White Paper

Small-business credit evaluation

The evolution of risk management.

Executive summary

The recession has taken a profound toll on the small-business community and on the firms looking to extend credit to them. The recent modest economic recovery has largely bypassed the small-business community. With creditors still wary about extending credit beyond the very lowest-risk businesses, Experian is seeing demand for new and informative tools to evaluate commercial credit risk. Yet, as in the past, creditors too often rely on commercial or consumer data stored in silos rather than leveraging them together. Increasingly creditors find they require a broader, more robust set of intelligence tools and analytics to evaluate the credit and fraud risk of a small-business owner and their business. Experian has developed unique advancements that virtually dissolve traditional silos and provide creditors with additional insights. Now a creditor can get unprecedented visibility into a business owner's relationships with current and former business interests. With this new advancement, creditors are better equipped to make a credit decision. These new tools can also be used to analyze portfolios of small businesses to identify new growth opportunities or proactively mitigate losses on declining accounts for the nation's estimated 27.2 million small businesses[1] and the creditors that serve them, the deep recession has left profound and indelible scars. The slow economic recovery has bypassed many within the small-business community.[2] As for their creditors, they remain wary of extending credit. They've tightened their credit standards and are scrutinizing applicants' financials and payment histories more carefully.

National trends: Payment performance deterioration noted in 2010

Several factors explain this "small-business market malaise," including the fact that key payment-performance indicators continued to deteriorate in 2010. Indicators that measure days beyond terms (DBT), delinquent dollars, and incidence of severe payment delinquency each deteriorated by double-digits in 2010.[3]

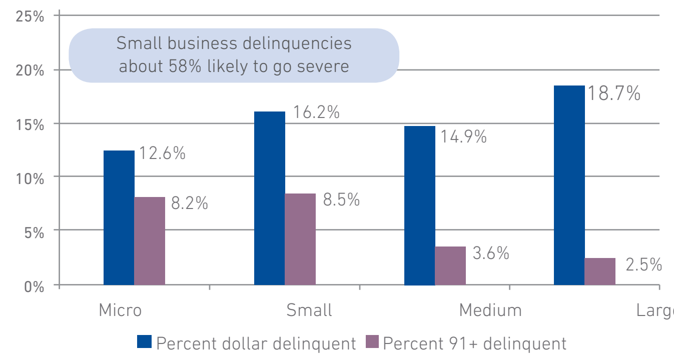
Business benchmark trends
March 2010 to March 2011 Key categories

Category	Mar	Change	Trend
Risk score	54.7	3.9	↓
DBT	7.47	18.9%	↓
% Delinquent	14.4%	22.0%	↓
$91+	7.3%	40.4%	↓

[1]Small Business Administration (SBA) estimate, included in 2011 SBA news release about National Small Business Week.
[2]As defined by the Small Business Administration, a small business is an organization with fewer than 500 employees or less than $7 million in sales.
[3]Source: Experian data.

Such weakening spells trouble because once a small business is delinquent there is a 58-percent chance that conditions will continue to weaken for the small business.[4]

Likelihood of a delinquency stretching to severe
By size of business



Even with these challenges, small businesses seem to be displaying a growing sense of optimism. Seventeen percent more small businesses expect sales to increase in the next 12 months than those anticipating sales to slide. As for profits, an equal number expect declines compared with those anticipating higher profits over the next year.[5]

Small-business profit expectations improve[5]

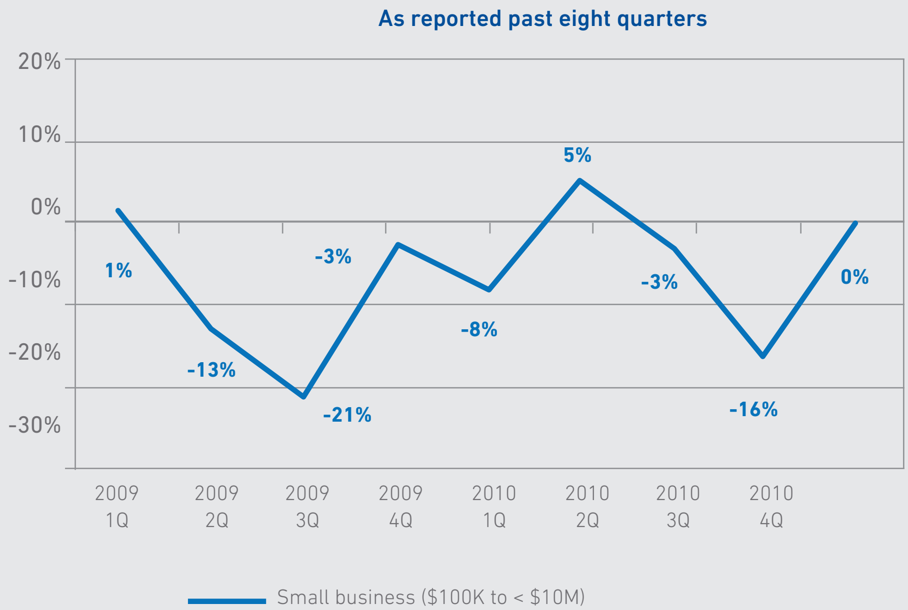
Profit after taxes next 12 months
As reported fourth quarter 2010

Sample = 409	Small business ($100K to < $10M)
Increase	31%
Decrease	31%
Net Differences	0%

[4]Source: Experian data.
[5]Barlow Research, 1st Quarter 2011 Economic Pulse Survey.

It is important to note, however, that while optimism is improving, the underlying facts do not necessarily or completely support such optimism. For example, there has been a near-stagnant demand for goods and services because consumers are reluctant to return to their old spending patterns. In addition, further global economic uncertainty is a factor, as are a drop in new-business creation and the real-estate market's continued depression.

Net difference between business owners expecting profit increases and those expecting profit decreases[6]



[6]Source: Barlow Research, 1st Quarter 2011 Economic Pulse Survey

Small business isn't leading the way this time

Traditionally, a clear relationship exists between small business and the economy in general. That's especially true in the United States because startup businesses often fuel much of the economic growth in the U.S. Recently, however, that does not seem to be the case. As large companies are flush with cash — in many ways because they have been successful in extending their small-business suppliers — small businesses are unable to get the credit they need to finance growth. They are still struggling to maintain the cash flow necessary to meet their current obligations, much less begin hiring in earnest. Thus, in this post-recessionary period, America's small and micro companies aren't leading the recovery through increased hiring, as occurred in the past. The fact that small firms are remaining on the sidelines is troubling and continues to threaten a more rapid recovery.

The impact on small business credit risk evaluation

With the business outlook so murky, the risks associated with doing business with small firms can be more unclear than ever. Creditors are finding it increasingly essential to employ a broader, more robust set of tools and analytics when evaluating today's small-business risks. Historically, and still far too often, creditors rely solely on commercial or consumer data in silos when considering whether to extend credit. But in this post-recessionary period, creditors require more information to gain a complete picture of a business and its principal's credit and fraud risks.

Prior to the 1990s (when creditors began using blended consumer and commercial scoring), many creditors evaluated small-business risk the same way they handled large business applicants. They didn't fully recognize then that small-business credit risk is often related to the business owner's consumer credit risk. At the opposite extreme, some small-business creditors began relying exclusively on the consumer credit of the business owner to predict the credit risk associated with the business. Both of these approaches ignore critical performance information that may provide indications of increased credit risk. Today, creditors use credit scoring, multiple data sources and credit-risk models that align with small business-specific activity. These tools and analytics lead to improved risk prediction as fresh sources of data mature and the tools that support them develop further. But post-recession, creditors require even more information to gain a complete picture of a business and its principal's credit and fraud risks.

New tools, analytics assisting creditors

Reflecting today's economic realities, creditors are seeking ever-more sophisticated tools that allow for more analytical capabilities on which to base their small-business credit decisions. For example, creditors are making much greater use of blended data, uniting business and personal information to allow credit managers to look beyond just a business' credit report or its owner's consumer credit report. Experian's Intelliscore Plus[SM] report delivers such a blended analysis in isolation. The report supplies key indicators for creditors to evaluate when making a credit decision on a small business.

The Business Owner Background Report

Experian has now developed another unique analysis instrument that allows creditors to dig even deeper into a small-business owner's background. Experian has introduced the Business Owner Background Report, using patent-pending technology to link businesses and their principals. The Business Owner Background Report gives a creditor unprecedented visibility into a business owner's business and fraud risks by providing data that highlights that person's relationship with current and former business interests.

The Business Owner Background Report combines Experian's robust consumer and commercial data assets with state-of-the-art analytics. Specifically, it provides a business owner's total risk across all the businesses the owner is associated with, as well as information on how each business performed under the individual's management. Additionally, the Business Owner Background Report allows a creditor to verify the individual's association with a business and provides indicators of potential fraud.

For a creditor, this wealth of insight saves time and money in assessing risk. A creditor also has the option to include in-depth fraud intelligence and/or the principal's personal credit information. The Business Owner Background Report can be used to manage fraud and credit risk throughout an account's lifecycle, including in the areas of commercial fraud prevention, accurate commercial-line assignment at origination, commercial portfolio management, deposit policy and commercial collections, among others.

Historically, the behavior of small businesses has been highly correlated with the consumer behavior of the business owner. This is especially true for single business owners, as the business is predominantly the financial lifeblood of the owner, and the owner will make sacrifices to his or her personal credit to fund the business and keep it afloat as long as possible. With the development of the Business Owner Background Report, Experian is now able to identify and analyze the complex interaction of a business family — one owner with multiple businesses.

Experian's analysis found that, for owners of multiple businesses, the relationship between the consumer's credit and the credit for their businesses is not as direct as that for the owner of a single business. Within a typical business family, the individual risk of businesses can vary broadly, with one business looking healthy and stable while another business is severely delinquent. Experian's Business Owner Background Report provides visibility to these relationships to allow for a more complete review of the credit risk of a business.

The following example illustrates a hypothetical business family. In the example, the business owner has a low-risk consumer score. This owner owns two businesses, with business A having a high-risk commercial score and business B having a low-risk commercial score. Without the Business Owner Background Report a creditor may view business B as very low risk due to the business' low-risk commercial score and/or the owner's low-risk consumer score. This conclusion could be drawn if either the consumer report or the commercial report was reviewed independently or in a blended evaluation. However, the Business Owner Background Report provides the additional insight about business A that may need to be considered when evaluating the risk associated with business B. Experian has observed an incremental lift in predicting commercial delinquencies when the entire business family is evaluated as part of the complete credit-review process.

Conclusion

In today's economic climate, creditors must use all the tools and analytical capabilities available to determine if a small business is a good credit risk. With the emergence of more sophisticated evaluation tools, creditors are more prepared to evaluate small-business credit risk. These capabilities come at a time when small-business evaluation is more complex than ever before. With these new tools creditors can feel more comfortable evaluating small businesses as they play their role in helping advance a more rapid emergence from the economic recession.

For more information about Experian's advanced business-to-business products or this study, visit www.experian.com/b2b or call 1 800 520 1221.

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10/16 • 1051-BIS