MAIN^ST REPORT

Your window into small business health

Q2 2018

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About the report

The *Experian/Moody's Analytics Main Street Report* brings deep insight into the overall financial well-being of the small-business landscape, as well as providing commentary around what certain trends mean for credit grantors and the small-business community. Key factors in the Main Street Report include a combination of business credit data (credit balances, delinquency rates, utilization rates, etc.) and macroeconomic information (employment rates, income, retail sales, industrial production, etc.).

Executive summary

The overall outlook for small-business credit is positive. Outstanding balances rose in the second quarter, as did the average balance per business. Delinquency rates continued the downward trend they have maintained through the expansion, and default rates stabilized at the level they reached last quarter. Continuing strength in the economy will keep small-business credit performance strong through the end of the current expansion, if not longer. Rising rates and destabilizing trade policy are potential sources of trouble, but thus far they haven't slowed down small-business credit growth.

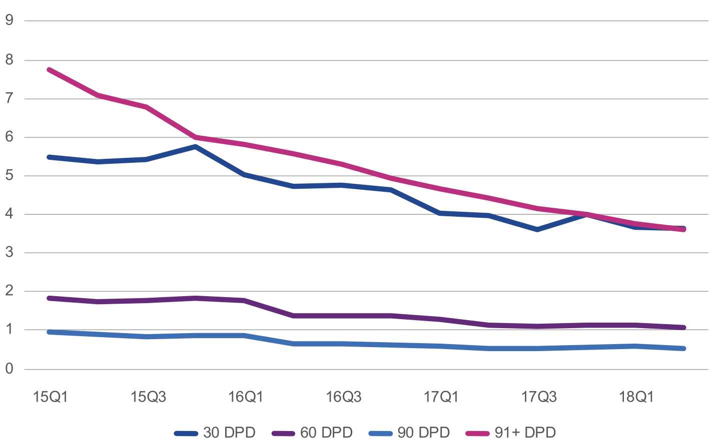
Small-business credit conditions remain positive in Q2

Small-business credit looks good

Delinquency rates for small businesses with fewer than 100 employees fell in the second quarter after showing mixed performance in the first quarter. Combined with growth in the number of businesses accessing credit markets, the data suggests that credit conditions continue to loosen. Specifically, the percentage of accounts that were 30+ days delinquent dropped from 9.2 percent to 8.8 percent. This trend is likely to continue as businesses that are 91+ days past due continue to drop out of the data as they transition into bankruptcy and as fewer performing accounts become distressed.

Small businesses continue strong performance

Delinquencies for small businesses (% balance)

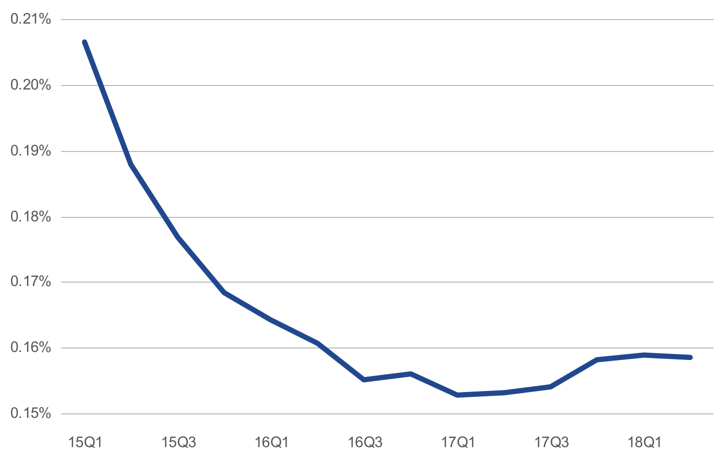


Source: Experian, Moody's Analytics

The bankruptcy rate leveled off in the second quarter, easing speculation about what an increase would mean for small-business credit. Bankruptcy rates will likely remain constant at this level, given underlying economic strength, but could decline slightly as creditors charge off — and remove — severely delinquent businesses from their books. At 15 basis points, the current bankruptcy rate is healthy given the state of the economy and growth in the number of businesses accessing credit. The increase in the number of businesses seeking credit was more than enough to offset the rise in businesses entering bankruptcy in the second quarter.

Bankruptcies level off

Bankruptcy rate, % count



Source: Experian, Moody's Analytics

Average balances in the second quarter rose 3.6 percent from a year ago. This growth is largely attributable to businesses entering the data set in the fourth quarter of 2017 and both quarters in the first half of 2018. Some of these businesses have re-entered our sample after falling out due to nonactivity. (Businesses need to have been actively accessing credit for at least two consecutive quarters to be counted in our analysis.) This paints a fairly rosy picture for small-business lenders, as there appears to be no shortage of demand for their product. While encouraging for the market overall, we examine the consistency of this trend across industry segments.

Balances rise as more firms access credit

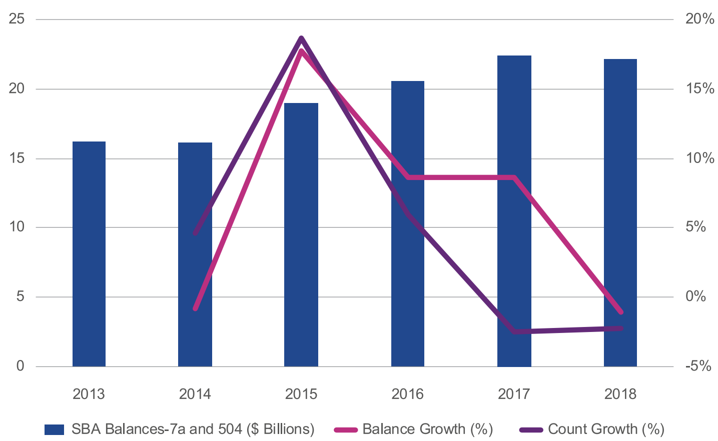
Change in total small business balances and average balance (YoY, % balance)

Source: Experian, Moody's Analytics

The Small Business Administration (SBA) reported that 2.2 percent fewer businesses accessed SBA loans — both 504 and 7(a) — in the second quarter than in the same period last year. In contrast, Experian data suggests that the number of small businesses tapping credit markets was up more than 13 percent for the quarter. Some of this growth may be attributable to increased reporting to Experian by credit providers rather than organic expansion. But some of it may reflect a preference by small-business owners to access credit from community banks or private lenders with more streamlined underwriting relative to the SBA lending programs. While some caution is warranted in interpreting the balance growth numbers, the data suggests balances are rising for private creditors, including those that provide trade credit.

SBA loan balances down 1% YTD vs. last year

SBA 7(A) and 504 Loan Originators and YoY growth ($ Pink, #Purple) through March each year, $ billions

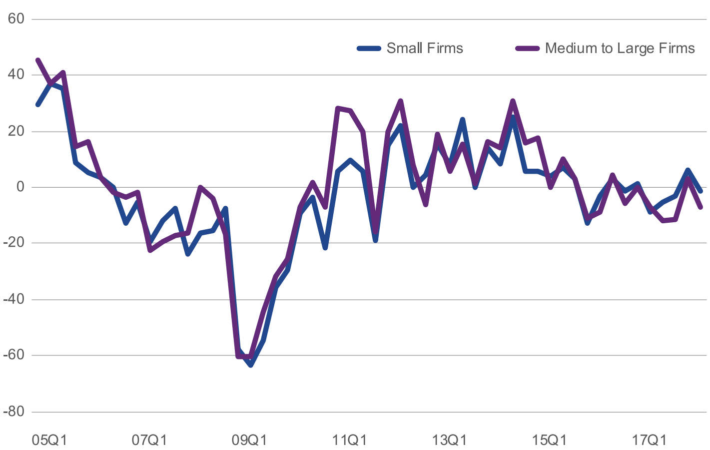


Source: Experian, Moody's Analytics

Although credit balances overall may have risen recently, the Federal Reserve's Senior Loan Officer Survey for commercial and industrial (C&I) loans suggests that there may be some reduction in the future — at least among bank lenders. Loan officers are reporting weaker demand for C&I loans to both small and large firms. But it's important to note that this is a net measure that subtracts the number of lenders reporting lower demand from those reporting higher demand. On net, more lenders are reporting lower demand as opposed to higher demand, but the vast majority (78 percent) report no change in demand. Given the preference of small businesses to deal with smaller community banking institutions and other lenders not captured in the Fed's survey, this could be noise.

C&I loans indicate lower demand in Q2

Net percent of senior loan officers reporting higher demand for C&I lending

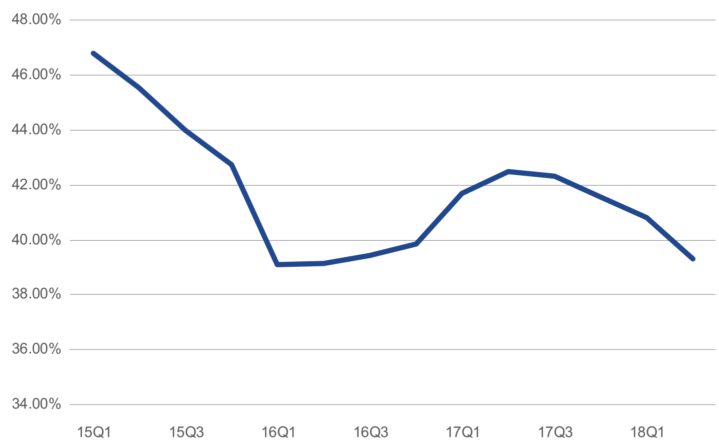


Source: Experian, Moody's Analytics

Utilization rates fell to 39.3 percent in the quarter as additional businesses entered the data with larger lines of available credit. With utilization getting close to the lows experienced in 2016, businesses have the capacity to expand their borrowing quickly if needed. As long as balances continue growing and performance remains sound, this level of credit utilization is an encouraging sign that borrowers have the capacity to take on more debt but are choosing not to. Until this trend starts to turn up sharply, performance should remain favorable.

Utilization pull-back continues unabated

Utilization rate, percent of available credit



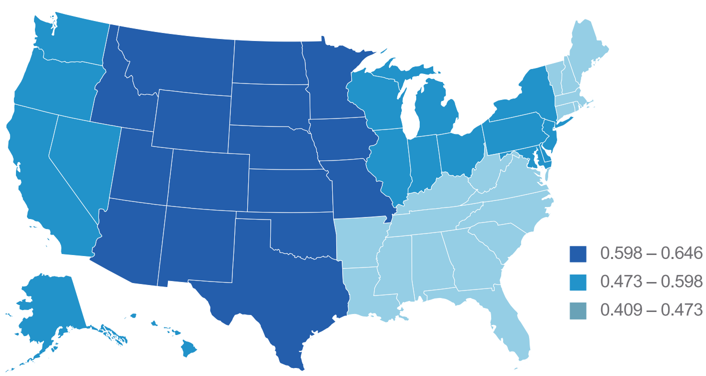
Source: Experian, Moody's Analytics

Taking a regional view

Severe delinquency rates — defined as 90 days past due — improved across all Bureau of Economic Analysis (BEA) regions relative to the first quarter. We have introduced BEA regions into this report to help tamp down some of the noise that would be otherwise observed at the state level from quarter to quarter. This will help to identify trends that are real and developing rather than one-off events that turn out to be false signals. The BEA regions we will use are: Far West, Great Lakes, Mideast, New England, Plains, Rocky Mountain, Southeast and Southwest. See the map below for the regions and the states they contain.

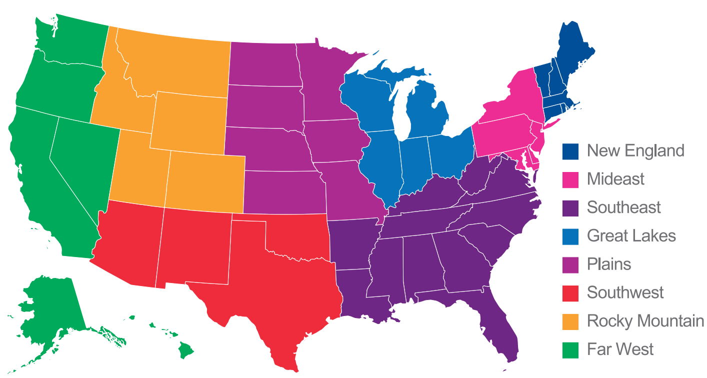
Severe delinquency highest in Interior of the country

Regional 90 DPD as of 2018 Q2



Source: Experian, Moody's Analytics

BEA Regions



Source: Experian, Moody's Analytics

Far West: Performance in the Far West is strong, as the region had a severe delinquency rate of only 54 basis points in the second quarter. On a year-over-year basis, services were the only industry that showed any gain that could be more than noise, rising 14 basis points to 0.52 percent. Risks to businesses are more on the supply side than the demand side, as employers in the services industry face difficulties attracting workers in a rising wage environment.

Great Lakes: Credit performance in the Great Lakes region remained strong in the second quarter with the severe, 90-day delinquency rate coming in at just 0.51 percent. This was weighed down by the construction industry which, at 76 basis points, was the worst-performing industry in the region. This was in spite of a 28-basis-point decline from the first quarter, but this seasonal drop in delinquency wasn't enough to overpower the 9-basis-point rise from the same quarter last year.

Mideast: The severe delinquency rate in the Mideast saw a modest pullback year-over-year, moving from 58 basis points to 59 basis points. This was driven primarily by a deterioration in the performance of Mideast mining firms, which saw a spike in delinquency to 1.39 percent, up 96 basis points from last year.

New England: New England had a severe delinquency rate of 45 basis points, down 5 basis points from last year. But this was held back by mining firms, which saw a jump in delinquencies, rising 28 basis points to 0.38 percent in the quarter. Some of the weakness may have been isolated to a few firms or reflect volatility in the data given that the rate has fallen in nine of the last 12 quarters.

Plains: The Plains region had the second highest 90-day delinquency rate in the second quarter, but still came in at a low 62 basis points. Performance improved both from the first quarter and on a year-over-year basis. The transportation/utilities and wholesale industries saw performance improve by 27 and 23 basis points, respectively. The strength in these industries was more than enough to offset the weakness in Plains mining firms, which saw severely delinquent balances up 7 basis points from the first quarter.

Rocky Mountain: The Rocky Mountain region had the highest delinquency rate among regions in the second quarter — 64 basis points. This was on the back of broad-based performance declines across industries, excluding services, which improved 13 basis points from last year. Performance results from the first quarter were mixed, so a rebound in performance for the Rocky Mountain region may be near.

Southeast: The Southeast had the lowest severe delinquency rate in the second quarter with extensive performance improvement across industries from the first to second quarter. Year-over-year performance was a mixed bag, with industries such as finance and agriculture showing improvement and mining and transportation coming in weaker.

Southwest: Small-business credit performance in the Southwest has been trending toward improvement, and the second quarter was no exception. The severe delinquency rate fell to 62 basis points, an improvement of 5 and 3 basis points quarter-over-quarter and year-over-year, respectively. In Q2, every industry except services saw improved performance, and even services only saw a 2-basis-point rise. Year-over-year results were mixed, but mining and finance saw improvement of 24 and 47 basis points, respectively. The improvement in the region's credit performance looks set to continue for some time.

Risks from trade policy warrant scrutiny

The two most salient risks on the horizon for small businesses are rising interest rates and trade disruptions.

The Federal Reserve has raised rates twice so far in 2018 and looks set to raise rates two more times before the end of the year, bringing the federal funds rate to a range of 2.25 percent to 2.5 percent by year's end. In addition, the Fed has begun reducing the size of its balance sheet. Treasury yields have taken a wild ride early in 2018, with the yield on 10-year maturities hitting 3 percent for the first time in four years. This move toward tightening monetary policy has already been pushing up short-term interest rates, but longer-term rates have stood their ground. This developing situation could result in a yield curve inversion as soon as next year. Historically, an inverted yield curve has been an accurate predictor of recessions within 12 to 18 months following the inversion. Any sign of a brewing recession may discourage small businesses from borrowing to fund operations or expansion — or from forming in the first place.

Trade policy poses its own risks to small-business credit markets, especially through wealth effects. If trade tensions escalate far enough, they could affect the labor market and incomes. The bouts of volatility in financial markets this summer are attributable to trade actions that could be aggravated by the imposition of additional tariffs or other actions limiting trade. Small-business owners who use personal sources to finance their businesses could be disinclined to invest if markets are unsettled. Additionally, if employers begin laying off workers under an aggravated trade scenario, this could dampen the positive labor market outcomes, which are starting to result in faster rising wages, thereby reducing demand from consumers. More likely than not, trade will remain a small fish in the pool of risks to credit, but it's a risk that bears watching, especially given heightened trade tensions.

So far, these risks are having little effect on small-business sentiment. But this could change rapidly, since small-business owners are still enjoying the benefits of deficit-financed tax cuts, and optimism is understandably high. A deterioration of the real economy would bring the party to an abrupt end.

2018 outlook remains positive

The second quarter didn't bring much in the way of changes for small-business credit. In light of improving credit performance across regions and in a majority of industries, there is nothing in the data to suggest a change in the positive outlook in the short term. Combined with continuing strength in the economy, small-business credit looks set to continue its recent strong performance.

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