305 Loans		Total Loan Amount
			Number	Amount	Number	Amount	
1964	664	11,300	2,625	\$218,130	6,776	\$237,535	\$524,422
1960	124	643	160	14,436	483	15,755	30,190
Difference	540	10,657	2,465	\$213,694	6,293	\$221,780	\$494,232

Sources: "Small Business Investment Company Loan and Equity Financing Transactions--By Industry, Cumulative Through September 30, 1960," Washington, Small Business Administration, (December 16, 1960).

"Activities Data Report for Quarter Ended September 30, 1964," Washington, Small Business Administration (April 9, 1965).



Size classification and financial  
information

The Small Business Administration divides the licensees into three groupings by size. These groups are based on the statutory capital and surplus as follows:

1. Small companies - not more than \$325,000
2. Medium companies - from \$325,000 to \$1,000,000
3. Large companies - more than \$1,000,000

Each grouping will be discussed to show its importance in the industry. Figures pertaining to each group are shown in Table 6. Though small investment companies make up 56 percent of the industry they have provided only 19 percent of the funds lent. This group has about three times as many dollars in Section 305 loans as in Section 304 loans. This fact indicates that the small investment companies tend to concentrate their funds in safer, more conservative Section 305 loans which have a higher yield and require little management assistance.

Few small investment companies have full-time management and can provide management assistance to small businessmen. With a Section 305 loan it is not common for the investment companies to become involved with the small business by offering advice or by having a seat on the board of directors. Even where equity funds are provided, a close relationship is seldom established.

TABLE 2  
NUMBER OF SBICS AND FUNDS LOANED BY THE INVESTMENT COMPANIES  
SEPTEMBER 30, 1964, SHOWN BY SIZE CATEGORY

(In Thousands)

Size	Number of Companies	Percent of Number of Companies	304 Equity Loans	305 Straight Loans	Direct Stock Purchase	Total Dollars Provided	Percent of Total Dollars Provided	Paid in Capital and Surplus (a)
Small	370	56	\$ 24,316	\$ 67,408	\$ 7,190	\$ 98,914	19	\$ 59,607
Medium	228	34	45,246	85,848	11,282	142,376	27	77,282
Large	66	10	148,568	84,279	50,285	283,132	54	328,558
Total	664	100	\$218,130	\$237,535	\$68,757	\$524,422	100	

Source: Small Business Administration Letter to All Licensed Small Business Investment Companies (February 19, 1965).

(a) Exclusive of Government funds.

Investment companies of this size fall only slightly above the minimum (\$300,000) size. It is likely that they cannot generate enough income from interest on loans to enable them to show a real profit. The lack of full-time management reduces the availability of assistance from the investment companies and lessens the thoroughness of investigation before the loan is made. A change in the regulations now allows two to five small investment companies with an aggregate paid-in capital not exceeding \$750,000 to share joint management. This arrangement makes it possible for investment companies to employ full-time management and arrange for management assistance to borrowers.

The medium-size group consists of 228 investment companies. It comprises 34 percent of the industry and has provided 27 percent of the loans advanced to small businesses. This group also has the heaviest concentration of dollars in Section 305 loans; the amount, however, is only about twice as large as the amount in Section 304 loans. The medium sized companies show more interest in equity financing.

The companies in this group vary in size. Some are almost at the \$1 million figure, and others slightly above the \$325,000 minimum. A majority in this grouping employ full-time management, and some provide consulting

services on a fee basis. The interest collected on funds provided by these investment companies provides sufficient income to cover management and staff costs. These companies thus take a more active interest in the borrowing firms. Managers make frequent visits to the portfolio company to discuss problems and to provide guidance. Frequently, these investment companies hold seats on the boards of directors.

The large size category includes the giants of this relatively young industry. Their size varies greatly. Some are barely over \$1 million. Others have sold public issues and have assets of \$20-30 million. This group comprises 10 percent of the industry but has provided 54 percent of the funds. The paid-in capital and surplus amounts to about 2.5 times the total of the other two groups. The bulk of the funds is in equity securities, evidencing a move away from conservative high interest bearing straight loans.

All of these companies employ full-time management to investigate applicants and to provide management assistance. The caliber of their executives is generally higher than it is in other investment companies so they have greater experience and can more effectively serve small businessmen. Some companies in this group require, as part of the terms of the loan, that a member of their staff be hired as a member of

the management of the small business to provide continuing advice, more positive control, and guidance. A seat on the board of directors of the portfolio company is usually held by the investment company. Members of the latter's management are usually in close contact with the portfolio companies. Some larger investment companies have subsidiary management consulting firms, which provide consulting services to both portfolio and non-portfolio small business.<sup>21</sup>

Clearly, there is a wide divergence in the size and operations of investment companies. A move is under way to curtail the licensing of investment companies in the small category. The Small Business Administration wants existing investment companies to grow and provide better services.<sup>22</sup> The new licensing standard should help guarantee well-managed and economically-viable investment companies.

#### Research Subsequent to The Act

Two studies offer some discussion of consulting and advisory services by investment companies. The first concerns both the use of consultants and management guidance. The second considers only the latter.

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<sup>21</sup>Information derived from interviews, see Chapter IV.

<sup>22</sup>"Freeze to End: Squeeze to Remain," op. cit., p. 4.

### The use of consultants

In the past, usage of consultants by small businesses has been limited. Joel Ross studied investment companies and their portfolio companies in one region of the Small Business Administration by sending questionnaires to each group. Responses came from 74 investment companies and 60 portfolio companies. He reported that 31 percent of the latter indicated frequent use of consultants, 57 percent infrequent use, and 12 percent no use.<sup>23</sup> This leads to the question of whether further use of consultants would not be advantageous for the small business.

Among the 74 investment companies reporting, Ross learned that 59 offered management services and 15 did not.<sup>24</sup> The following management and advisory services were offered (the number following each indicates the number of investment companies offering that service): legal 25, marketing 26, engineering 50, research 9, general management 6, bookkeeping 2, real estate appraisal 2, and one each for production, purchasing, supervision, personnel, sales, and planning. This shows that services are available to small business but leaves the question of why they aren't used.

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<sup>23</sup> Joel E. Ross, Small Business Investment Companies & An Evaluation of the Small Business Investment Act of 1958 with a Background Study of Public Policy Affecting Small Business, Its Role and the Availability and Adequacy of Financing (unpublished Ph. D. thesis, Washington, The George Washington University), June, 1961, p. 135.

<sup>24</sup> Ibid., p. 134.

Ross further reported that 73 percent of the portfolio companies feel that consulting services are not required and that 27 percent said that the cost of such services is too high.<sup>25</sup>

These services, reported by Ross, were offered by investment companies and not by outside consultants. He indicated that some limitations on offering services to portfolio companies may exist. One may be the prospect of unreimbursed costs. Investment companies may be in a position to provide services but not be able to press for collection. Further limitations lie in the legal restrictions of the traditional lender relationship. An investment company as an investor and consultant could be involved in a conflict of interests. Another reason that portfolio companies do not use consultants from the investment companies is unwillingness of the former to have the latter "snoop" or interfere.

Ross also reported that few small businessmen realize their need for outside assistance, and some feel that it is too expensive. To correct these attitudes a program of education may be necessary.

Ross carried out the initial study on management services and developed a list of those offered. His work, however, is limited to the investment companies of one region.

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<sup>25</sup> Ibid., p. 135.

The surveys conducted for the present study not only cover a larger number of investment and portfolio companies but extend to all regions. This study expands on the use of the services by concentrating on them, while only a portion of Ross's work is devoted to them.

Role of the investment companies  
in providing management  
assistance

One purpose of investment companies is, as indicated, to provide management assistance to small business. This aid can come in the form of membership on the latter's board of directors, free advice, or consultation. The important thing is that investment companies should attempt to supplement the talents of small businessmen with the wisdom of experienced persons.

In his study of investment companies in 1960 Vaughn reported:

During the first few months of operation of the small business investment program, optimistic writers suggested that the officers of the SBICs were in a perfect position to furnish managerial and financial advice to their small business customers. The counseling program, however, has not materialized in a majority of the investment companies. The types of managerial and financial advice furnished to small business clients usually deal with such things as:

1. Advice on sales
2. Advice on advertising
3. Auditing work
4. Bookkeeping services
6. Management and counseling on financial matters.



Items three and four above are usually provided on a fee- basis while the others may be provided free or on a fee-basis. The management consultant group in charge of operating one of the SBICs supplies managerial and financial services to their customers. Many of the SBIC officials do not desire to become too deeply involved in the managerial problems of their small business customers, especially when their financing has been on a long-term loans basis. For the most part, those companies which have acquired a convertible debenture issue or other equity securities from small businesses require that one of the officers or directors of the SBIC be elected to the board of directors of the small business customer. The services of the director are usually on a non-fee basis and serve as insurance for protecting the investment of the licensee.<sup>26</sup>

Vaughn contacted investment companies in Region Ten of the Small Business Administration. He mailed nineteen questionnaires and received eight replies. He studied investment companies' impressions of the program and information about their operations. One question about the services offered was meant to determine whether the investment companies were utilizing this section of The Act. The industry then was only two years old.

According to Vaughn, investment companies can function as outside advisers in their relationships with portfolio companies. Thus they may work with small businessmen and act as advisers. This relationship encourages businessmen to accept the idea that the investment company is their partner.

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<sup>26</sup> Donald Earl Vaughn, op. cit., pp. 146-7.

In essence, the investment companies are partners of the small businessmen, for if the advice given is bad, the investment companies share in the failure of the business. In working with the small businessmen as advisers, investment companies may fill gaps in the former group's ability.

In taking a position on the board of directors of a small business, an official of an investment company fills the role mentioned above, but with this difference: a position of authority and responsibility is involved since the investment company representative has a legal obligation for the operation of the small business. The investment companies are still in the position of partners of the businessmen in providing advice and guidance as requested. Ross reported that, of the investment companies replying, 46 required board membership, and 18 did not.<sup>27</sup> Obviously, a majority of the investment companies feel that it is advisable to hold board membership. By supplying a board member, the investment companies can work on special projects, advise, and take part in management decisions. They also are in a better position to watch the small business and protect their own investment. A seat on the board of directors does not give the investment company authority to control the small business but does afford it an opportunity to assist the management.

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<sup>27</sup> Joel E. Ross, op. cit., p. 153.

Another form of assistance is provided when the investment company has one of its members placed in the management structure of the small business as a paid executive. In this way the investment company helps the portfolio companies in day-to-day problems and is in constant touch with the situation. This type of arrangement, however, is not common. Ross reported that of 57 investment companies answering this question, 15 did require management contracts, and 42 did not.<sup>28</sup>

Above studies indicate several of the ways in which investment companies can provide management assistance to small businesses. The important point is that they offer this assistance to help the small businesses grow and to improve their own equity position.

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<sup>28</sup>Ibid., p. 153.

## CHAPTER III

### SURVEY RESULTS

This chapter concerns the survey of the investment companies and of the small businesses which have borrowed from them. The first subject discussed will be the sample itself. It will cover the percentage of return of the questionnaires, the geographic distribution, and related factors. Following this, the makeup of the questionnaire will be discussed. The second section will cover the results of the surveys. It includes a report on the types of services rendered by investment companies, and how each can assist small businesses. The results of the survey will then be presented. Responses are then analyzed to determine if the services are utilized and how the responses vary according to size of firms and the industry. The last section will analyze additional services which the responding small businesses say would assist them.

#### Nature of the Sample

##### Number of questionnaires and response

Investment companies which are members of The Association were chosen for the first survey. Questionnaires were sent to 325 of a total of 723 licensees at the time.

According to Mr. Robert Leisy, Assistant Deputy Administrator for Investments of the Small Business Administration, 51 of the investment companies were considered "inactive." They were over three years old and had less than 40.8 percent of their assets invested. This means that 48.4 percent of the active investment companies were sent questionnaires. Of the 325 sent, 105 were returned; this return reflects 32.8 percent of those surveyed and 15.7 percent of all active investment companies.

The second survey included small businesses nominated by the investment companies. The latter listed 153 portfolio companies on a sheet attached to the questionnaire sent to them. Some investment companies supplied several names, others provided none.

From these 153 companies a response rate of 65.1 percent was obtained--99 questionnaires. Two had been returned because of incorrect addresses, and one company said that it had not borrowed funds.

This response rate was higher than expected. It may have occurred because the cover letter indicated that the names were submitted by investment companies, a statement that may have caused the companies to feel they should respond. It may further indicate a high interest among investment companies in the topic being researched. Since the number of portfolio companies volunteered was small, a high response rate was most desirable.

Responses by geographic location

Replies came from investment companies in all nine of the Small Business Administration Regions. Table 3 shows the percent of investment companies in each region and the percentages of the responses from each region. The responses from most regions are close in actual percentage. The New England Region has a response rate in excess of its proportion of total investment companies, and the East North Central Region is also high. Other regions fell below their percentage of representation. The fact that the New England and East North Central regions are high is probably related to the fact that many individuals who work with The Association reside in these regions. Since this was an Association questionnaire, these individuals would be likely to cooperate. Because only 105 investment companies responded, a difference of only two or three questionnaires from a region creates a noticeable shift in percentage. It is believed that this difference does not affect the results because the percentage of responses agreed closely with the percentage of investment companies in all regions.

Table 3 also shows the percent of investment company loans made to small businesses located in each region. Some small businesses have obtained more than one loan. This means that the same small business may be counted more than once. These were the only figures available for comparative purposes and which indicate the number of small businesses

borrowing from investment companies in each region. Table 3 then presents the percentage of the small businesses responding from each region. In several cases there is considerable variation between the actual figures and the responses. The largest difference is found in the East North Central Region. This occurred because the writer is an executive of an investment company in this region, had more contact with other investment companies in it, and therefore received more names of small businesses in it. He also had the list of small businesses which had borrowed from his own investment company. In some of the other regions there is also considerable difference; the reason is not known.

#### Responses by the size of firm

The responses by the investment companies were broken down according to the size groups mentioned previously. Table 4 shows the number of responses in each group and its percentage of the total. The small group lacks adequate representation while the large group is overly represented. This occurs because all of the large investment companies belong to The Association and have full-time management available to complete the questionnaire.

An initial tallying of responses revealed that the size factor made no difference in answers received to most questions. The responses, therefore, will be treated as a

TABLE 3

RESPONSES FROM INVESTMENT COMPANIES AND SMALL BUSINESSES  
 (PERCENT OF ACTUAL COMPARED TO RESPONSES FROM REGIONS, 1965)

Region*	Investment Companies		Small Businesses	
	Actual In Region*	Responses From Region	Loans In Region*	Responses From Region
1- New England	10	15	25	11
2- Middle Atlantic	24	22	15	11
3- East North Central	11	14	6	26
4- West North Central	4	4	4	5
5- South Atlantic	15	11	10	3
6- East South Central	2	1	5	4
7- West South Central	15	13	16	25
8- Mountain	2	3	2	5
9- Pacific	17	17	17	10
Total	100	100	100	100

\*Small Business Administration Figures and regions.



group in presenting the data in tabular form. When a significant difference is present, a comment and the figures will be given in the discussion.

The small businesses were also broken into three groups, based on the size of the investment company from which funds were borrowed. It was felt this would be the best way to classify them since to ask for financial data, generally considered confidential, would probably have lowered the response rate. This method would also seem logical since answers could then be compared with answers given by the size of investment companies supplying the funds.

Again the large category is overly represented because several large investment companies supplied a complete list of the small businesses to which they had lent funds. They stated that since the names of their portfolio companies are listed in their published statement, they would provide them for the survey. But as with the investment companies, size in most cases does not occasion a noticeable difference in the responses. Where a significant difference exists, it will be noted in the discussion. All three categories will be combined in the tables.

#### Responses by industry

The small businesses responding provide a cross section of the kinds of businesses borrowing funds from investment companies. Table 5 shows the percentage of small

TABLE 4  
INVESTMENT COMPANIES AND SMALL BUSINESSES IN EACH SIZE CATEGORY  
1965

Size Category	Investment Companies			Small Businesses <sup>(b)</sup>	
	Responses Number	Percent	Actual Percent <sup>(a)</sup>	Number	Percent
Small	36	34	56	11	11
Medium	38	36	34	36	36
Large	31	30	10	52	53
Total	105	100	100	99	100

(a) Small Business Administration figures see page 42.

(b) Based on Size of investment company from which funds were obtained.

businesses responding in each kind of business as compared to figures obtained from the Small Business Administration. All kinds are fairly consistent with the Small Business Administration figures except for real estate and contractors, who had low representation, and manufacturers, who had high representation. No final explanation can be supplied for this, but possibly the investment companies did not supply names of persons engaged in real estate and contracting on the premise that they would not respond. On the other hand, the names of manufacturers were supplied since it might be assumed that they would respond. On most questions no difference was noted among the responses of small businesses in the various industries, and they will not be separated in the tables. Where a significant difference does occur, comment will be included in the discussion.

### Questionnaires

This section will briefly discuss the two questionnaires. The first part includes a review of how the questionnaires were developed and the material each contained. The second discusses the pretest results on the second questionnaire.

#### How developed

The first questionnaire was prepared jointly with the Management Service Committee of The Association. After a questionnaire had been prepared for this study, it was

TABLE 5

PORTFOLIO COMPANIES IN DIFFERENT LINES OF BUSINESS COMPARED  
 TO FIGURES OBTAINED FROM SMALL BUSINESS ADMINISTRATION  
 1965  
 (In Percent)

Line of Business <sup>(a)</sup>	Figures Obtained From Study <sup>(b)</sup>	Figures Obtained From SBA <sup>(c)</sup>
Manufacturer	54	31
Service Business	14	11
Real Estate & Contractor	9	34
Wholesale	9	3
Retail	9	10
Science	8	5
Transportation & Utility	0	4
Other	13	0

(a) Established by Small Business Administration

(b) Figures total more than 100 percent since some companies checked more than one line of business.

(c) Figures as obtained total less than 100 percent.

learned that the committee was also seeking information on management services. After some discussion, it was decided to combine the two questionnaires and that The Association would distribute the resulting one. It includes some questions not pertinent to this study, but omits no material needed for it. A copy of the questionnaire is included as Appendix A.

The questionnaire has two parts. Only Part I pertains to this study, Part II sought information for The Association on how its members feel about its operations. Part I consists of two sections. The first asked for information pertaining to (1) why the companies approached the investment companies, (2) what management services are rendered, (3) the need for, and sources of, additional funds, (4) assistance rendered in obtaining additional business, and (5) underwriter connections. The second section concerned paid consulting services offered. The review of the literature had provided insight into the areas in which investment companies can render assistance.

The purpose of the questionnaire was to get information pertaining to services which investment companies provide to small businesses. This not only applied to the specific areas mentioned above but also to any other assistance which might be offered. It is clear that information about the number of investment companies offering each service is desirable, since this provides some insight into its importance.

The second questionnaire was designed specifically for this study. It was intended to cover the same services as the first questionnaire, the objective being to determine if the small businesses feel that they are getting the services offered by investment companies. They were also asked to list any services which they would like to have and are not receiving.

The second questionnaire was submitted to an official of The Association and the chairman of the Management Services Committee to see if they could improve the wording of any questions or think of additional information which should be obtained. These individuals found no fault with either the material covered or the wording of the questions. They agreed that if the information requested was obtained it should correlate with that gained from the first questionnaire.

#### Pretest results

After receiving these comments, it was decided to pretest the second questionnaire. This was done to check questionnaire construction and question clarity. For pretesting, 20 small businesses were selected at random from the list of 153 names, and questionnaires were sent to them.

Of the 20, 16 were completed. No comments were made about the questions, but the answers to four questions made it evident that clarification was required. These were

the two questions concerning the frequency of visits and the time spent by the investment companies, and the two questions concerning the rate of growth of the small businesses. In the former the answer blanks were changed to read "times per year" and "length per visit." The questions about growth were reworded to try to clarify the method of calculating the answer.

After the changes were made, it was felt that the questionnaires would elicit information needed to complete this study.

#### Report of Survey Results

This section will analyze the questionnaires one section at a time, based on services provided. Both questionnaires will be considered together to compare the results. Each type of service will be studied as the results are presented and information from the review of the literature will be introduced at that point.

#### Types of financing provided by investment companies

As pointed out earlier, investment companies were instituted to provide long-term loans and equity capital. Funds are provided in several forms:

1. Loans only in which Section 305 type financings are provided and in which investment companies have no equity position.

2. Loans and equity in which Section 304 funds are provided on a straight note and additional funds are invested directly in stock of the companies.

3. Loans and warrants in which Section 304 funds are provided in the form of a debenture with warrants attached. The warrants give the investment companies the option to obtain stock.

4. Convertible debentures in which Section 304 funds are provided in the form of a debenture, all or a portion of which may be converted into stock.

5. Equity only involving the use of Section 304 funds for direct purchase of stock in the companies with no loan being made.

From Table 6 it can be seen that the most common method of providing equity capital is a loan with warrants attached. Loans with an equity position are the second most common type of financing. The least commonly used arrangement is a straight equity position, which provides the investment companies with no income on their investments unless the borrowing companies pay dividends.

Advantages and disadvantages of  
the types of financing

When an investment company has an equity or potential equity position in a small business, it becomes interested in the growth of the equity. Investment companies rely on appreciation in equity to obtain capital gains on



their investments. Interest income from the loan covers the investment companies' money cost and provides some income for operations. It does not provide most investment companies with the return on investment they desire. That return can be obtained only through capital gains.

Funds provided by investment companies where an equity position is involved are subordinated debt and are unsecured. Risk is relatively high in this type of financing because other creditors of the small business must be satisfied before the investment companies are repaid. Since the only funds behind the investment companies come from stockholders, the former are vulnerable in event of liquidation. To compensate for such risk, a potential equity position is obtained through conversion privileges or warrants. If the small businesses grow, the investment companies are compensated for their risk; if they do not, the investment companies hopefully will receive interest on the debenture and have the principal repaid, but conversion privileges or warrants would be worthless. If the small business deteriorates, there is the probability of loss.

When the investment companies have an equity position, they tend to assume the attitude of partners of the small businessmen. They work closely with the small businesses in the hope of rendering management assistance and helping them grow. Growth strengthens the investment companies' position on the loan and increases their equity potential.

TABLE 6

TYPES OF INVESTMENTS MADE BY INVESTMENT COMPANIES  
AND CATEGORY IN WHICH THE MAJORITY FALL, 1964

Type of Investment	Number of Investment Companies Making this Type of Investment	Category in which Majority of Investments Fall
Loans and Warrants	83	60
Loans and Equity	75	31
Convertible Debentures	57	13
Loans Only	48	21
Equity Only	25	6

To be read: 48 companies have made loans only, but in only 21 companies do loans make up the majority of the investments.

Some investment companies tend to concentrate on loans only. These investment companies are apparently not so interested in capital appreciation. They are not willing to provide management assistance unless their loans are in jeopardy; then they may have to do so to prevent loss.

Reasons small businesses approach investment companies

The traditional reason that small businesses approach investment companies is to borrow funds. That, naturally, is the most important reason, but some small businesses are interested in other matters. Since investment companies are authorized to provide consulting and advisory services, a purpose of this study was to learn if small businesses actually do approach them for these services. In Questionnaire 1 the investment companies were asked if they had been approached for reasons other than to obtain funds. Thirty-four of 104 (33%) said they had. Here a significant difference based on size existed as 23 percent of the small, 34 percent of the medium, and 46 percent of the large investment companies said they had been approached for other reasons. In Questionnaire 2, the small businesses were asked why they approached investment companies. Responses from each of these sources are discussed separately below.

Reason cited by investment companies

The investment companies were asked to tell why small companies had approached them: a number of reasons were cited.

TABLE 7

## WHY INVESTMENT COMPANIES ARE CONTACTED BY SMALL BUSINESSES, 1964

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Reason <sup>*</sup>	Number Listing
Management Assistance	13
Advisory Services	10
Information on the Equity Market	3
Financial Advice and Ideas	3
Management Evaluation	2
Looking for Acquisitions or Mergers	1
Seeking to be Acquired	1
Management Referrals	1

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<sup>\*</sup>As given by investment companies.

Table 7 shows that the most frequent reason was to get management assistance; the second most frequent reason was to secure advisory services. It is possible that these two reasons might belong together since the difference could be a matter of semantics. Both of these areas fall within the intent of The Act and show that small businesses do approach investment companies for management assistance.

At least two investment companies reported that they believe they have established a good reputation in the business community since they have been approached by small businessmen wishing the prestige of having someone from their organization be on the board of the borrowing companies.

Many small businesses coming into investment company offices cannot be helped directly, but the investment companies are still in a position to provide them with financial guidance. This guidance may be given by analyzing the situation and making suggestions as to possible alternatives. In some cases investment companies can guide the small businessmen to other sources of capital. Investment companies usually have contact with these other sources and can bring parties together.

Investment companies have been approached by firms looking for acquisitions or mergers and by others seeking to

be acquired. Investment companies may know of companies seeking to buy others and those wishing to sell. In either case small businessmen are served if sale or purchase is achieved. The objective of the investment companies is not to merge all of the portfolio companies into large publicly held corporations, but in some cases such action is best for all concerned.

Other reasons listed were in management areas pertaining to evaluation and referrals. Many small businessmen realize they are deficient in certain areas and approach investment companies for assistance. After investment companies have analyzed deficiencies and pointed out the need for assistance in an area, they may then be asked to help locate someone to undertake the job. This involves assistance in locating and screening applicants. The final selection, however, should be left to the small businessman since he must work on a day-to-day basis with the man selected.

Reasons cited by portfolio companies

Table 8 shows the response of the small businesses as to why they approached investment companies. It is significant that 97 of the 99 small businesses responding indicated that they approached the investment companies to obtain funds but two said that they were seeking management assistance and not funds. Other small businesses indicated they were interested in securing services in addition to funds.

TABLE 8

## WHY PORTFOLIO COMPANIES APPROACHED INVESTMENT COMPANIES, 1965

Reasons <sup>(a)</sup>	Number <sup>(b)</sup>
Obtain Funds	97
Management Assistance	8
Obtain Business	4
Consulting Service	2
Establish Business Relations	1
Underwriting Connections	0
Other	0

(a) As reported by portfolio companies

(b) Figures total more than the 99 since some companies checked more than one answer when responding.

TABLE 9

SERVICES THE PORTFOLIO COMPANIES LIST AS PROVIDED BY THE  
INVESTMENT COMPANIES, 1965

Service <sup>(a)</sup>	Number <sup>(b)</sup>
Providing Funds	99
Management Assistance	60
Consulting Services	44
Underwriting Connections	15
Providing Additional Customers	7
Other	0

(a) As reported by portfolio companies.

(b) Figures total more than the 99 since some companies checked more than one answer when responding.



This shows that they do approach investment companies for reasons other than, or in addition to, getting funds.

The small businesses were asked if they expected services to be available when they approached the investment companies. The purpose of this question was to ascertain the awareness of the availability of services. It was found that 38 of 92 (41%) of the companies indicated that they were aware that services were available. The small portfolio companies were less aware of the availability of services than were the large ones: 27 percent compared to 36 percent, an indication that the large investment companies offer more services.

The small businesses were then asked to list services available from the investment companies. Table 9 shows the results. All of the companies said funds were available, a majority received management assistance, and other services were less frequent. Each service is discussed in the remainder of this chapter.

#### Management assistance

As determined by interviews and the literature, there are three ways in which investment companies can render management assistance: by having an individual from their organization become a member of the board of directors, by offering service as an officer, or by establishing a close working relationship with the small businesses.

### Assistance rendered

The board of directors can be composed entirely of individuals from within the company or of individuals from other organizations. These are known as "inside" and "outside" boards respectively, but a "mixed" board is claimed to have the best features of both.<sup>1</sup> The board appoints the corporate officers, passes on recommendations of the management and is the primary policy-making body of the organization. It is interested in broad corporate problems affecting the conservation and use of capital.<sup>2</sup> It may receive reports of the results achieved by the organization and compare them to planned results. Its decisions are the basis for planning, organizing, and controlling the corporate activities. It is not a staff organization, of course, as it is the source of delegation of functions, responsibilities, and authority within the organization.<sup>3</sup> It promulgates broad general plans and policies and it plots the corporation's general course of action over the years.

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<sup>1</sup> Ralph Currier Davis, Industrial Organization and Management (New York, Harper & Brothers, 1957), pp. 162-63.

<sup>2</sup> Ralph Currier Davis, Fundamentals of Top Management (New York, Harper & Brothers, 1951), p. 164.

<sup>3</sup> Ibid., p. 486.

The board of directors should be detached from operations and should view the company as a whole.<sup>4</sup> In the typical small business the outside board member serves another important function by being someone the small businessman can talk to and test his decisions against. Management is isolated when it is so small that it does not provide a diversity of background and temperament. Therefore, board members are needed whose experience, outlook, and interests are different from those of management. What is needed is not people who agree with management but people who are likely to see things differently, to disagree, and to question.<sup>5</sup>

Boards in small businesses are often mere legal forms, with the owners of the business serving as directors. At the same time many other small businesses have found a board useful for improving the quality of their management.<sup>6</sup> The typical small businessman has a distrust for outsiders and is timid to ask anyone to serve for fear that he can't make it worthwhile. "On the other hand, many public-spirited business and professional men see in the small business the heart of the American private enterprise system, a challenge

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<sup>4</sup> Peter F. Drucker, The Practice of Management (New York, Harper & Row, 1954), p. 180.

<sup>5</sup> Ibid., p. 181.

<sup>6</sup> Harold Koontz and Cyril O'Donnell, Principles of Management (New York, McGraw-Hill Book Company, 1964), p. 357.

to professional experience and ingenuity, and a means of being of genuine service in the building of well-managed business enterprise," according to Koontz and O'Donnell.<sup>7</sup>

The board performs many functions on an informal basis. A common misconception about directors is that their most important function is to attend meetings. Formal meetings do have a place in the scheme of things, but failure to recognize the informal aspect of board activities leaves out a significant part of the picture.<sup>8</sup>

The board of directors of a small business can be of real value to it. If wisely chosen, board members will bring in fresh outside viewpoints uncluttered with daily operations and unprejudiced by personal attachments.<sup>9</sup> Small businessmen must be careful in their selection of members of their board of directors. Members must be persons with whom the businessmen are willing to discuss problems and whose judgment they respect. The businessmen must be willing to listen to their suggestions and heed their advice. Failure to do this will destroy the relationship among the individuals

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<sup>7</sup> Ibid., p. 358.

<sup>8</sup> Henry H. Albers, Principles of Organization and Management (New York, John Wiley & Sons, Inc., 1961), pp. 197-9.

<sup>9</sup> Myles L. Mace, The Board of Directors in Small Corporations, Graduate School of Business Administration (Boston, Harvard University, 1958), p. 15.

and render the boards useless. Members must be interested in the small business, attend board meetings, and be willing to give of their time on other occasions. Care must also be taken so that a conflict of interest does not arise.

A number of specific services can be rendered by board members.<sup>10</sup> They can aid the small businessman in policy making, as outside experience and viewpoints can be helpful in setting up policies for the day-to-day operations of the businesses. Board members can also aid in long-range planning. Their guidance can be valuable in keeping the companies headed in the proper direction. Many times small businesses may be tempted to veer from their original objectives; by discussing such situations with the board members, they can re-establish direction.

— If board members are familiar with industries directly related to the business, they can be of assistance by pointing out better management practices or by offering direct management help. The board members should supplement the qualifications of the businessmen. At the same time they must be careful not to meddle and thus alienate the businessman.

In case of the untimely death of the small businessman, the directors may be able to provide a successor from among their ranks until a competent person can be hired. Many small businessmen fail to prepare someone to take over in case

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<sup>10</sup> Ibid., pp. 13-20.

of an emergency. If the board members have been doing their job properly, however, they will be certain that someone in the organization is prepared.<sup>11</sup>

If the businessmen need outside technical aid, the board members may be able to locate such assistance. Many times they will have contact with persons or know of firms doing this work. They can help evaluate proposals made by consultants. This will aid the companies since it is useful to discuss the different proposals with someone.<sup>12</sup>

Board members can often help businessmen locate competent replacement personnel. This can be accomplished by recommending names of qualified persons to the businessmen or by sending individuals for interviews. Board members should not make decisions on the hiring of personnel. This is the responsibility of management.<sup>13</sup>

Advice may also be rendered in the area of financial management or accounting. This may consist of pointing out outside conditions such as governmental actions or business conditions which will affect the operation.<sup>14</sup> It can also be through review of financial statements, trends, and ratios, with the small businessman to point out significant factors. Accounting aid can be rendered by helping the

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<sup>11</sup> Ibid., p. 27.

<sup>12</sup> Ibid., p. 60.

<sup>13</sup> Ibid., p. 63.

<sup>14</sup> Ibid., p. 28.

small business use proper procedures and formats and by seeing that accurate figures are maintained. Accounting is an important area to small business and is one in which many businessmen are deficient unless outside assistance is had. Investment companies receive periodic financial statements from the portfolio companies and must ascertain that these are accurate. By requiring a small businessman to make accurate statements periodically investment companies assure that he knows what is happening.

Investment companies can also be of assistance by placing someone directly in the management of the small business. This allows an individual to work directly with the business and be available to provide advice on day-to-day operations. It brings outside assistance into the company that it probably could not afford otherwise. Most small businesses don't have ready access to reliable management guidance.<sup>15</sup>

No specific information about the competence of the representatives of the investment companies is available. However, the majority of the individuals managing them have been successful in other lines of business or have earned advanced college degrees. Investment companies are operated as a second business by some individuals who have funds and have decided to invest through the investment company program.

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<sup>15</sup>A.D.H. Kaplan, Small Business: Its Place and Problems (New York, McGraw-Hill Book Company, Inc.), 1948, p. 97.

These are generally the smaller investment companies which lack full-time management. Investment companies which have full-time management usually employ persons that are deemed capable of running them and of providing assistance to the portfolio companies.

This discussion has been mostly confined to the services rendered by the board of directors. It is not necessary that one be a board member to render this assistance. The important factor is that the representative of the investment company brings in the outside viewpoint and competent assistance.

#### Survey results

Table 10 shows the nature of the participation by investment companies. It was found that 61 of the investment companies responding have representation on the board of all or most of their portfolio companies. Table 11 reveals that 60 percent of the portfolio companies report that the investment companies are represented on the board. This conflicts somewhat with the fact that the portfolio companies reported that 70 percent of the investment companies insisted on board membership. The reason for the difference probably lies in the structure of the sample. Considering the number of situations where investment companies do have a board membership or attend meetings regularly one concludes that this is evidently the most prevalent method of providing assistance.



Table 11 indicates that 62 percent of the portfolio companies seek help and advice from investment companies. Responses differ according to company size. Forty-five percent of the small, 69 percent of the medium, and 60 percent of the large portfolio companies sought assistance from the investment companies. This emphasizes the fact that wider use could be made of assistance available.

The portfolio companies reported the nature of assistance varied based on both size and kind of business. Forty-five percent of the small, 8 percent of the medium, and 27 percent of the large companies said that the investment companies were creditors only and provided no assistance. The significantly larger number of the small companies receiving no assistance indicates that the small investment companies are not providing help to management. And since 27 percent of the large companies are also receiving no assistance, some large investment companies are also falling short. It was further found that 45 percent of the small, 72 percent of the medium, and 74 percent of the large companies report that the investment companies have representation on their boards. This places the medium and large size investment companies in a better position to render assistance. The following list shows type of firms and percentage with a representative from the investment company serving on their board:

Service business	93%
Manufacturers	62

TABLE 10

PARTICIPATION IN PORTFOLIO COMPANIES BY INVESTMENT COMPANIES  
1964

## AFTER INVESTING

Participation*	Proportion of Portfolio Companies			
	All	Most	Few	None
Offer Free Consulting Service	20	32	33	7
Serve on Board	15	46	29	8
As Creditor Only	7	22	28	13
Offer Paid Consulting Service	6	4	42	24
As Stockholder Not on Board	3	2	21	29
Attend Meeting but not serve as Board Member	2	8	19	31
Participate Directly in Management	0	12	27	34

\*As reported by investment companies.

To be read: 20 investment companies report they offer free consulting service to all of their portfolio companies, 32 offer it to most, 33 offer it to a few, and 7 offer this service to none.

Science firms	62
Wholesalers	56
Retailers	43
Realtors and Contractors	33

Seemingly the nature of the business affects the interest of investment companies in serving on the board. This could be based on the need of the small businesses or the feeling by the investment companies that they have someone competent to render assistance. It was also found that 15 percent of the manufacturers, 11 percent of the realtors and contractors, and 7 percent of the service businesses indicated someone from the investment companies participated directly in management. None of the retailers, wholesalers, or science firms indicate that they receive such aid. This again suggests that the investment companies render assistance to the type of business with which they are familiar and hold back in areas in which they may not be so well prepared.

According to Table 11, 86 percent of the portfolio companies report that the investment companies take an active interest in them -- a significant fact. It shows that small businessmen are willing to discuss their problems with someone and seek outside help. Portfolio companies report that 66 percent of them had asked for aid in solving

TABLE 11

MANAGEMENT ASSISTANCE PROVIDED PORTFOLIO COMPANIES, 1965  
FROM INVESTMENT COMPANIES

Nature of Assistance <sup>(a)</sup>	Number	Percentage <sup>(b)</sup>
<b>Type of Relationship</b>		
Serve on Board of Directors	60	60
Offer Consulting Services	36	36
None, Creditor Only	22	22
Attend Board Meetings, but not member	10	10
Participate Directly in Management	10	10
<b>Assistance Rendered</b>		
Active Interest in Company	81	86
Required Board Membership	69	70
Help with Specific Problem	65	66
Help and Advice	61	62
Works Closely with Company	60	73
Pay for Services Received	38	40
Assistance Requested, not received	10	11

(a) As reported by portfolio companies.

(b) Based on the number of companies answering this question.

specific problems and had received it. Only 11 percent say that assistance had been refused when requested. This indicates that investment companies are willing to render aid when it is asked. By doing so, the failure rate of small businesses can be reduced because the small businessmen are supplementing their own abilities. The greatest barrier lies in getting the small businessman to consider the investment company as a partner and then to seek and to use its assistance. In Questionnaire 1 the investment companies were asked if they find managements of portfolio companies generally reluctant to accept assistance, and 21 of 103 (21%) indicated they had experienced some difficulty. Obviously some barriers still exist and must be lowered.

When asked to list other services that they had received but that were not previously covered, portfolio companies listed these: legal, engineering, data processing, project development, operations research, and market research. Some investment companies provide assistance in these specialized areas and seek companies to whom to render this assistance.

The investment companies were asked to assess the services they offer and to list them in the order of effectiveness. These results were:

1. Management counseling and assistance
2. Financial counseling
3. Sitting on the board of directors

4. Accounting
5. Marketing assistance and obtaining business
6. Obtaining additional funds
7. Acquisition and merger
8. Procurement of personnel
9. Engineering and project development
10. Legal.

Certainly this list points out the services that investment companies feel are of the most benefit to the companies and indicates the types of services to be concentrated on to bolster the companies. The portfolio companies were not asked to list the services they receive in order of effectiveness. Table 9 did show, however, the services which the portfolio companies indicate they receive.

Another method used by investment companies to provide assistance is to place someone in the management structure of a company. This practice is not common as noted in Table 10, as only 12 of the investment companies report they participate directly in the management of most of the portfolio companies, and 34 report that they never do this. Twelve percent of the portfolio companies report that investment companies have someone in their management structure, as seen in Table 11.

Investment companies were asked to indicate what position their representatives hold in the portfolio

companies. The following list indicates the position and the frequency of occurrence:

Chairman of the board	12
President	13
Vice President	16
Treasurer	14
Other (Secretary, Assistant Secretary, and Assistant Treasurer)	13

There is no significant difference in the number of occurrences of any one position. The position of chairman of the board usually is honorary in a small business and may relate to one of the reasons given for companies' approaching investment companies, that of prestige. In three instances investment companies indicated that they have placed a man in the position of president because they took over the companies in time of difficulty, as an interim measure to save them.

The companies were then asked to indicate how frequently the investment companies visit them and how long the visits last. They indicated that the frequency ran from 0 to 100 a year, with the average being about once a month. This shows that some investment companies are content to let the portfolio companies operate on their own, but others check quite often. An average of once a month suggests contact only at board meetings.

The length of visits ranges from one-half to 16 hours. No correlation exists between frequency and length of the visit. Some investment companies visit weekly or even oftener and spend two to three hours per visit. Others visit only a few times per year and spend but one hour per visit. Frequency and length of visits must depend on factors not covered in the questionnaire. It may reflect the needs of the companies and the desire of the investment companies to supervise closely. One making only infrequent and short visits cannot provide as much assistance as one visiting more frequently and remaining longer. Generally the companies which said they are receiving the most services are the ones visited most frequently.

The size of the portfolio company caused no difference in the answers to the question of whether the investment company works closely with it, but difference does exist according to different kinds of business. The following list shows type of firms and percentage giving affirmative answers to this question:

Service businesses	90%
Retailers	71
Realtors and Contractors	66
Manufacturers	50
Science firms	50
Wholesalers	45



This again demonstrates that the investment companies provide more assistance to certain types of firms.

When asked if they expected to pay for assistance received, the firms' responses varied both by size and kind of business: 54 percent of the small, 31 percent of the medium, and 40 percent of the large portfolio companies said they expected to pay. The higher percentage in the small group is probably caused by the fact that the investment companies have no equity positions and are trying to supplement their income. The medium and large companies obtained funds from medium and large investment companies which are equity holders and would be willing to provide service free. The following list shows type of firms and percentage indicating they expect to pay for consulting service:

Service business	50%
Manufacturers	41
Science firms	38
Realtors and Contractors	12
Wholesalers	12
Retailers	12

This varies from figures given previously as to the amount of assistance rendered in different lines. It indicated that the greater the service rendered, the more likelihood there is of the small business's expecting to pay.

Since 59 percent of the investment companies are small, a Small Business Administration official was asked about the size of the professional staff of investment companies. He furnished the following data:

<u>Size</u>	<u>Percent</u>
Less than one full-time person	40.0
One full-time person	22.6
One full-time and one part-time person	16.4
Two full-time persons	10.2
Three to five persons	8.2
Six to ten full-time persons	2.2
More than ten full-time persons	.4

It can be seen from these figures that about two-thirds of all the investment companies have one or less full-time professional persons on the staff. This must limit the services which they can provide. With 40 percent of them employing less than one full-time person, the seriousness of the problem is clearly evident. Persons devoting only part of their time to the investment companies are less likely to be as interested in the investment companies as they are in their own primary job. The Small Business Administration is currently trying to remedy this situation by requiring that all new investment companies have full-time management and by encouraging established ones to provide it. Since only one-third of these firms employ

more than one full-time person, the services that the industry offers are obviously limited.

The problem, of course, lies in financing full-time management. It is practically impossible for a small investment company to employ a full-time person and still show a profit. Only the larger medium-sized and the large investment companies can afford to employ more than one person. A possible solution is that the small investment companies must grow if they are to provide proper services.

#### Consulting services

Consultants help business to solve management and related operating and technical problems. They supplement the work of the manager particularly in areas in which he is not qualified or for which he does not have time. They bring in wide experience and knowledge gained from working in a variety of situations and in a large number of companies.<sup>16</sup>

#### Role of consultants

Consultants may be called in to work on problems ranging from broad to specific. They may work in any of three primary functions of business (production, marketing, or finance) as well as in any staff function. They may work on specific problems in such areas as work measurement, compensation and incentive plans, work methods, system

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<sup>16</sup>Directory of Membership and Service (New York, Association of Consulting Management Engineers, Inc., 1961) p.5.

analysis, market research, research and development, product planning, budgetary control, and personnel. They may also operate in such human relations areas as external company relations, the education and the evaluating of managers, and problems arising from the social environment in which the business operates.<sup>17</sup>

When a businessman calls in a consultant, he seeks someone to find an objective solution, have the courage to tell him about it, and then urge him toward a sound course of action. The businessman must realize four things: (1) there are no easy panaceas or formulas to solve his problems, (2) problems are seldom solved solely through systems, procedures, or techniques, (3) he should avoid consultants who make extravagant claims, and (4) he should thoroughly investigate the consultant's references. It is recommended that he call in several consultants to obtain a variety of views, if he is not sure of the problem.<sup>18</sup>

Seymour Tilles found that many businessmen waste money when they engage consultants.<sup>19</sup> He also observes that many times a consultant cannot give a flat answer to

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<sup>17</sup> Ibid., p. 4.

<sup>18</sup> Ibid., p. 10.

<sup>19</sup> Seymour Tilles, "Understanding the Consultants Role." Harvard Business Review. Vol. 39. No. 6 (November-December, 1961), p. 87.

a problem even though one is expected. At times top management won't admit that it has been at fault. These factors affect the relationship of the parties.

Management must decide what type of relationship it desires with a consultant. This can take one of three forms: a take-over by the consultant, a subordinate position for him, or equal status for him. The position taken will vary with the result sought.<sup>20</sup>

If the relationship with a consultant is to be successful, certain steps must be taken. The businessman must decide exactly what he hopes to achieve before he invites the consultant in. He must permit others in the organization to determine whether they would like outside help, because participation gives a better chance of achieving satisfactory results. He must permit others to participate in the decision concerning what the help will be. He must have periodic appraisals by the participants as to what is being accomplished, and he must review the established goals.<sup>21</sup> The last thing he must do is to execute the recommendations. When the consultants make these, it does no good if the report is filed and left unused.

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<sup>20</sup>Ibid., p. 90.

<sup>21</sup>Ibid., p. 98.

Consultants working with small businesses will be able to help them solve their problems. This in turn will help reduce the failure rate. But this can happen only if the small businessman is willing to seek the consultants' advice and then heed it.

#### Survey results

Under the consulting relationship, the investment companies work in a specific area. Services rendered may be on a paid or non-paid basis. Ninety-eight percent of the investment companies which provide consulting services on a paid basis also, at times, provide them free. Seventy percent of the portfolio companies said they receive service free on occasions. Charges are not consistent because the companies are not in a position to pay, though they seriously need the service. In these cases, to protect their investment, the investment companies provide free service.

The areas in which the investment companies provide consulting services are listed in Table 12. Portfolio companies report that 55 percent of the investment companies provide consulting services.

Table 12 cites the consulting services provided on a fee basis by the investment companies. It is not surprising that the majority of the investment companies provide assistance in the financial area because many of their managers are trained in finance. If small businessmen take advantage

of the services offered, it should aid considerably in solving their management problems.

Table 12 also shows the consulting services which are available, as reported by the companies. The availability of consulting service varies only slightly with the size of the company, but the kind of business reveals significant variance. The following list shows type of firms and percentage indicating consulting service available:

Retailers	90%
Service businesses	79
Realtors and contractors	66
Manufacturers	50
Wholesalers	45
Science firms	35

This again suggests types of firms to which the investment companies feel competent to render assistance.

The percentage of investment companies which require the use of consultants as a condition of lending, was found to be 52 percent of those responding to the question. This percentage varies with the size of firm as the small and medium-sized ones require more consulting than the large firms, probably because the small and medium-sized investment companies are attempting to increase their income. Since the large investment companies have sufficient income from invested funds, they don't require consulting contracts

TABLE 12

## PAID CONSULTING SERVICES PROVIDED TO PORTFOLIO COMPANIES, 1964-65

Consulting Area	Service Provided (a)		Consulting Available (b)	
	Number	Percentage (c)	Number	Percentage (c)
Accounting	21	52	23	43
Financial Management	31	78	42	78
General Management	29	74	45	83
General Technical	10	25	2	4
Manufacturing	7	18	6	11
Marketing	15	38	7	13
Research	5	12	5	9

(a) As reported by investment companies.

(b) As reported by portfolio companies.

(c) Based on number responding to this question.



and they render more management assistance, as has been pointed out. One company was quite unhappy about required consulting and indicated it on the questionnaire. Table 13 shows that 78 percent of the companies felt that required consulting services are not desirable. This fact varied with size, with the small and medium companies having a larger percent and the large companies the smallest percent. All companies which have the requirement indicated they feel it is unnecessary.

Thirty-three percent of the companies say that the investment companies recommend the use of consultants. Table 13 also shows that only 41 percent of the companies indicate that they have used consultants. An attempt was made to learn if cost is a deterrent. Table 13 shows that 32 percent of the companies indicate that it is.

Fifty-four percent of the portfolio companies say that consultants could not benefit their company. Answers vary both by size and kind of business: 64 percent of the small, 42 percent of the medium, and 46 percent of the large portfolio companies feel that the services of consultants could not be of benefit to them. This probably reflects the overconfidence of the managers of small companies in themselves and distrust of the worth of assistance rendered by consultants. The management of larger companies may be of better quality and may feel the need for consultants. The

TABLE 13  
 USAGE OF CONSULTING SERVICES BY PORTFOLIO COMPANIES, 1965

Usage <sup>(a)</sup>	Number	Percentage <sup>(b)</sup>
Consultants Should Not Be Required	66	78
Consultants Would Not Benefit Company	40	54
Have Used Outside Consultants	39	41
Not Used Due to Cost	29	32
Recommended by Investment Companies	27	33
Required by Investment Companies	8	8

(a) As reported by portfolio companies.

(b) Based on those responding to question.

TABLE 14

REASONS GIVEN BY PORTFOLIO COMPANIES FOR NOT USING CONSULTANTS  
(EXPRESSED AS NUMBER OF RESPONSES, 1965)

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Reason	Number Listing
Consultants Not Qualified	15
No Need at Present	11
Too Small to Use Consultants	3
Consultants are Waste of Money	3
Consultants Know Only Book Material	1

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following list shows type of firms and percentage indicating they felt they could benefit from consulting service:

Service businesses	62%
Wholesalers	45
Manufacturers	41
Retailers	29
Realtors and Contractors	25
Science firms	25

This indicates the types of businessmen who feel consultants are qualified to assist them.

Reasons for their not using consultants were given by the companies (Table 14). The most frequent, given by 15 companies, is that consultants were not qualified. Seven of these are in the science and manufacturing lines and state that this is because of the specialized nature of the business. One cites the fact that it is felt that there is a great deal of mediocrity among consultants, and another said that everyone thinks he is an expert and is becoming a consultant.

Eleven companies said there is no need for consultation at present. They express the opinion that their management team and the assistance rendered by the investment companies is adequate. Another company said that consultants know theory but don't understand practical business problems.

Three companies have tried using consultants and conclude they are a waste of money. Three other companies think they are so small that consultants aren't interested in working with them. They have talked to consultants and have received the impression that the latter only want to work with large companies.

If consultants are to benefit portfolio companies, they must have good quality consultants interested in small business problems. And the consultants must be willing to work at a price that the companies can afford.

Consultants are not as widely used by the portfolio companies as they could be. Some companies do not feel consultants can benefit them and the investment companies are not recommending their use. Though several reasons were expressed by the portfolio companies for not using consultants most of these could be overcome by educating the companies in the benefits to be derived. Possibly some investment companies also are not aware of these benefits. A program to acquaint the investment companies and the small businessmen with the advantages of using consultants might help to overcome much of this reluctance.

#### Banking function of the investment companies

Investment companies are somewhat of a cross between a commercial banker and an investment banker, without being either.

### Role of commercial banker

A primary purpose of the commercial bank is to aid commerce through lending money to finance commercial transactions.<sup>22</sup> Commercial banks provide primarily short-term credit, equipment financing, and some term credit. Thus the commercial bank is a major source of seasonal funds, but provides very little long-term operating capital for small business.

The commercial banker also provides other services. He may serve on the board of the small business or may establish a close working relationship with the small businessman. In this way he may render many of the services discussed previously. He knows of companies for sale and of those seeking to buy others. He will also know of people looking for jobs, and may be able to help locate competent personnel. Thus, the banker can render services besides providing funds, but the latter is his primary interest.

### Role of the investment banker

The role of the investment banker is considerably different from that of the commercial banker. The former is primarily concerned with long-term financing, through

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<sup>22</sup> Elvin F. Donaldson and John K. Pfahl, Corporate Finance (New York, The Ronald Press Company, 1963), p. 512,

the sale of stocks and bonds.<sup>23</sup> If he finances a small business at all, he does it only for the brief period that may elapse between the time he purchases and sells the stock or bonds.<sup>24</sup>

The investment banker furnishes several services to the businessman:<sup>25</sup>

1. As a middleman, he works to bring together the companies needing capital and investors seeking financial opportunities. This allows a manufacturing company to find individuals who would like to invest in its operation.

2. The investment banker guarantees that the sale of securities will be successful. The company will not end up with only half of the issue sold, and will receive all of the funds at one time.

3. He is an expert on the securities market and can provide advice on the type of issue to sell. He can advise on the timing of the sale and the interest or dividend rate to be placed on the securities.

4. He will strive to see that the securities are well placed. His sales organization contacts investors rather than speculators.

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<sup>23</sup> Ibid., p. 307.

<sup>24</sup> Robert W. Johnson, Financial Management (Boston, Allyn & Bacon, Inc., 1959), p. 366.

<sup>25</sup> Donaldson and Pfahl, Op. cit., pp. 308-9.

5. The investment banker will support the market by buying stock while issues are being sold if the price weakens.

6. He may continue to lend his aid to the company for an indefinite time after the issue is sold. The banker's reputation is affected by the performance of the securities he sells so he is interested in the future success of the company. He may serve as a financial advisor so long as the securities are outstanding and may serve as a member of the board.

7. He buys only securities of companies he believes will be successful and he rejects those of companies he distrusts.

The investment banker may also locate individuals who wish to buy into the business. He may also know of companies willing to merge and others wishing to buy, and can introduce the businessman to such prospects.

#### Role of investment companies

The investment companies are neither commercial bankers nor investment bankers, but tend to provide some of the services of both. They provide short-term credit and advice as does a commercial banker. They tend to function as investment bankers in that funds are provided, and securities or options are obtained. Investment companies actually lend funds to the small businesses in the interim



period and hope that the securities they obtain can be sold in the future. They will generally have contacts with both commercial and investment bankers to call on the services of both for the portfolio companies.

#### Survey results

Many of the companies, after obtaining initial funds from investment companies, need additional money for growth or because of financial difficulty. Whatever the reason, investment companies are in a position either to provide or to help obtain funds. The investment company's loan agreement prohibits the portfolio company from obtaining additional financing other than trade credit or short-term credit from the bank. Investment companies, therefore, must be consulted before borrowing companies obtain additional long-term funds.

Table 15 shows that 60 percent of the portfolio companies have needed additional funds. Answers varied among portfolio companies' stating that additional funds were requested, based both on size and kind of business. Seventy-three percent of the small, 53 percent of the medium and 61 percent of the large companies said they asked for additional funds. Their need could have been because of growth or other problems and also could have been for short-term or long-term period. The following list shows

type of firms and percentage indicating they had requested additional funds:

Service businesses	78%
Realtors and contractors	56
Manufacturers	56
Retailers	25
Science firms	25
Wholesalers	0

The questionnaire revealed no explanation for this variance.

With such a large percentage of the companies needing additional funds, where did the funds come from? Forty-four companies reported that they obtained funds from the following sources:

Investment companies	31
Banks	9
Additional investor	3
Savings and Loan	1

The position of investment companies in the financial community and in relation to their own shareholders may provide investors. If the investment companies cannot make the loan, one of their investors may provide funds. If no stockholders are willing to invest, they may know other individuals or companies willing to do so.

Having access to many sources of funds, investment companies can assist in obtaining money. As Table 15 indicates, 81 percent of them claim to have rendered such

TABLE 15

## ASSISTANCE RENDERED IN OBTAINING ADDITIONAL FUNDS, 1964-65

Area of Assistance	Assistance Provided (a)		Assistance Received (b)	
	Number	Percentage	Number	Percentage
Additional Funds Required by Companies	90	86	59	60
Additional Funds Were Obtained	(c)	(c)	44	80
Investment Companies Provided Funds	57	54	31	72
Investment Companies Assisted in Obtaining Funds	25	81	8	38

(a) As reported by investment companies answering questionnaire.

(b) As reported by portfolio companies answering questionnaire.

(c) No comparable question asked in The Association survey.

assistance, but only 38 percent of the companies have received help. There is no explanation for this lack of assistance except that the names of portfolio companies benefited were not given for the study. Three of the companies which say they did not receive assistance indicated they obtained funds on their own. Two others said their condition was so bad that no one was willing to help.

Investment companies assisted the companies not only by providing the initial funds but also in either lending or helping to obtain added money. Small businesses in difficulty or growing at a rate faster than can be supported by retained earnings find this a valuable service.

Table 16 shows that 47 percent of the investment companies have contacts with investment bankers (underwriters). These connections can be important to the companies if they hope to become publicly owned at a later date. When asked if they hoped that their company would someday have a public sale of securities, 45 of 77 (58%) of the small businessmen answered affirmatively. This response was greatest in the large group with 56 percent answering "yes" while 35 percent of the small and medium-size companies gave a similar answer.

This answer also varied by kind of business. The following list shows type of firms and percentage feeling their company would someday have a public offering:

Service businesses	71%
Manufacturers	50
Wholesalers	50
Science firms	50
Retailers	29
Realtors and contractors	0

This shows that some companies in certain types of businesses are thinking of going public. This is encouraging since the small businessman must want his company to "go public" if the investment companies are to realize a capital gain. Among the companies responding, 56 of 71 (79%) indicate they feel the investment companies can aid in the sale of a public issue. This varies by size of company: 36 percent of the small, 56 percent of the medium, and 62 percent of the large companies feel that investment companies can help either in aiding the company to grow and prepare for a sale or in stimulating interest in the issue.

When asked if they would encourage their shareholders to purchase stock in a portfolio company which was "going public," 65 percent answered "yes". About 15 percent wrote that it depends on the situation. Investment companies would be in a position, after following the progress and growth of a portfolio company, to advise their shareholders

TABLE 16

## ASSISTANCE RENDERED IN OBTAINING ADDITIONAL BUSINESS AND SELLING STOCK, 1964-65

Area of Assistance	Assistance Provided (a)		Assistance Received (b)	
	Number	Percentage	Number	Percentage
Send Additional Business	86	88	56	60
Promote Dealings Between Portfolio Companies	58	60	34	44
Encourage Investment Company Shareholders to Purchase Stock of a Portfolio Company	49	65	51	71
Underwriting Connections	47	47	49	70
Dealings Requested Between Portfolio Companies	46	46	54	76

(a) As reported by investment companies answering questionnaire.

(b) As reported by portfolio companies answering questionnaire.

as to potential. By recommending securities to their shareholders, investment companies can aid in the sale of the stock and thus assist portfolio companies.

Investment companies were asked if any of their companies had sold a public issue of stock: Table 17 shows that 26 indicate that they have. When asked how many companies had "gone public," only 21 were listed. All 21 indicate the results were successful or moderately successful, and none indicate that problems were encountered. Two investment companies listed multiple sales so only 18 of the 26 investment companies reported on the success of the issue being sold. It may be surmised that the eight investment companies failing to respond may have experienced less than satisfactory results.

The majority of the sales, 15 of 21, were of companies borrowing from large investment companies. This was expected since they invest in larger portfolio companies, which will be ready to market sooner. There has been no notable inclination to sell companies out of the investment companies' portfolio. The young age of the investment company industry, coupled with the poor market for new issues in the securities market in the past two to three years, has kept many issues from being marketed, but 21 successful sales indicate progress is being made.

TABLE 17

## PUBLIC OFFERINGS OF STOCK OF PORTFOLIO COMPANIES, 1964

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Results <sup>*</sup>	Number
Number of Investment Companies Reporting Sale of Stock of One of Their Companies	26
Number of Companies Going Public	21
Number of Successful Sales	21
Number of Investment Companies Reporting Successful Sales	18

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\*As reported by investment companies.



### Obtaining additional business

Investment companies are usually in a position to help the portfolio companies get business. With their connections in the community and the connections of their stockholders and directors, additional customers can be found.<sup>26</sup>

Investment companies may be able to promote dealings among the companies in their portfolio if the kinds of business permit. This promotional work serves the portfolio companies by obtaining another customer or a source of supply; a transaction that can be guided by the investment companies and that can reduce expenses.

Directors and shareholders of the investment companies may be able to help the portfolio companies obtain additional business. Either or both of these groups may be in a business which can use the products of one of the companies. If so, they make it a point to buy from the portfolio company, assuming that prices are competitive and that quality meets required standards. They can also help to arrange introductions and visits for representatives of the companies to sell the product. This assistance can result in openings and sales not available to the companies.

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Samuel L. Hayes, and Donald H. Words, "Are SBICs Doing Their Job?" Harvard Business Review, Vol. 41, No. 2 (March, April, 1963), p. 194.

### Survey results

The investment companies report (Table 16) that 88 percent of them tried to help portfolio companies get business. In addition, 60 percent say that they try to send additional business to the companies from other portfolio companies. Only 44 percent of the portfolio companies indicate that they receive this type of assistance while 76 percent say they have requested it. Obviously dealings among companies are not promoted to the maximum.

It was found that whether transactions were promoted between portfolio companies varies with the kind of business. The following list shows the type of firms and percentage of each that said dealings were promoted:

Service businesses	43%
Manufacturers	35
Wholesalers	35
Realtors and contractors	22
Retailers	14
Science firms	14

This order seems logical since some businesses can work with others more easily. On the other hand, the rate is low as one would have expected a much higher number of investment companies to promote dealings among portfolio companies.

The following list shows the type of firms and the percentage of each saying they would like to get business from other portfolio companies:

Service businesses	86%
Manufacturers	52
Science firms	48
Retailers	48
Wholesalers	48
Realtors and contractors	33

Clearly some kinds of business firms feel this could be a good source of increasing their business.

It is evident that more could be done to promote dealings between the portfolio companies. The investment companies are not making a great effort to do so and the portfolio companies are not pursuing the issue. This is a source of business which should be promoted by all concerned.

General comments by the companies

When asked if they had grown since receiving funds, 85 percent of the companies indicate that they have. The companies were then asked their rate of growth of net profit before taxes, both before and after they obtained financing, but answers to this question were not significant, and no conclusions can be drawn.

When asked if they would go to investment companies again if they needed funds, 81 percent of the portfolio

companies answered that they would (Table 18), and 86 percent said that they would recommend investment company financing to a friend. Clearly, the majority of the companies are satisfied with their relations.

Companies stating they would not go to investment companies again were asked why. The most common response (Table 18) is the cost that financing involves. The second most common answer concerns the equity position which is required. One company feels that the restrictions in the loan agreement make it difficult to talk to potential investors. Three respondents say they would go only if other funds were not available. The responses to this question are not significant enough to suggest any conclusion except that there is no single serious weakness in the program.

#### Other services desired by the companies

A further area to be investigated concerns other services which investment companies can render to small business. Are there additional services that the companies would like to receive? What are these services, and can the investment companies provide them economically?

TABLE 18

FEELINGS OF THE PORTFOLIO COMPANIES TOWARD THE INVESTMENT  
COMPANY PROGRAM, 1965

Feelings <sup>(a)</sup>	Number	Percentage <sup>(b)</sup>
Have Grown Since Obtaining Funds From Investment Companies	79	85
Would Go to Investment Companies Again	76	81
Would Recommend Investment Companies to a Friend	76	86
Reasons For Not Using Investment Companies again		
(a) Cost	4	
(b) Due to Equity Requirement	2	

(a) As reported by portfolio companies.

(b) Of those responding "yes" to question.

Portfolio companies were asked to provide information on any additional services they would like to receive. Only one area of assistance was mentioned with any frequency. This indicates that there is no other major area in which assistance is needed and not received.

The only frequently mentioned area for increased assistance is that of financial management. The need for assistance and guidance in such areas as cash flow, budgets, and financial planning was expressed. There generally seems to be a lack of this type of talent in small businesses. Many companies do not know how to forecast their needs for funds and to determine sources. This is necessary when approaching a lender, because he will require an indication of how the requested figure is determined. If a company is growing and additional funds are needed, they should be planned for, and arrangements should be made in advance rather than when the need arises. Budgeting of expenditures is also important. Companies need to know how much money they can afford to spend on an item and the savings involved. Many companies buy equipment without determining the pay-back period. Guidance in such areas could be provided by the investment companies.

It was shown earlier that a great number of businesses fail due to the lack of well rounded experience

on the part of the small businessman. Financial management is an area in which many lack judgment. It seems that some recognize their deficiency and are suggesting that the investment companies provide the needed assistance. This could be done easily by most investment companies and might help prevent the companies from getting into trouble due to lack of financial planning. This could help reduce the rate of failure of small businesses.

## CHAPTER IV

### FOLLOW-UP INTERVIEWS

In analyzing the questionnaires and the responses, some further questions arose. Interviews were conducted with 18 investment companies in the North Eastern and North Central sections of the country to gather information to supplement that contained in the questionnaires. Cases that demonstrate how management assistance aided portfolio companies were obtained during the interviews and are presented first. The remainder of the interview response is then discussed in the sequence used in the questionnaires: (1) management assistance, (2) consultants, (3) the banking function, and (4) locating added business.

The cases provide added information on the specific types of services which were rendered and their effectiveness. Each investment company interviewed was asked to cite one or more cases where it had assisted a portfolio company. Twenty-five cases were reported and 12 were selected for presentation in this paper. Those chosen illustrate situations where assistance had been rendered in all four areas listed above. They also reflect the service given by large, medium, and small investment companies.



When the investment companies were asked to submit cases, they were also requested to report the background, the problem, the assistance rendered, and the result. They were later queried about the situation, especially the service rendered. The interview was conducted as an open discussion of the case. Investment companies understood that the material would be written up so the identities of the portfolio companies were not disclosed.

### Cases

#### Case 1

An investment company invested in a small manufacturer of industrial equipment. The latter had a good product line but needed assistance in marketing. Aid in opening channels to obtain government business and in establishing connections for exporting the product was given. Both opened new areas of profitable sales. In addition, the investment company representative made sales calls. Without this help the company would not have grown.

Besides this service in marketing, the company also required additional funds. The investment company not being in a position to provide the money, assisted in two ways in obtaining it. First, the investment company convinced the shareholders that they should put more money into the company because of its promising future. Second, although the bank would not make a regular loan to the company, a

line of credit was opened using government contracts as collateral. These funds allowed the company to continue in operations and to grow.

In addition, assistance was given in the allocation of funds to such things as research, development, and advertising. This allowed the company to develop new products to promote the existing ones and presented over- or under-expenditure in certain areas.

### Case 2

This company is a manufacturer of electronic equipment. The investment company stepped in to solve technical and managerial problems. Advice was given in perfecting the product and in packaging and selling it. Some assistance was rendered by investment company personnel and some by outside consultants. Now that the problems are solved and the company is operating profitably, the small businessman wrote to the investment company to express his appreciation for its help. He felt that the guidance he had received would not have been available elsewhere and that the investment company had filled the role of a "dutch uncle" in its relationship. Assistance had also been rendered in getting a line of credit from the bank and in sales, even to the extent of making sales calls.

Part of this company has since been sold to outside people who could assist in management. The investment company located the buyers.

Case 3

This is a service business financed by the investment company. The two stockholders disagreed over management problems and were ready to liquidate the business. The investment company stepped in to protect its interest, settled the dispute, and thus saved the company. The partners currently are working together, and their business is thriving.

Case 4

A small growing telephone company in the Midwest needed added executive talent. The investment company suggested that one person hired be a treasurer. It felt this man should be a forceful individual, not just a bookkeeper. He would then be capable of meeting people and conducting business for the company as it expanded. The investment company helped locate such an individual, and he was hired. He fit in well in the organization and has helped immensely.

Stock in this company was publicly held, but there was no active market for it. Some shareholders desired to make a market, and the investment company found a broker to do so. The investment company is currently trying to get the stock price quoted in the newspapers.

Case 5

A small Midwestern mortgage banker desired to sell and asked the investment company to find a buyer. Two

prospects were located, and sale terms were discussed. The investment company helped decide which offer was the more attractive. The better deal was completed to everyone's satisfaction.

#### Case 6

This company manufactures hydraulic component parts. The product was well accepted, but the owner was not capable of running the business, and it was about to fail. The investment company exercised a voting trust, took control, and dismissed the owner. It conducted the business until it was operated profitably. During this period additional funds were lent by the investment company. The business has since been sold, returning a capital gain to the former owner. The action by the investment company prevented it and the owner from losing their investment and kept the small business in operation, thus preserving the jobs.

#### Case 7

An investment company financed a shopping center. The small businessman involved was taking funds out of the corporation for private ventures, and the company was deteriorating. The investment company bought out the individual and completed the work on the project. This

action prevented it from failing, preserved the stores for the community, and prevented the owners from suffering a loss.

#### Case 8

A company in the paper converting industry had no unique product. Competition in the industry is stiff and margins are small. After funds were received from the investment company, operations expanded, but the company started to deteriorate. Profits fell and losses were incurred. The problem was inefficient manufacturing. At this time the investment company found the president was a good salesman but not a production man. The company defaulted on the loan agreement, and the investment company took over operation of the plant with the president continuing to sell. Eventually a production manager was trained, and now the investment company only visits biweekly to check operations. The company is profitable, and the investments of all parties have been saved.

#### Case 9

A company had been operating profitably but suddenly reversed and sustained a substantial loss. Most of the loss was caused by development costs on a new line of equipment, but part was caused by excess overhead. The investment company stepped in, asked questions, and forced

management to evaluate the situation. Cuts were made in personnel and other expenses to reduce overhead, and development was curtailed. Budgets were made up to show minimum projected sales and expenses to operate profitably. Operations were cut back to the minimum level to conserve capital. Then, as sales grew, operations were increased. Without this action the company would have failed. The representatives of the investment company, a board member, plus another outside board member teamed up to see that expenses were held in line and guided the company during this period.

The investment company lent additional funds to pay trade creditors. In addition, a loan was arranged with the bank using inventory and accounts receivable as collateral. The company is operating profitably and has resumed its rate of growth with sales at record levels.

#### Case 10

In a furniture company production could not keep pace with sales. The president was an excellent salesman but a poor production man. As sales increased, delivery dates lengthened. The investment company insisted that an outside consultant be brought in to correct production problems and that a production manager be hired. Consultants were screened with the investment company's aid, and one was engaged. Prior to his starting work, a new production

manager was named. The latter worked with the consultant, the lay-out of the plant was modified, and motion study work was accomplished. Production is now keeping up with sales, and the company is expanding.

With sales increasing, additional capital was required. The company talked to factors and commercial finance companies but found the interest rate quite high. The investment company did not wish to put in more funds so it helped arrange a secured line of credit with a bank. Thus it provided the needed funds at a lower interest rate.

#### Case 11

A company had developed a new product line and required added funds to finance it. Since the investment company already had an investment, it lent additional funds. As sales began to grow, still more funds were required so the investment company helped to arrange receivables financing with a bank. The new product line continued to grow, and profits expanded. Without help from the investment company, the new product line could not have been brought out and expanded so rapidly.

#### Case 12

This small manufacturer was having problems with both executive and operating personnel. The investment company helped locate and screen a new production manager. The first man hired turned out to be the wrong one. The

second try produced a suitable man who took control of production while the president sold the products. The investment company representative then helped evaluate production problems and make recommendations for improvements.

While this was going on, efforts were made to solve operating personnel problems. The caliber of the worker, the pay scale, working conditions, and fringe benefits were studied. Working conditions were satisfactory, but worker caliber needed to be raised by hiring some replacements. The wage scale was equal to that of the community, but fringe benefits were lacking. Adjustments were made to the benefits to provide insurance and more paid holidays. With the changes employee morale improved as did output. This, coupled with the management changes, reduced costs and increased profits.

### Summary

From the cases it can be seen that the investment companies offer assistance in several ways: (1) management assistance, (2) financial management, (3) locating and lending funds, (4) helping to obtain business, (5) locating prospective buyers when a company is for sale, (6) marketing the product, (7) acting as a mediator, (8) locating expert personnel, and (9) helping make the market in the company's stock.



Such assistance has helped to prevent the failure of small businesses which would have resulted in loss to the owners and to the investment companies. By helping solve problems and by working in areas where the small businessman either was not proficient or did not have time to work, investment companies contributed to insure the small firms' survival.

#### Discussion of Assistance

Besides the cases already reported other information was gathered in the interviews to gain further insight into the services covered in the questionnaires. In the information gathered in the questionnaires, some additional questions arose, and it was felt the best way to obtain answers was through interviews.

The interviews were conducted for the most part in the offices of the investment companies being surveyed, but some took place elsewhere. The interviews were unstructured. Interviewees were encouraged to talk about the types of services they rendered; questions were used to stimulate discussion, to increase depth, and to obtain information concerning: (1) things needed to help the investment companies so they can better serve the portfolio companies, (2) how much assistance they render, (3) their opinions on consultants, and (4) problems they have encountered

which affect the services they render. The ideas and opinions in the following section are those expressed by the interviewees.

#### Management assistance

In discussing assistance rendered, there are mixed feelings about board-of-director membership. Some say they insist on it while others do not want a board seat. Those insisting on membership do so to stay in close contact with the companies and to keep informed of happenings. In most instances the investment companies demand monthly meetings, but sometimes only quarterly ones are required. Investment companies not requiring board membership feel the same assistance can be rendered without it. They attend meetings and obtain all information but are not in a position of control and were relieved of fiduciary responsibility.

Most of the investment companies render assistance, but two of the small ones indicated that they have very little time for it. Those giving assistance feel the outside objectivity is beneficial to the companies. This is done by asking questions to be certain that the small businessman understands what is going on and to stimulate him to make the right decisions. By asking questions about the future, they cause him to examine his plans and make decisions concerning the future. The same technique is used in policy formation, budgets, and other areas.

One investment company says it tries to employ specialists in several areas to help the companies. Because this requires a considerable outlay for salaries, it can be done only by the larger investment companies. Another says it uses its directors, who specialized in different areas, to work with the companies.

Assistance is offered by most investment companies in financial management by insisting that a budget be established. Thus the small businessman must think about the future and do some forecasting. The forecast and budget are then reviewed, assistance is given if needed, and plans are made based on them. As time passes, control is exercised by comparing actual costs and income to the plan and taking corrective action if it is required. By forcing this action, investment companies assist management in making and carrying out financial plans.

Investment companies actively working with their portfolio companies say they try to make periodic visits and be available when needed. On these visits they review happenings and think of things which day-to-day management does not consider. They feel they should be close if they are needed but not be involved daily. This gives the businessman someone to turn to with his problems, as each investment company representative feels he is qualified as somewhat of an expert on small business problems and can render assistance.

Investment companies act as catalysts in working with the businessmen. The entrepreneur wears many hats in his operation and is hungry for advice. He will try any suggestion made; so, when offering advice, the investment company tends to become part of the management team.

A good method of providing assistance is through management by exception. Trends can be watched and compared to past performance and forecasts. Then if changes are necessary they can be forced by the investment company.

From the foregoing it is clear that the investment companies try to work closely with their portfolio companies. They think they can provide help in a number of ways and guide the companies in the perilous journey to success. These comments, coupled with the cases showing that management assistance helped companies, demonstrates that assistance is being rendered effectively.

Four investment companies expressed the opinion that the Small Business Administration should make provisions for them to borrow more funds. This would provide more leverage and thus more income. With this added income more staff could be hired to provide added assistance.

#### Consultants

None of the investment companies interviewed have active consulting organizations although two had had them in the past. They found they can work more closely with

the companies by providing management assistance, and they did not wish to require consulting contracts in the loan agreement. In essence, the companies are receiving the consulting service but not paying for it.

Most of the investment companies say they recommend the use of outside consultants when conditions require them. They feel these individuals can help the small businessman. The investment companies usually only suggest the use of consultants, but if the advice is not followed, their use can be demanded.

One investment company states it does not recommend the use of consultants because they cannot afford to work for most small businesses, nor can the small business afford them. The individual in this case considers himself a special consultant for his portfolio companies but does not charge for his time.

Several investment companies indicate they have trouble locating consultants to work with portfolio companies. Two reasons were given: lack of qualified consultants to work with small business and the lack of interest in small business by consultants. It was found that investment companies recognize these problems, and The Association's Management Services Committee is currently working on a plan to remedy the situation. A list of qualified personnel in the investment companies willing to do consulting work with

small business will be established. Consultants on the list can also be from outside the investment companies, but they would have to express a desire to be included. The listing will be available to the investment companies and the portfolio companies so consultants who can and will work may be obtained. This should help correct, in part, the reasons expressed for non-use of consultants. The problem of cost will still remain because many small businesses simply cannot pay for consulting services.

All of the investment companies interviewed realized small businesses' need for consulting help. The problem is to find the consultants and then get the small businessmen to use them.

#### Banking assistance

Assistance rendered is separated into two categories based on commercial and investment banking functions. They will be discussed in that order.

#### Commercial banker

In the cases reported, many companies required additional funds. Investment companies stated they either were willing to put in the needed funds or to try to locate a source of funds. One large investment company said it prefers not to supply extra funds but had done so on occasions. It felt that such funds could generally be obtained from some

other source, such as a bank or an investor, and every effort was made to obtain them in that way. Generally an outside investor is sought who can supplement the management ability of the small businessman. By doing this, help is obtained in two ways.

Several investment companies indicate they were successful in locating outside investors. These individuals are sometimes associated with the investment companies and sometimes not. The latter felt their connections in the community helped locate interested investors.

Two bank-affiliated investment companies said they made the facilities of the bank available to portfolio companies. The small business could then use the credit department for credit checking, thus providing a vital service.

#### Investment banker

The investment companies felt their connections and those of an underwriter could definitely be of assistance. Instances were mentioned where investment companies had helped arrange a sale, and one stated that it had aided a portfolio company to purchase a competitor.

One large investment company said it lets portfolio companies seek their own merger candidates. After locating one, the proposal is then presented to the investment company, which takes over negotiations. In this way the

investment company acts as the "bad boy back home" and can work out a better transaction for the small businessman. The feeling is also expressed that connections with an underwriter can be beneficial. The latter helps locate investors for the company if they are required during the growth period. Then when the company reaches the stage where it is thinking of offering a public issue of stock, more assistance is available. The underwriter helps get the company ready for the public issue by showing how to keep costs down and increase profits, thus making the issue more attractive.

#### Obtaining additional business

As was noted in the cases, several investment companies said they helped get business for the portfolio companies, even to the point of selling for them. Most of the ones interviewed indicated they try to find business for the portfolio companies but limit their assistance to locating contacts.

Assistance is given by introducing the small businessman to potential customers and occasionally setting up appointments. The objective is to open doors for the companies but not actually make the sales. This attitude changes somewhat if the company is in difficulty. Then more effort is directed toward making sales. Someone may help



with the presentation and try to complete the sale. Help is also offered by getting contractors and manufacturers listed so they can bid on business.

The investment companies indicate that this assistance is provided not only by their management but also by their directors. They talk to potential customers in a public relations way for the companies. One investment company even enlists the aid of shareholders in this type of assistance.

In the interviews three suggestions were made on how added business may be secured. One proposal urged more advertising of companies' products. For instance, the Small Business Administration sponsors meetings and conferences. At one of these a display by some portfolio companies was arranged. This program could be expanded. This would allow firms in different parts of the country to display products in meetings conducted for the small businessmen in the area. At a meeting such as this the companies do not have to compete with larger companies for advertising space and displays. This type of exhibit allows the businessmen from the portfolio companies of different investment companies to meet. It could lead to increased sales and profits for all.

Another suggestion was a trade mission sponsored by the Small Business Administration. A trip to Europe is

currently being organized for spring of 1966. This type of trip, when sponsored by a government agency, can have good results, by assuring participants that the companies will have proper recognition in foreign countries. It provides an opportunity to go at less cost than if the companies went individually.

An area in which considerable effort has been expended is that of getting small businessmen more government contracts or subcontracts. Much has been accomplished in this activity to date. The problem is to see that the small companies have an equal opportunity to compete.

One investment company holds a meeting for the managers of the portfolio companies in its group once a year. Its first objective is to teach new methods and procedures and allow for cross fertilization of ideas. Another is to try to stimulate business among the companies.

#### Summary

Most of the investment companies believe they can assist portfolio companies. The discussions have presented their views on what they can offer and how they can do it. The interviewees also discussed those problems which prevent their being of more assistance. They have made a number of suggestions on what can still be accomplished.

The case analyses also has shown that assistance is being rendered by the investment companies. They have helped some small businesses to grow and have prevented others from failing. Clearly the investment companies are utilizing the section of The Act which permits them to provide management assistance. They should in the future help other small businesses to succeed and should reduce the number of failures.

## CHAPTER V

### FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

#### Purpose

This study has examined the management assistance provided to the portfolio companies by investment companies. The need for services by small business, the services offered, and their use have been analyzed. An attempt has been made to determine what additional services small business desires. Thus, the ultimate purpose of this study was to provide information to investment companies in improving services and in fulfilling effectively the roles intended for them under The Act.

#### Findings

The research conducted for this study reveals that

1. Small businesses make a significant contribution to the economy.

Small businesses are the backbone of the economy in view of the fact that 99 percent of all businesses are classified as small. Approximately one-half of the work

force earns its livelihood from them. Small business provides an opportunity for individuals to start on their own. Small businesses also contribute by keeping the economy competitive.

2. The human element contributes to business failures.

Although finance is normally cited as the main reason for business failure, it is historically an effect, not the true cause. The Dun and Bradstreet report, discussed in Chapter II, shows that the underlying cause of 91.9 percent of all business failures is management shortcomings. These are listed as: (1) lack of experience in the line, (2) lack of managerial experience, (3) unbalanced experience, and (4) incompetence. These deficiencies result in the company's eventually becoming financially embarrassed.

3. Studies show that investment companies can and do provide some management assistance and consulting services to portfolio companies.

It was found that investment companies provide a great deal of management assistance. This is done in the primary functions of production, marketing, and finance or any staff function, either through an informal or a formal relationship. One study found that 48 of 64 investment companies insist on having a seat on the board of directors of the portfolio companies. Another study also found that

59 of 74 investment companies offer management assistance to portfolio firms.

It was found that 12 percent of the companies do not employ consultants and 57 use them only infrequently. Several reasons are assigned for not utilizing the services, the main ones being cost and the opinion that they are not needed.

4. The Small Business Investment Act provides for financing and management assistance to small businesses.

The Act provides for Government chartered investment companies. These are to provide long-term credit, equity financing, and consulting and management services to small business. It was felt that when investment companies provide equity financing, they would be vitally interested in the growth and development of their portfolio companies. They will then establish a close working relationship with the small businessmen and provide assistance by helping them in areas in which they are weak.

5. Equity financing is the most common type provided by investment companies.

Table 6 shows that the most common type of financing provided was that of loans with warrants attached; the second most common type was that of loans with an equity position. These are both Section 304-type financings and

provide the investment companies with an interest in the growth of the companies, thus encouraging management assistance.

6. Small businesses approach investment companies for reasons other than to obtain funds.

The investment companies reported that 33 percent of them had been approached for reasons other than to obtain funds. A number of reasons were given, but the most frequent one was to secure management assistance, and the next most frequent one was to get advice. All of the reasons shown in Table 7 involved services generally furnished by the investment companies.

Several portfolio companies reported that they had approached investment companies for reasons other than to obtain funds. Two indicated that their primary reason was to obtain management assistance. Most companies were aware of the availability of other services when approaching an investment company.

7. Management assistance can be rendered to portfolio companies in three main ways: by holding a seat on the board of directors, by occupying a position in the management structure, or by an informal working relationship.

It was found that management assistance is rendered in these three ways. Table 10 shows that the investment companies report the most common method of providing this assistance is to have a seat on the board

of directors and the least common is to occupy a position in the management structure. Table 11 shows that portfolio companies report that 60 percent of them have someone from the investment company on their boards, but only 10 percent say that they have someone in the management structure. Eighty-one percent of the portfolio companies say the investment companies take an active interest in them, and 60 percent say the investment companies work closely with them. Sixty-five percent of the companies have received help from the investment companies, and 61 percent voluntarily seek help and advice. One factor which hinders many investment companies from providing management assistance is that they lack full-time personnel. Two-thirds of them employ one, or less than one, full-time professional staff worker.

8. Consulting services are available to the companies and are supplied by the investment companies.

Consulting services, offered by a majority of the investment companies, are provided either on a fee basis or free according to the situation. Sixty percent of the companies report that consulting services are available and are provided in several areas, the main ones being management, marketing, and finance, as shown in Table 12.

Table 13 shows that 33 percent of the investment companies recommend the use of outside consultants by the companies, and 41 percent of the companies use them. Thirty-two percent of the companies say they are deterred from



using consultants because of cost, and 54 percent feel consultants would not benefit them. Some say they do not use consultants for several reasons, including the fact that their business is highly specialized and that they lack confidence in consultants, as shown in Table 14.

9. Investment companies assist portfolio companies in securing additional funds.

Table 14 shows that 86 percent of the investment companies have had portfolio companies in need of additional funds. They themselves have supplied 54 percent of the funds required. When they do not see fit to provide the money, they help the companies get it from other sources. These include banks and commercial finance companies. It was found that 48 percent of the small businesses could not have raised additional funds had it not been for the investment companies. Eighty percent of portfolio companies requiring added funds obtained them.

10. Connections of the investment companies with an underwriter assist portfolio companies.

These associations bring information on the securities market and guidance to companies which hope to some day "go public." In the interviews it was found that having an underwriter who can be approached for useful information is of value. Forty-seven percent of the investment companies indicate they have connections with an underwriter, as shown in Table 16. Of the portfolio

companies responding, 71 percent feel that the investment companies could assist in a public sale of their stock. The latter respond that 65 percent would recommend the stock of the companies to their shareholders, if a sale were made. If a public sale is not feasible, underwriters know of individuals or of larger corporations looking for acquisitions.

11. Investment companies help bring additional business to portfolio companies.

Such business may come from other portfolio companies or from outside contacts. Table 15 shows that 86 percent of the investment companies try to send additional business to the portfolio companies, and 46 percent promote business among them. Seventy-six percent of the portfolio companies request dealings between portfolio companies, but only 44 percent say it is done. The interviews disclosed that some investment companies have their directors and stockholders look for business for the portfolio companies, either from their own firms or from those operated by friends.

12. Portfolio companies are satisfied with their relationships with the investment companies.

Eighty-one percent of the companies say that they would go to the investment companies again, while 19 percent say that they would not. The two main reasons given for not going are the cost involved and the equity position required as shown in Table 18.

13. Investment companies have prevented some portfolio companies from failing.

From the interviews and cases it was found that in several instances management assistance from the investment companies had prevented small businesses from failing. In some cases the investment companies took over the portfolio companies, and in other cases they merely helped the small businessmen with their problems. This assistance has prevented losses to the investment companies and the portfolio companies.

14. Investment companies need additional funds to invest if they are to provide more management assistance.

The interviews revealed that some investment companies feel they need added income to support the staff of qualified personnel necessary to provide adequate management. They felt that added funds should be made available to them by the Small Business Administration so they can grow and hire more full time personnel.

#### Conclusions

Based on the findings of this study, it may be concluded that

1. Congress intended that the investment companies should provide management assistance and consulting services to small businesses.

The review of the literature and interviews leads to the conclusion that Congress was concerned with the failure rate of small businesses when it drafted The Act. Although there is nothing in the Congressional Records concerning this subject, several articles mention the need for assistance. One interview also brought out the fact that Senator Sparkman, a framer of The Act, was concerned with this problem, and the Senate discussion makes numerous references to the Dun and Bradstreet Failure Reports. The Act includes a section which permits the investment companies to provide management assistance.

2. The investment companies are effectively implementing The Act by providing services.

The investment companies are providing services in five main areas: (1) management assistance, (2) consulting, (3) obtaining funds, (4) obtaining business, and (5) through underwriter connections. The cases and interviews make it clear that these services are being utilized. Most of this assistance is rendered by the investment companies' holding places on the board of directors of the portfolio companies. Assistance is given in such specific areas as: (1) financial management, (2) production management, (3) marketing management, (4) general administrative management, (5) obtaining added business, (6) helping to obtain additional funds, (7) helping to locate buyers for a company, and (8) helping to locate competent personnel.

Eighty percent of the investment companies say they offer management assistance. Eighty-six percent have helped portfolio companies obtain additional funds, and 88 percent have helped to locate additional business. Thirty-three percent say they were approached by portfolio companies for reasons other than to request funds.

Several portfolio companies reported they were seeking services and funds. Two companies approached investment companies primarily to obtain management assistance. Forty-one percent of the companies report they were aware of the management services when they turned to investment companies. The investment companies are providing assistance if the small businesses seek it.

3. The investment companies should provide more assistance in financial management.

The area of financial management seems to be the one where the most assistance is required. Most small businessmen lack competence in it. Many of them are excellent salesmen or engineers but have had no financial experience. Investment companies are capable of providing this assistance. Help in this area can reduce the failure rate of small businesses and help them grow.

4. Investment companies need to grow if they are to provide adequate services to the portfolio companies.

If the investment companies are to be able to provide adequate assistance, they must have the staffs to do so. At present most of them are not staffed to give such service. To employ sufficient full-time staff requires income to cover the cost. To generate income the investment companies must have funds to lend. When they have more money to lend, they can generate still more income and engage more people to better assist the portfolio companies. Such people must be available immediately when help is needed because the small businessman cannot wait until an inadequately staffed investment company can get around to sending assistance to him. It may come too late. Since the small businesses ask that competent assistance be available in several areas, an investment company with only one, or less than one, full-time person cannot adequately meet the need.

5. The services which the investment companies provide to the small business community are important to the latter and to the economy.

The investment companies offer a variety of services. It has been pointed out that small businessmen need assistance and guidance to avoid failure. Investment companies are not only allowed to provide such service but are encouraged to do so, and many are doing so. They can provide assistance in areas where the small businessman is weak, thus strengthening

his organization as was shown in the cases. This furnishes companies with assistance which they otherwise might not be able to find or to afford. It should help reduce the failure rate and increase the role of small business in the economy.

6. The ideas of saving the investment company's capital and of saving the small business from failure cannot be separated.

The fact that the investment companies have funds involved causes a question to arise: Is management assistance primarily provided to protect the investment or to help the small businessman? Evidence indicates that the two objectives cannot be separated. The investment company provides help to make the small business grow and to prevent failure. When its equity position increases, so does the value of the investment company's capital. As growth occurs, the investment company stands less chance of loss. If trouble arises, it must move in to protect its funds and to carry the small businessman through his difficulty. The two aims cannot be separated.

#### Recommendations

As a result of the findings and conclusions of this study, the following recommendations are in order

1. Investment companies should strengthen and increase the services which they offer.

It is clear that a variety of services are available from the investment companies and are being utilized by some of the portfolio companies. On the other hand, many small businesses approach investment companies for reasons in addition to that of raising funds. It seems, therefore, that more investment companies should arrange to provide the services reviewed in this study so that a greater number of small businesses will have access to them. Investment companies which already offer the services can improve their quality and can publicize the fact that such services are offered. A program to educate small businessmen to the advantages of working with the investment companies is called for. This may well prove to be an added inducement to bring additional small businesses to investment companies. It would bring them new investment possibilities and also provide the companies with the assistance desired.

Service should be provided in the eight specific areas listed in Conclusion 2, but it is not necessary that services be limited to this list. Others may be required. All will supplement the ability of the small businessman by guiding him in areas in which he is not competent or where time does not permit him to work effectively. Services such as these can benefit small businesses and, of equal importance, set investment companies apart from other financial institutions.



2. Investment companies should work more closely with the portfolio companies.

Small businesses need management assistance, which investment companies can provide. They should aim to establish a close working relationship with the companies. By establishing this type of relationship, they can be of greater assistance. If the companies consider the investment companies as partners, they will confide in them and allow them to assist with problems. The companies should understand that the investment companies have an interest in their success. When the small businessmen realize this, they will accept assistance from the investment companies because they will realize the latter are qualified and are sincere in their intentions. If they work closely with the companies, they will be better able to serve and assist.

3. The Small Business Administration should help the investment companies obtain additional funds to invest so that they can afford full-time and competent personnel.

The Small Business Administration can help arrange for funds to be borrowed by the investment companies for investment in small businesses, thus generating income. These funds are needed if income is to be available to investment companies to pay the staff needed to help the small businessman with his problems and reduce the number of failures. In turn, this will accelerate the rate of

growth of the small businesses and increase the value of the investment company's equity position. After providing these, the Administration might desire to ascertain that investment companies obtaining funds hire competent personnel to provide service and not merely generate profit. This can be done by checking the number and qualifications of personnel. Large investment companies are able to afford the staff so help should be directed toward the small and medium-size ones. However, the Administration should also determine whether large investment companies employ staff sufficient to provide the desired assistance.

4. A follow-up study could be undertaken to determine the effectiveness of the services and assistance which the investment companies provide.

Although an attempt was made in this study to determine if the services were utilized, it has not sought to determine their effectiveness. Another study might determine if the availability and use of these services reduce the failure rate of portfolio companies as compared to the average failure rate for all small business. Material for this type of study would be difficult to obtain because unfavorable information would reflect on the management ability of the investment companies. They would understandably be reluctant to provide derogatory facts and opinions.

Even though a majority of the companies report that they have grown since receiving investment company funds, this does not necessarily mean that the services have contributed to this growth. Further studies might for example, correlate growth with assistance received.

**APPENDIXES**

APPENDIX A

Please return to:  
Walter B. Stults,  
Executive Director  
NASBIC  
537 Washington Building  
Washington, D. C. 2005

PART I

Management Services  
Offered by SBICs to Portfolio Companies

1. Company name (optional) \_\_\_\_\_  
(if name is not given, please give regional location)
2. Capital \_\_\_\_\_ No. of current investments \_\_\_\_\_
3. Publicly held \_\_\_\_\_ Closely held \_\_\_\_\_
4. Bank affiliated \_\_\_\_\_
5. Type of investments made:
  - (a) Loans only \_\_\_\_\_
  - (b) Loans and equity \_\_\_\_\_
  - (c) Loans and warrants \_\_\_\_\_
  - (d) Convertible debentures \_\_\_\_\_
  - (e) Equity only \_\_\_\_\_
  - (f) Other (specify) \_\_\_\_\_

Please indicate in what category the majority of your investments fall: (a) \_\_\_\_\_ (b) \_\_\_\_\_ (c) \_\_\_\_\_ (d) \_\_\_\_\_  
(e) \_\_\_\_\_ (f) \_\_\_\_\_
6. Do you feel that any company has approached you for reasons other than to obtain funds? Yes No  
If yes, for what reason? \_\_\_\_\_
7. Do you find managements of portfolio companies generally reluctant to accept assistance you offer? \_\_\_\_\_  
If yes, how do you go about convincing them they need help and to accept it? \_\_\_\_\_

8. Nature of participation in portfolio companies after investment: (\*Refers to proportion of portfolio companies)

	<u>*All</u>	<u>*Most</u>	<u>*Few</u>	<u>*None</u>
(a) As creditor not on Board	_____	_____	_____	_____
(b) As stockholder not on Board	_____	_____	_____	_____
(c) Attend Board meeting but not serve	_____	_____	_____	_____
(d) Serve on Board	_____	_____	_____	_____
(e) Participate directly in management	_____	_____	_____	_____
How?	_____	_____	_____	_____
(f) Offer free consulting service	_____	_____	_____	_____
(g) Offer paid consulting service	_____	_____	_____	_____
(h) Other _____	_____	_____	_____	_____

9. Nature of special services offered:

(a) None	_____	_____	_____	_____
(b) Active Board participation	_____	_____	_____	_____
(c) Serve as officer of company:	_____	_____	_____	_____

	<u>Number</u>	<u>Paid</u>		
		<u>Yes</u>	<u>No</u>	<u>How</u>
Chairman of the Board	_____	_____	_____	_____
President	_____	_____	_____	_____
Vice President	_____	_____	_____	_____
Treasurer	_____	_____	_____	_____
Other	_____	_____	_____	_____

Do you control (own 51% or more of voting stock) any of these companies? How many? \_\_\_\_\_

(d) Paid consulting services: (If you offer this, please fill in special questionnaire at end.)

	<u>Yes</u>	<u>No</u>
(e) Have any of your companies required additional financing since the original loan?	_____	_____
If yes, were you able to provide the funds?	_____	_____
If no, were you able to aid the company in obtaining the funds?	_____	_____
What was the source of the funds obtained?	_____	_____

(f) Have any of your portfolio companies asked you to send them business from another portfolio company?	_____	_____
Do you attempt to promote dealings between the companies?	_____	_____
Do you attempt to locate new business for your companies?	_____	_____

Yes      No

(g) Does your SBIC have connections with a securities underwriter?

\_\_\_\_\_

Have any of your companies sold a public issue of stock?

\_\_\_\_\_

If yes, how many? \_\_\_\_\_

What were the results? \_\_\_\_\_

Would you encourage your shareholders to purchase stock in one of your portfolio companies if the stock were marketed?

\_\_\_\_\_

(h) Other services offered. Please describe

\_\_\_\_\_

\_\_\_\_\_

10. Of all services you offer, which have been most effective in helping portfolio companies (please list several most effective services and rate degree of effectiveness).

\_\_\_\_\_

\_\_\_\_\_

11. Will you enclose typical covenants from your agreements relative to management services required as a loan provision (consulting service, Board membership, etc.).

12. Will you describe a case history, or several, telling how any of your non-financial services have materially helped a portfolio company.

\_\_\_\_\_

\_\_\_\_\_

Questionnaire for those offering  
paid consulting services

Yes      No

1. Do you have a special organization for this? \_\_\_\_\_
- If no, do you ever charge consulting fees? \_\_\_\_\_
- % of total company revenue derived from consulting \_\_\_\_\_
- Number of full-time consultants: \_\_\_\_\_
- Senior \_\_\_\_\_ Junior \_\_\_\_\_
- Number of part-time consultants: \_\_\_\_\_
- Senior \_\_\_\_\_ Junior \_\_\_\_\_
- Source \_\_\_\_\_
- % of permanent staff time devoted to consulting \_\_\_\_\_
- Maximum rate charged (if on time basis) \_\_\_\_\_
- Average \_\_\_\_\_
- Other charge basis (retainers, etc.) \_\_\_\_\_
- Do you also serve non-portfolio companies? \_\_\_\_\_
- % of total consulting income derived from non-portfolio companies \_\_\_\_\_
- Type of consulting: \_\_\_\_\_
- General management \_\_\_\_\_
  - General financial \_\_\_\_\_
  - General technical \_\_\_\_\_
  - Accounting \_\_\_\_\_
  - Manufacturing \_\_\_\_\_
  - Marketing \_\_\_\_\_
  - Research \_\_\_\_\_
  - Other \_\_\_\_\_
- Do you consider your paid consulting activities successful? \_\_\_\_\_
- If no, explain why \_\_\_\_\_
- Are paid services ever required in loan agreement or other agreement? \_\_\_\_\_
- Under what circumstances? \_\_\_\_\_
- If you offer paid consulting services, do you ever provide this "free"? \_\_\_\_\_
- Under what circumstances? \_\_\_\_\_



APPENDIX B

Reply to:  
--John E. McDavid  
827 Central Trust Tower  
Cincinnati, Ohio 45202

Management Services Received by Companies  
Which Have Obtained Funds From an SBIC

Name and Address of Respondent Company:

\_\_\_\_\_

1. Please check the type of business your company operates.

- |   |  |
|---|--|
| <input type="checkbox"/> Manufacturer           | <input type="checkbox"/> Real Estate Firm          |
| <input type="checkbox"/> Retail Store           | <input type="checkbox"/> Food Processor            |
| <input type="checkbox"/> Wholesale Firm         | <input type="checkbox"/> Processor other than food |
| <input type="checkbox"/> Research Firm          | <input type="checkbox"/> Business Consultant       |
| <input type="checkbox"/> Transportation Company | <input type="checkbox"/> Building Contractor       |
| <input type="checkbox"/> Other (Specify _____)  |  |

2. Why did you approach a SBIC (please check one or more)?

- To obtain funds
- Management assistance
- To help obtain business
- To help establish business relations
- Consulting services
- For underwriting connections
- Other (Specify) \_\_\_\_\_

3. Did you expect services to be available from the SBIC other than providing funds? Yes or No

4. What services are available from the SBIC?

- Providing funds
- Management assistance
- Consulting services
- Providing additional customers
- Underwriting connections
- Other (Specify) \_\_\_\_\_

5. Were the requested amount of initial funds provided? Yes or No
- (a) Have additional funds been requested since the initial financing? Yes or No
- (b) Were these funds obtained? Yes or No
- (c) If the preceding answer is yes, please list the source of the funds obtained
- (d) \_\_\_\_\_ Could these funds have been obtained if the SBIC had not have made a previous investment in your company? Yes or No
- (e) If the answer to (b) is no, why not? \_\_\_\_\_

6. Nature of management assistance provided by the SBIC.

- \_\_\_\_\_ None, creditor only
- \_\_\_\_\_ Attend board meetings, but not a member
- \_\_\_\_\_ Serve on Board of Directors
- \_\_\_\_\_ Participate directly in management
- \_\_\_\_\_ Offer consulting services
- \_\_\_\_\_ Other (Specify) \_\_\_\_\_

- (a) Did the SBIC insist on placing someone on your board? Yes or No
- (b) Do you ask management help and advice from the board member or from the SBIC? Yes or No
- (c) Does the SBIC management take an active interest in your problems? Yes or No
- (d) Has the SBIC helped you with a specific problem? Yes or No
- (e) Has management assistance been requested and not received? Yes or No
- (f) Do you expect to pay for help received? Yes or No
- (g) Does the SBIC management work closely with you? Yes or No
- (h) How frequently does someone from the SBIC visit you? \_\_\_\_\_ times per year
- (i) How many hours are spent by the SBIC representative working with you? \_\_\_\_\_
- (j) Does the SBIC participate \_\_\_\_\_ per visit directly in the management of your company? Yes or No
- (k) If the above answer is yes, please specify in what capacity. \_\_\_\_\_

7. Does the SBIC with which you deal offer consulting services? Yes or No

(a) If the answer to Number 7 is yes, in what areas?

<u>          </u> General Management	<u>          </u> Research
<u>          </u> Manufacturing Management	<u>          </u> Accounting
<u>          </u> Finance	<u>          </u> General Technical
<u>          </u> Marketing	<u>          </u> Other (Specify)

- (b) Is there a clause in your loan agreement requiring the use of consultants? Yes or No
- (c) Do you feel these services are necessary? Yes or No
- (d) Are the services provided on a fee basis? Yes or No
- (e) Is any work done free of charge? Yes or No
- (f) Does the SBIC recommend the use of outside consultants? Yes or No
- (g) Have you used outside consultants? Yes or No
- (h) Are you deterred from using consultants due to the cost involved? Yes or No
- (i) Do you feel that consultants could benefit your company? Yes or No
- (j) If the above answer is no, why not?

8. Does the SBIC from which you borrowed attempt to obtain additional business for your company? Yes or No

- (a) Have you requested such assistance? Yes or No
- (b) Is business promoted between companies which the SBIC has financed? Yes or No
- (c) Would you like to obtain business from the above source? Yes or No

9. Does the SBIC with which you deal have connections with an underwriter? Yes or No

- (a) Do you hope that eventually your company may go public? Yes or No
- (b) Do you feel the SBIC can aid in sale of a public issue of securities? Yes or No
- (c) Do you feel that the stockholders of the SBIC would be willing to purchase stock in your company? Yes or No

10. General

- (a) Has your company grown since obtaining the SBIC funds? Yes or No

- (b) What was your rate of growth in profit before taxes, prior to obtaining SBIC funds? \_\_\_\_\_ % per year
- (c) What has been the rate, using the same basis, since obtaining funds? \_\_\_\_\_ % per year
- (d) Would you go to a SBIC again if you needed funds? Yes or No
- (e) Would you recommend SBIC financing to another company in need of funds? Yes or No
- (f) If no, why not? \_\_\_\_\_
- (g) List any services not previously mentioned that you receive from the SBIC.
- (h) List any additional services you would like to see the SBIC industry provide.
- (i) Please describe some incident in which the SBIC has aided your company other than by providing funds.

## APPENDIX C. DEFINITION OF TERMS

A small business under the Small Business Act of 1958. A small business is defined in Section 203 of The Act as follows:

For purposes of this title a small business concern shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation.

In addition to the foregoing criteria the Administration in making a detailed definition may use these criteria among others: Number of employees and dollar volume of business.<sup>1</sup>

A small business concern for the purpose of financial and other assistance: A small business for the purpose of financial and other assistance is defined as follows:

A small business concern for the purpose of financial and other assistance (except procurement assistance) is a business concern, including its affiliates, which is not dominant in its field of operations and can further qualify under the following criteria:

- A. Manufacturing: Any manufacturing concern is classified:
1. As small if it employs 250 or fewer employees;
  2. As large if it employs more than 1,000 employees;
  3. Either as small or large, depending on its industry, if it employs more than 250 but less than 1,000 employees.
- B. Wholesale: Any wholesale concern is small if its annual dollar sales is \$5,000,000 or less. Any wholesale concern also engaged in manufacturing is not a small business concern unless it so qualifies under both the manufacturing and wholesaling standards.

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<sup>1</sup>U. S., Congress, House, Select Committee on Small Business, Definition of "Small Business" Within Meaning of Small Business Act of 1953 as Amended, H. Res. 114, 84th Cong. 1st Sess., 1956, p. 19.

- C. Retail: Any retail concern is classified:
1. As small if its annual sales are \$1,000 or less;
  2. As small if it is primarily engaged in making retail sales of general merchandise (including department stores) or new and used motor vehicles or groceries with fresh meats and its annual sales are \$2,000,000 or less.<sup>2</sup>

A small business firm for purposes of receiving assistance from investment companies. In order for a small business to receive assistance it must qualify under the preceding paragraph or be classified as a business concern which,

Together with its affiliates, is independently owned and operated, is not dominant in its field of operation, does not have assets exceeding \$5,000,000, does not have net worth in excess of \$2,500,000 and does not have an average net income, after Federal income taxes, for the preceding two years in excess of \$250,000 (average net income to be computed without benefit of any carry-over loss).<sup>3</sup>

Small Business Investment Company: The term small business investment company refers to a corporation duly organized under the provisions of Title III of the Small Business Investment Act of 1958, as amended.<sup>4</sup>

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<sup>2</sup> U. S., Congress, House, Select Committee on Small Business, Definition of "Small Business" Within Meaning of Small Business Act of 1953, as Amended, H. Res. 56, 85th Cong. 2nd. Sess., 1959, p. 13.

<sup>3</sup> 25 Federal Register 10087 (October 22, 1960), Section 121. 3-11.

<sup>4</sup> U. S., Congress, Senate, Select Committee on Small Business, Small Business Investment Act, Text Explanation and Related Tax Provisions, Public Law 699, as Amended, 85th Cong., 2nd. Sess., 1960, p. 2.

Licensee: The term, Licensee, refers to a corporation chartered by the Small Business Administration under Section 301 of the Small Business Investment Act of 1958, to conduct in the territory in which it operates the activities described under Title III of The Act.<sup>5</sup>

Operating Territory: The area in which a small business investment company is authorized to carry on its operations is referred to as the "operating territory". It refers to the territorial area in which the licensee is authorized to furnish equity capital, long-term credit and consulting and advisory services to small business.<sup>6</sup>

Types of loans to small business by SBICs: A small business investment company is authorized to provide funds to small businesses under Sections 304 and 305 of The Act. Section 304 loans provide Equity Capital for small business concerns as follows:

(a) It shall be primary function of each small business investment company to provide a source of needed equity capital for small business concerns in the manner and subject to the conditions described in this section.

(b) Capital shall be provided by a company to a small business concern under this section only through the purchase of debenture bonds (of such concern) which shall:

(1) bear interest at such rate, and contain such other terms, as the company may fix with the approval of the Administration;

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<sup>5</sup> Small Business Administration, op. cit., Section 107.12.

<sup>6</sup> Ibid.

(2) be callable on any interest payment date, upon three months notice, at par plus accrued interest; and

(3) be convertible at the option of the company, or a holder in due course, up to and including the effective date of any call by the issuer, into stock of the small business concern at the sound book value of such stock determined at the time of the issuance of the debentures.<sup>7</sup>

Section 305 of The Act provides for long-term loans as follows:

(a) Each company is authorized to make loans, in the manner and subject to the conditions described in this section, to incorporated or unincorporated small business concerns in order to provide such concerns with funds needed for sound financing, growth, modernization and expansion.<sup>8</sup>

Consulting and advisory services: The investment company may provide consulting and advisory services to the small business concern. These are defined and allowed for under Section 308b of The Act as follows:

Each small business investment company may make use, wherever practicable, of the advisory services of the Federal Reserve System and of the Department of Commerce which are available for and useful to industrial and commercial businesses, and may provide consulting and advisory services on a fee basis and have on its staff persons competent to provide such services.<sup>9</sup>

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<sup>7</sup> U. S., Congress, Senate, Select Committee on Small Business, op. cit., p. 7.

<sup>8</sup> Ibid., p. 8.

<sup>9</sup> Ibid., p. 9.



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