

*A review by the* **Federal Reserve Bank of Chicago**

# Business Conditions

1961 May



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# THE Trend OF BUSINESS

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**E**vidence is accumulating that the economy passed a low point some time during the first quarter of 1961. Although the up-trend of recent weeks has been mild, many industries have reported higher orders, and no important segment of activity has shown substantial further deterioration.

Total employment and average weekly hours in manufacturing, seasonally adjusted, have been improving since December. Retail trade was at a low in January and industrial production and construction activity apparently touched bottom in February. The precise month marking the end of the decline for general business may remain a matter of dispute because various industries have followed different patterns during the past year.

Cutbacks in steel began early in 1960 and were much steeper than in other industries. However, steel production has been rising each month since December, and the new order trend suggests that this movement will continue. Inventories of most steel users are now down to desired levels and in some cases are being increased.

Passenger car production declined sharply after October and continued to sag in the first two months of 1961, the only major industry which was slipping appreciably during this period. An improved sales trend beginning in late February caused auto makers to increase output schedules in March and April. Assemblies for the second quarter are expected to exceed the first by over 20 per cent.

Farm machinery is another important Midwest industry which was depressed during much of 1960. In recent months sales of farm machinery to dealers have risen substantially. Part of this increased demand has been satisfied by reducing manufacturers' inventories, but production has risen and some workers previously laid off have been recalled.

Modest sales gains also have been reported for trucks, construction machinery and some types of industrial equipment. On the other hand, railroad equipment producers and most consumer hard goods industries, including appliances and furniture, have not reported increased demand. In the aggregate, the durable goods industries, which played a major role in the recession, are expanding production. Because of the importance of these lines in the Midwest, the area can be expected to share more than proportionately in any general recovery.

## **Employment rising**

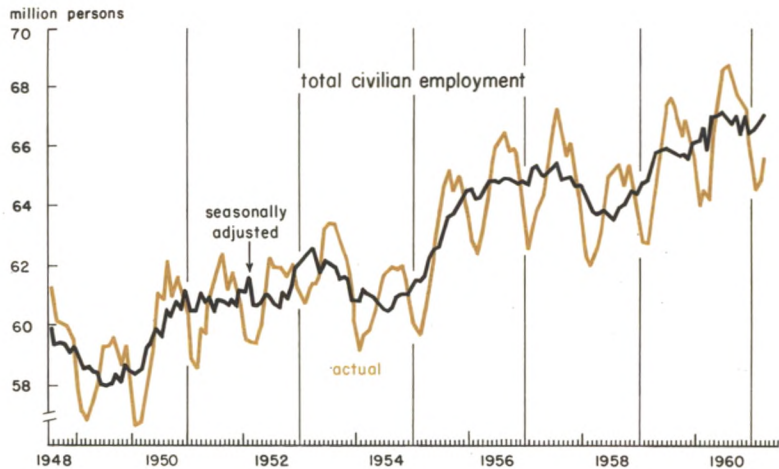
Virtually all measures of general activity indicate that the recent decline was the mildest of the postwar period. This is particularly evident in the case of total employment (see chart). In no month during the recession did employment drop below the corresponding month a year earlier. During the first three months of 1961 employment, seasonally adjusted, has been rising, and in March it was only slightly below the record high of mid-1960.

Total employment was 1.2 million higher in March than a year earlier. This gain was in agriculture, construction, trade, service and government. Manufacturing employment was 1 million lower than a year earlier with 900,000 of this decline in the durable goods industries. Employment was lower also in mining and transportation. In general, the declines in employment have been in the highest wage industries.

Another contrast in the employment picture is between men and women. The latter now account for about one-third of the labor force, a proportion that has shown a persistent upward trend. In March there were 1 million more women working in nonfarm employment than a year before, whereas the number of men was 200,000 less. Despite higher employment, unemployment was at a relatively high level in March—4.9 million seasonally adjusted or 6.9 per cent of the labor force—and was at a postwar high for the month. Because of layoffs in the industrial sector and the increase in the civilian work force (those working or seeking work) over and above the increase in the number of jobs, unemployment was 1.3 million higher in March than a year earlier.

There was a net increase of 2.5 million in the labor force in the twelve months ending in March, bringing the total to over 71 million. Only once before during the postwar period, between March of 1955 and

### Employment rose in the first quarter and in March was a record high for the month



March of 1956 (a time of strong labor demand), did an increase in the labor force approach the March-to-March rise of 1960-61.

The Department of Labor in March classified 101 of the 150 major labor market areas (19 of 23 in the Seventh District) as having a substantial labor surplus—6 per cent or more unemployed.

In the District the strongest labor market areas are Cedar Rapids, Des Moines, the Quad Cities and Madison with 3 to 6 per cent unemployment. These medium-size centers feature farm machinery manufacturing, state government and educational institutions. The areas of highest unemployment, over 9 per cent of the labor force, include steel and auto production centers—such as Gary, South Bend, Muskegon, Flint and Detroit—where conditions are improving but are still quite depressed.

#### Postwar upturns

The upturns in the three prior postwar



recessions have differed greatly. Nevertheless, comparisons are of interest in appraising the current situation. Contrasts in the performance of important sectors during upturns are particularly marked in residential construction, new plant and equipment and total disbursements to the public by the Federal Government.

The upturn in expenditures for residential construction in 1949 occurred at roughly

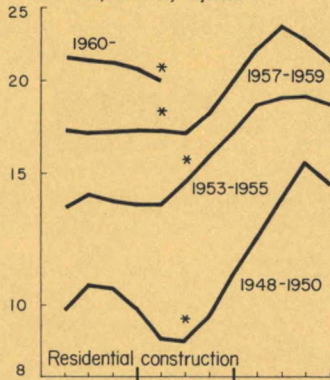
the same time as in total expenditures for all goods and services—gross national product; in 1954 housing led the turn and in 1958 it lagged.

New plant and equipment expenditures, on the other hand, lagged gross national product by at least two quarters in each of the upturns. Thus, as in previous recovery periods, the rise in this type of spending—indicated in recent surveys to begin in the second half of 1961—may be expected to reinforce an upturn.

Federal Government spending, frequently thought of as a major stimulus to demand during recessions, has, in fact, played a greatly varied role during the postwar upswings. In 1949, total cash payments rose moderately but slipped back temporarily in the third quarter. These outlays declined in 1954, but a reduction in income taxes helped boost personal consumption and business investment spending. During 1958, Government spending rose continuously, leveling off in early 1959 as business conditions improved and concern with possible inflationary aspects of a large Federal deficit became stronger.

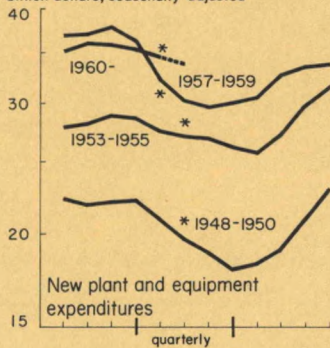
### Performance of individual sectors has varied during upturns following postwar recessions

billion dollars, seasonally adjusted

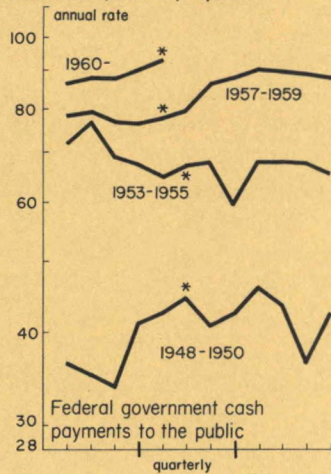


Expenditures for new plant and equipment have usually lagged upturns in total output, but the patterns in residential construction spending and Federal cash payments to the public have been more varied.

billion dollars, seasonally adjusted



billion dollars, seasonally adjusted



\*Low quarter for GNP; preliminary for 1961.

# Mortgage rates decline further

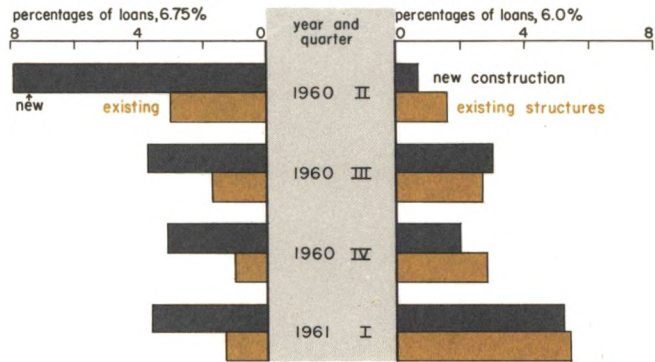
Interest rates on home mortgages in the Chicago area declined somewhat further in the opening months of 1961, continuing a tendency under way since early last year. Rates on conventional loans averaged 6.2 per cent, including the effect of commissions and other fees along with contract interest rates. This rate was about a fifth of a percentage point below the second quarter of 1960.<sup>1</sup>

On a monthly basis, most of the decline in rates since the high in late 1959 and early 1960 took place before last September and in February and March of this year. During the intervening months, rates were fairly stable at about 6.25 per cent.

Easing is reflected in a general decline in the proportions of loans bearing relatively high rates and a rise in the proportions at lower levels. In the second quarter of 1960, for example, 25 per cent of the longer-term, low down-payment conventional loans secured by new properties carried effective rates in the 6½ to 6⅞ per cent range. In the first quarter of this year, the proportion was down to 9 per cent. Loans in the 5⅞ to 6⅞ per cent range, on the other hand, climbed from 2 per cent to 13 per cent of the total during the same interval.

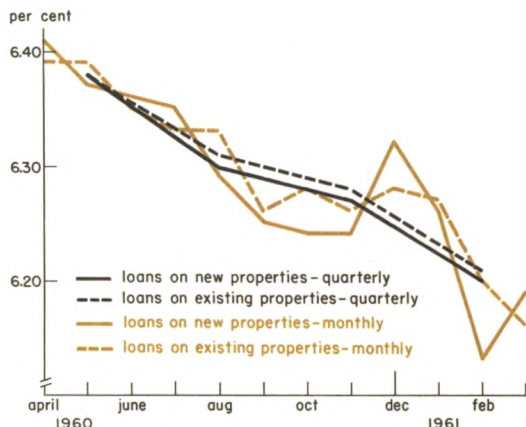
<sup>1</sup>Data sources and methods of analysis are described in "Terms of home mortgage loans," *Business Conditions*, June 1960.

## Recent changes in frequency of highest and lowest rates for long-term, low-down-payment loans\*



\*Terms 22½ years and more for loans on new properties; 17½ years and more for loans on existing properties. Loan-to-value ratios for both classes, 75 per cent and more.

## Interest rates decline on home loans (average effective rate, conventional loans, Chicago metropolitan area)





# Twentieth anniversary of savings bonds

Sales of series E savings bonds are now entering their twentieth year. These bonds are by far the largest element in the U. S. Treasury's savings bond program which was initiated in 1935 to foster savings among lower- and middle-income groups. Revamped and expanded in May 1941, when it became apparent that defense expenditures would rise sharply, the program was then intended to help raise funds in a way that, according to the Secretary of the Treasury, would "best safeguard the nation against the evils of inflation and . . . give all American citizens a sense of taking part in the defense of the country."

Savings bonds played a key role in the financing of the war. At the end of hostilities in 1945 over 45 billion dollars of these securities were outstanding—about one-sixth of the total Government debt.

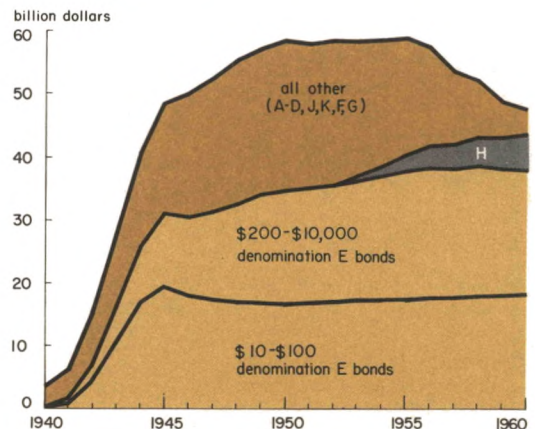
The Treasury has announced recently that series E bonds issued between May 1941 and May 1949 may now be held for an additional 10 years beyond their already extended maturity. For this period the interest rate is raised to 3¾ per cent annually, compared with an average of 2.9 per cent for the first 10 years and 2.9 to 3.5 per cent for the second 10 years. This increase brings the return on these bonds approximately equal to the return on E bonds issued since February 1957. A \$100 bond purchased for \$75 in May 1941 would have a value of \$195.04 if held the additional 10 years to 1971.

Experience with the savings bond program can be divided conveniently into three

periods. The first includes the war years during which sales of savings bonds increased sharply and redemptions were relatively small. During this time the small denomination bonds accounted for a large part of the program, indicating participation by many people of modest means. Nearly half of the total sales were E bonds of \$100 denomination or smaller and these represented about 40 per cent of all savings bonds outstanding. The success of the program in this period can be attributed to both the strong appeal of patriotism and to the rate of interest offered which was as high or higher than rates offered on savings deposits or other similar investments.

The second period includes the immediate

## Savings bonds outstanding fell after 1955; rise of H bonds partially offset decline of other series



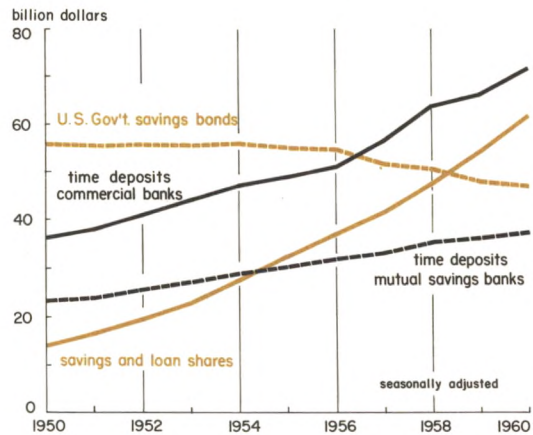
postwar years, 1946 to 1950. Many families in those years were aggressively acquiring the goods and services which had not been available during the war. Not only was a greater share of current income used for these purchases, but many families also redeemed savings bonds and other liquid assets. Sales of the smaller denomination E bonds fell sharply, from 8.8 billion dollars in 1945 to 3.1 billion in 1946. Sales of savings bonds as a whole, including accrued interest (interest credited but not paid) on outstanding appreciation bonds, however, continued to exceed redemptions; and the total volume of bonds outstanding increased, although at a slower pace than in the war years.

#### After 1950, no growth

The volume of savings bonds outstanding was quite stable from 1950 until 1955; thereafter, it declined even though the volume of other forms of liquid savings, such as commercial bank time deposits, deposits in mutual savings banks and share capital of savings and loan associations, continued to grow quite rapidly. At the end of 1960, 47.5 billion dollars of savings bonds were outstanding, compared with 58.5 billion in 1955 and 58.2 billion in 1950. In contrast with the immediate postwar period, the 1955 to 1960 decline was largely in bonds of \$200 denomination or larger. These bonds decreased from 71 per cent of total savings bonds outstanding in 1955 to 62 per cent in 1960.

The relatively poor showing of savings bonds since 1951 can be attributed in large measure to the less advantageous interest rates on savings bonds compared with rates on some other liquid investments. While in the 1940's the interest yield on savings bonds was usually greater than on most other forms

### Savings bonds have not participated in rise in liquid financial assets since 1955



of savings, in the second half of the 1950's the situation was on the whole reversed. "Thrifty" institutions and marketable Treasury securities offered interest yields as high or higher than were obtainable on savings bonds, with the result that a small percentage of the new savings were channeled into the Treasury's savings-type security.

To hold down the redemption of outstanding savings bonds and to provide some additional push to sales, the Treasury increased interest rates three times. In 1952 rates were increased from 2.9 per cent to 3 per cent on all newly issued series E and H bonds and on all newly extended matured bonds of the E series. In 1957 rates were increased to 3¼ per cent on newly issued bonds and in 1959 to 3¾ per cent on newly issued E and H bonds and by approximately one-half per cent on outstanding issues. The increases in rates in 1957 and 1959 provided some stimulus to sales and slowed redemptions. As a result the total of sales and accrued interest on series E bonds outstanding rose above



redemptions in 1958 and again in 1960.

### Bonds ease debt management

Although the volume of savings bonds outstanding has been declining, these securities represent almost one-quarter of the total Government debt in the hands of the public. [Approximately 28 per cent of the total debt is not held by the public but by the Government in various trust funds—the largest of which is the Federal Old-Age and Survivors Insurance Trust Fund (Social Security)—and by the Federal Reserve Banks; it is therefore largely outside of the Treasury's current debt management problems.] If the volume of savings bonds outstanding was to decline substantially, more funds would have to be raised from other sources; hence, the Treasury has desired to maintain the savings bonds program at a high level. On the other hand, if the cost of

maintaining this large volume becomes excessive relative to alternative sources of funds, or if holdings of savings bonds should become highly volatile, this instrument would complicate rather than simplify the management of the United States debt.

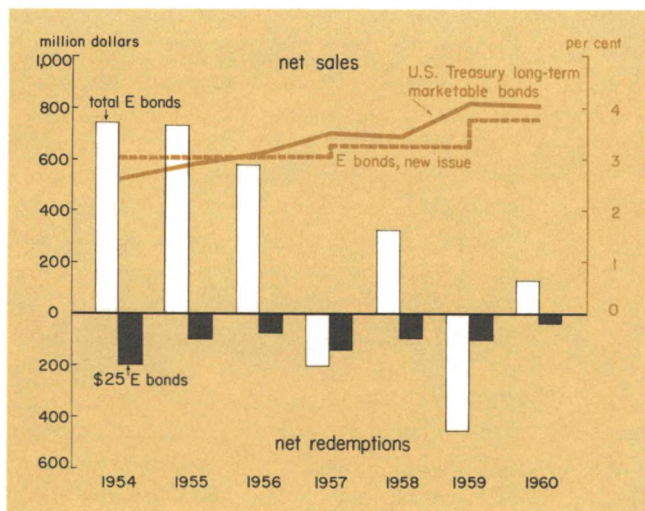
In addition to adjusting interest rates, the program has been modified in several ways in recent years, largely to keep the bonds primarily in the hands of those who normally do not purchase marketable debt. The type of purchaser eligible to purchase savings bonds and the amount which can be purchased annually have been restricted, and the maturities of bonds other than the series E's have not been extended.

Commercial banks have been permitted to purchase savings bonds for their own accounts only on rare occasions, but other financial institutions had been eligible to purchase such bonds, other than the E's and H's, in relatively large amounts. The savings bonds eligible for purchase by these institutions were discontinued in 1957 when interest rates were raised. At the same time the amount of series E and H bonds a person could purchase within one year was reduced to \$10,000, except when issued in exchange for maturing issues of other series of savings bonds.

Maturing or matured series F and G bonds may be exchanged for E's and H's and, on occasion, the Treasury has offered marketable issues in exchange for maturing issues of F's and G's.

Although the rate of interest on E bonds increases as the bonds approach maturity, many bonds, particularly those of the smaller

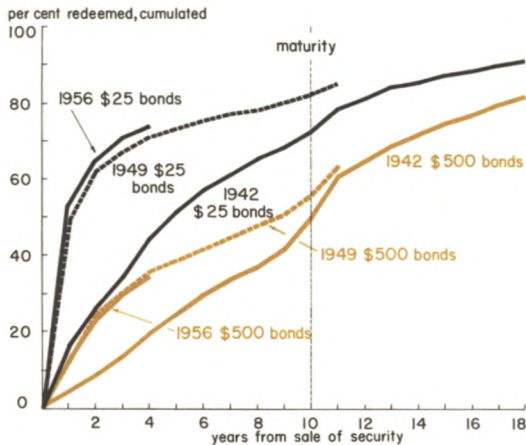
### Net E bond sales rose in 1958 and 1960 following rate increases in 1957 and 1959



<sup>1</sup>Total includes accrued discount; \$25 bonds at maturity value.



## Per cent of \$25 and \$500 series E bonds purchased in 1942, 1949 and 1956 redeemed in succeeding years



denominations, are redeemed before they mature. Over half of the E bonds of \$25 denomination purchased in the 1950's were redeemed within a year after purchase; over two-thirds were redeemed within 3 years and three-fourths of those purchased between 1950 and 1955 were redeemed within 5 years. Only about 10 per cent of those purchased in 1941 and 1942 were still outstanding at the end of 1960.

The proportion redeemed before maturity is smaller for the higher denominations. While an average of 53 per cent of the \$25 bonds purchased after 1950 were redeemed within a year of issue date, only 26 per cent of the \$100 bonds and 12 per cent of the \$500 bonds purchased in the same years were redeemed within a year. Redemptions of \$500 E bonds within 3 years of issue date have averaged 27 per cent; within 5 years, 36 per cent.

Series H bonds tend to be held longer than

series E bonds. Only about 4 per cent of the \$500 H bonds have been redeemed within a year of date issued.

The high proportion of the small denomination bonds redeemed soon after issue increases the cost of the savings bond program. Although no interest is paid on bonds redeemed within six months after issue, the benefits to the Treasury, or the holders are small and probably less than the cost of issuing and redeeming the bonds. However, it may not be possible for the Treasury to restrict sales of bonds which are redeemed quickly without also reducing the sales of those which would be outstanding for longer periods.

### Current models

Two types of savings bonds are sold today—the well-known series E and the possibly less-well-known series H. The E bonds continue to be the “appreciation” type, sold at 75 per cent of maturity value. Since their selling and maturity values are fixed, interest rate adjustments on new issues have been made by changing the number of years to maturity. The E bonds of the 1940's matured initially in 10 years and, as noted earlier, yielded 2.9 per cent if held this long. Since June 1959 the E bonds are due in 7 years and 9 months and yield  $3\frac{3}{4}$  per cent if held to maturity.

Maturities of those bonds issued in the 1940's have twice been extended at the option of the owner for an additional 10 years, and maturities of bonds issued in the 1950's have been extended once. With the exception of the new extension, commencing this month, the redemption values of the bonds are so scheduled that interest yields increase the longer the bond is held, until maturity. Except for the first two months following the date of issue, series E bonds

may be redeemed at any time.

Because the receipt of interest on series E bonds is deferred until the bonds are redeemed, the Treasury permits payment of the income tax on this interest to be similarly deferred. This feature makes the E bonds particularly attractive as savings for retirement. Since an individual's income, and consequently the rate of income tax, normally declines upon retirement, less tax need be paid on the interest effectively earned in prior, higher-income years. Furthermore, E bonds, as well as unmatured series F and J bonds, can be exchanged for series H bonds with the tax payment on the accrued interest postponed until the maturity or redemption of the H bonds.

Series H bonds, introduced in 1952, are "current income" bonds issued at 100 per cent of maturity value in denominations of \$500 and larger. Interest is paid semiannually, currently at the rate of 3¾ per cent if held to maturity. H bonds issued since 1957 mature in 10 years. All H bonds, however, can be redeemed at face value at any time after six months upon one month's notice.

Both series E and H bonds may be purchased either "over the counter" at banks and some other institutions or through payroll savings plans. Over half of all sales of E bonds are made through payroll savings plans operated by some 45,000 companies in the United States.

### Larger denomination series E bonds purchased in 1950's held longer than smaller denominations

Denomination	Redeemed within 1 year of purchase		Redeemed within 3 years of purchase		Redeemed within 5 years of purchase	
	Average of annual percentages		Average of annual percentages		Average of annual percentages	
	1959	1959	1959	1959	1959	1959
\$ 25	53	54	69	70	75	77
50	42	46	59	61	66	69
100	26	32	42	47	49	53
200	15	19	29	30	37	40
500	12	13	27	27	36	38
1,000	11	11	26	26	34	37

The efforts of the Treasury to make savings bonds more attractive to individual savers attests to the interest it has in the program. The sheer volume of savings bonds outstanding—accounting for almost one-fourth of the Government debt in the hands of the public—explains why. Despite the high early redemptions of small denominations, a substantial amount is firmly lodged with savers on a long-term basis, thus easing the Treasury's debt management problems.

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# Small business investment companies, a progress report

Over 200 *small business investment companies* (SBIC's) now are licensed to operate under the Small Business Investment Act of 1958. The number has more than doubled during the past year. Many additional companies are in the process of formation, and legislation currently under consideration may further accelerate the program.

Aside from funds held temporarily in cash or Governments, SBIC's invest only in the stocks and long-term loans of small businesses, as defined by the *Small Business Administration* (SBA), the agency responsible for administering the program. Thus, they are intended to help fill a "gap," which various studies have indicated to exist, in the supply of credit and equity funds available to small business firms.

The Government is aiding the SBIC's principally through loans, tax benefits and the privilege of operating under a special license. In return these firms agree to operate in conformance with regulations issued by the Small Business Administration.

Most of the SBIC's are relatively small, possessing the minimum capital of 300,000 dollars. However, a number of companies have "gone public" during the past year, selling their stock to private investors in amounts ranging up to 22.5 million dollars. Resources of all SBIC's now total 200 million, of which well over 50 million has been invested in small businesses.

There is some concentration of SBIC's on the East Coast, in Texas and in California. However, one or more are headquartered in

each of 34 states and some of these institutions operate nationally. There are seven SBIC's in Illinois, six in Wisconsin, four in Indiana, two in Michigan and one in Iowa. Two Wisconsin firms and one in Illinois have sold issues of stock to the public.

## Why SBIC's?

The importance of small firms in promoting competition and furthering economic progress is universally acknowledged. Studies of small businesses commonly have concluded that their growth might be enhanced if they could obtain equity and long-term credit more readily. The SBIC program is an attempt to fill this need by the promotion of specialized financial institutions.

A Federal Reserve study released in January indicated that small manufacturing firms have been far more successful in obtaining short-term credit than equity capital and long-term loans. Seventy per cent of the firms which desired short-term credit reported that these needs had been met satisfactorily. In the case of long-term credit only 34 per cent said that their needs had been met satisfactorily and in the case of equity capital, only 10 per cent. However, a surprisingly large proportion—about three-fourths of the firms with unfulfilled needs for long-term credit and equity capital—reported *they had made no effort to obtain money in this manner*. There is some question, therefore, as to how real is the demand for additional long-term credit and equity funds.

Many owners of small businesses are re-

luctant to share ownership and control with outsiders, an obvious prerequisite to equity investment. They prefer long-term loans. But new and small firms often fail to qualify for long-term credit because they lack sufficient long-lived assets to offer as security and because their future earning power is highly uncertain, even when past experience has been good. Small firms usually are undiversified and commonly are dependent upon the managerial abilities of one individual.

The purpose of the Small Business Investment Act was to provide arrangements which would induce private investors to lend to small firms on a long-term basis. The loans were to be in the form of convertible debentures and presumably would be converted into equity capital in those firms that proved to be successful.

One feature which has attracted funds into SBIC's is that realized losses can be offset against ordinary income for income tax purposes. This privilege is available to both the SBIC's and to the holders of their stock. Long-term capital gains are subject to the 25 per cent maximum rate. This tax feature is of particular interest to high-bracket taxpayers and helps to explain the active market in those SBIC stocks which have been sold to the public.

### **Starting an SBIC**

To begin operation, an SBIC must have 300,000 dollars in capital. Half of this sum may be obtained from the Small Business Administration through the issue of subordinated debentures which are junior to other debt. If 300,000 dollars or more in capital can be obtained from private sources, no Government capital is provided. However, the SBIC's can request that the SBA lend them operating funds up to the amount of 50 per cent of their capital. Both deben-

tures and loans bear interest at 5 per cent and usually mature in five years.

SBIC's must be licensed by the Small Business Administration. Licenses are issued after consideration of the qualifications of the applicants and the number of SBIC's already operating in a given area.

After hearing testimony on the experience of SBIC's in early 1960, the Senate Small Business Committee concluded that the "minimum economic size" for these firms was at least 1 million dollars in capital funds and that a 4 million dollar minimum appeared to be desirable. In a number of small SBIC's which are affiliated with other financial institutions such as commercial banks, part or all of the salary and overhead expense is assumed by the parent organization. Nevertheless, it is clear that a minimum-size SBIC, even with its funds fully invested at relatively high rates, can be expected to have difficulty in making an adequate return on its capital.

The framers of the SBIC legislation had hoped that these institutions could increase their profit potential through "leverage" by operating with a substantial volume of borrowed funds. They are permitted to borrow from all sources up to four times their capital. SBIC's, however, have not supplemented their resources by borrowing from private lenders thus far.

Commercial finance companies which lend to small businesses typically use borrowed funds equal to two or three times their capital. They are able to carry this debt because their loans to customers are fully secured and usually short-term. SBIC's, on the other hand, are authorized to make only equity investments and long-term loans which lack the liquidity of the typical finance company portfolio.

To encourage the development of larger



SBIC's the Senate Committee proposes that the SBA be empowered to buy up to 1 million dollars in debentures from each SBIC, but not to exceed the privately subscribed capital, and to make loans to them up to the amount of their total capital (including the debentures issued to the SBA). Under these provisions a 4 million dollar SBIC could be created by an investment of 1 million in private capital. The other 3 million could then be obtained from the SBA, 1 million in the form of subordinated debentures and 2 million in loans.

### Capital banks?

The SBIC program was adopted after consideration of various alternative proposals for new financial institutions to supply equity capital and long-term credit. Some sponsors of the plan believed that it would operate much like the Government-sponsored agricultural credit institutions which have developed, with considerable assistance, into well-established sources of credit for farmers. To this end, clients of SBIC's originally were *required* to purchase stock of the SBIC which extended credit to them. Under the amendments of June 1960 this provision was made optional rather than compulsory. As the program has developed the "co-op" features have played little part.

Other sponsors of the SBIC program hoped that it would provide equity capital to small firms through the purchase of common stock in the manner of certain of the "venture capital companies" which were established, wholly under private auspices, in the early postwar period. In the original act, however, SBIC's were not permitted to invest in small businesses through the direct purchase of stock. Since June 1960 investments in newly issued stock have been permitted but they have not been frequent. On

December 31, 1960, investments of reporting SBIC's in small businesses consisted of 22 million dollars in loans, 26 million in debentures and 4 million in stock.

The great bulk of the investments of SBIC's, therefore, has been in the form of debt. Except for special cases both loans and debentures must have original maturities of at least five years, but they may be amortized over this period. SBIC's may obtain stock in a small business through direct purchase, conversion of debentures or through the exercise of options or warrants.

Until recently the SBA did not permit debentures to be secured. With the elimination of this provision there is now little difference between "debentures" and "loans," except that some loans may be for less than five years if made to safeguard existing investments. However, SBIC's which buy convertible debentures often regard their investment as a permanent injection of funds which will be converted before the debenture is paid off.

All loans and debentures can be prepaid to the SBIC on interest payment dates. However, the SBIC must be given the opportunity to exercise its right to convert debentures before they are repaid. Also small businesses cannot pay off SBIC loans with funds borrowed elsewhere unless the SBIC approves. Loans can be made in participation with other lenders.

SBIC's, like other lenders, often require some measure of control over the firms they finance through covenants which restrict salaries and other outlays. Sometimes, too, they obtain the power to hire or discharge employees. Obviously, an SBIC having a potential equity interest in a business firm has a greater interest in management than a lender whose primary concern is the payment of interest and principal on a loan.



Because SBIC's operate under Government auspices and may use funds borrowed from the Government, the SBA has responsibility for determining whether the rates charged on loans are reasonable. Where applicable, of course, usury laws govern, but in many states borrowings of corporations, which account for the bulk of SBIC clients, are not covered by the usury laws. In practice, the SBA has approved effective rates as high as 15 per cent. Many SBIC loans yield only 6 to 8 per cent, but 12 per cent is quite

common. In addition to interest, SBIC's are authorized to supplement their earnings by charging for the managerial services they render to clients.

### **SBA loans to small business**

The Small Business Administration, the successor of the Reconstruction Finance Corporation, was established in 1953 to take over the program of Government loans to small firms. The SBA, like its predecessor, makes loans to small businesses which cannot obtain funds on "reasonable terms" from other financial institutions.

SBA loans to small businesses are limited to 350,000 dollars in size. Typically they are amortized; their term may be as long as ten years. The rate charged usually has been 5½ per cent. However, on April 5 the SBA announced that rates would be lowered to 4 per cent in areas of "substantial labor surplus," where more than 6 per cent of the labor force is unemployed, as determined by the Department of Labor. In March two-thirds of the major labor market areas were so classified, including most of the larger labor markets throughout the nation.

### **The Small Business Administration (SBA)**

A Government agency, established in 1953 "to advise and assist" small businesses

Makes loans to firms which cannot obtain private financing on "reasonable terms"

Makes loans to state and local development companies

Licenses, regulates and makes loans to "small business investment companies"

### **Small Business Investment Companies (SBIC's)**

Are private companies, licensed by Small Business Administration, under Small Business Investment Act, 1958

Organized by private investors and financed in whole or in part by private funds

Regulated and may be financed in part by the Small Business Administration

Make long-term loans and equity investments in small businesses

### **What is a small business concern?**

As defined by the SBA for purpose of its direct loans:

A firm that is independently owned and operated and, depending upon the kind of business, has fewer than 250 to 1,000 employees and yearly sales of less than \$1 million to \$5 million

As defined by SBA for purposes of SBIC loans and investments:

A firm that is independently owned and operated; has less than \$5 million in assets, \$2.5 million in net worth and \$250,000 of after-tax net income



At the end of June 1960 the SBA had 380 million dollars in loans outstanding to small businesses, including its share of participations with other lenders. During the period July 1960 through January of this year 112 million dollars of new loans were approved. Recently the rate of approvals has been close to 20 million dollars per month.

A small business firm, unable to obtain long-term credit from conventional sources, now has the opportunity of applying to either the SBA or an SBIC. The advantage of the direct Government loan is that it carries a lower rate of interest and does not involve offering the lender a potential share in ownership. The advantages of an SBIC loan are that it may be handled more expeditiously, the borrower may benefit from a more personal relationship with the lender and the funds may become a permanent addition to capital through conversion into stock.

### Variety in SBIC's

Some SBIC's have been sponsored by local private groups whose major interest is to promote new business in their area, rather than to realize a profit. Most of these, however, are minimum-size companies and, in the aggregate, they are much less important than the publicly sponsored state and local development companies which may be aided by the SBA under a separate program.

Most of the SBIC's are profit-oriented, minimum-size institutions operating locally. During the past year the large, publicly owned SBIC's, which account for more than two-thirds of all of the capital in the program, have attracted widespread interest. These firms differ considerably from one another in the scope and nature of their investment programs.

Some of the large SBIC's operate nation-

ally, but most tend to restrict their investments to individual states or regions. Those which operate over broad areas often specialize in certain industries, with electronics manufacturing a notable example. Others emphasize "growth" industries in general, including plastics and pharmaceuticals, while some concentrate on loans well secured by real estate or other collateral.

SBIC's differ also in their interest rate policies. If they are primarily interested in capital appreciation, they are likely to charge rates of less than 10 per cent. Others, which attempt to maximize current earnings, charge higher rates.

Small businesses may encounter financial problems as a result of mismanagement or a deterioration in competitive position. Financial stringency also may result from rapid growth, suggesting the need for an injection of capital if rapid progress is to continue. It is the latter type of enterprise which the SBIC program primarily is designed to aid.

Very often when a firm is considered "under-capitalized," the best remedy is a straight equity investment which entails no promise to repay any specific amount at any given time. When direct equity investments are made in small, growing firms it is usually understood, even required, that all earnings will be plowed back into the firm. In such cases the investor foregoes security and current income in hopes of profiting in the future through dividends or capital gains from the sale of the shares.

Direct equity money through the purchase of stock is not being provided by SBIC's in appreciable amounts, nor are they encouraged by the law or the SBA to make investments in this form. SBIC's are encouraged to make "equity-type" investments which are defined by the act to include "bonds or debentures providing a participation in



equity securities either through conversion or through accompanying warrants or options. . . ." Interest and other service charges must be met until the debt is converted or paid off.

When large, well-financed businesses issue convertible debentures, they obtain long-term funds at rates lower than would otherwise be available. Also they may use this means of obtaining equity through exchange of stock for bonds at a later date in order not to depress the current market price of their shares. Small businesses which sell convertible debentures to SBIC's might be unable to obtain long-term credit at all without offering this right. Obviously, owners of small firms consider carefully the proportion of their business which they are prepared to give up in order to obtain long-term credit or equity capital.

#### **The future of SBIC's**

Legislation now before Congress is intended to further accelerate the SBIC program. In addition to increasing the power of the SBA to loan to SBIC's, a number of other changes are proposed which these firms believe will enhance their profit potential and, hence, their ability to attract capital. It is proposed, for example, that restricted stock options be permitted to key officers and employees and that SBIC's be authorized to "pass through" capital gains to stockholders without the imposition of the tax on corporate income. Other recommended changes would clear up ambiguous legal points and increase the flexibility of SBIC operations.

Even without the suggested changes in the law the SBIC program has been moving along rapidly. Stocks of these firms generally are selling above issue price and certain issues identified with the "glamorous" elec-

tronics industry have risen sharply.

SBIC's are sometimes compared to open-end investment trusts which purchase securities of a number of business firms. However, there is a considerable difference between these types of institutions. Most investment trust shares are sold to individuals who desire high-grade equity investments but cannot achieve adequate diversification or supervision of investments on their own because of their limited amount of funds. Securities held by an investment trust usually have a ready market, and the present value of each share can be calculated from market quotations for the issues in its portfolio. SBIC's, on the other hand, appeal mainly to persons who are willing to take substantial risks in order to achieve possible large gains. The investments of these firms are intended to be in securities of small companies which are not well known, have no ready market and hence their value is not easily determined.

The experience of venture capital companies in operation during the postwar period and of wealthy individuals who have made small business investments on their own suggests that it may take several years before the degree of success or failure of an SBIC can be evaluated. Financing new enterprises is inherently a high-risk undertaking. Much time and effort is required to select suitable small business investments from the numerous alternatives available. After investments have been made there often will be unforeseen problems requiring further study and work with the management of the firms. Additional funds may be needed to finance further development of the products and markets if the original investment is to be protected. Profits realized from spectacular successes may be offset by losses on other ventures.