MAIN ST REPORT

Your window into small business health

Q3 2017

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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 comprised by 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, investments, etc.).

Executive summary

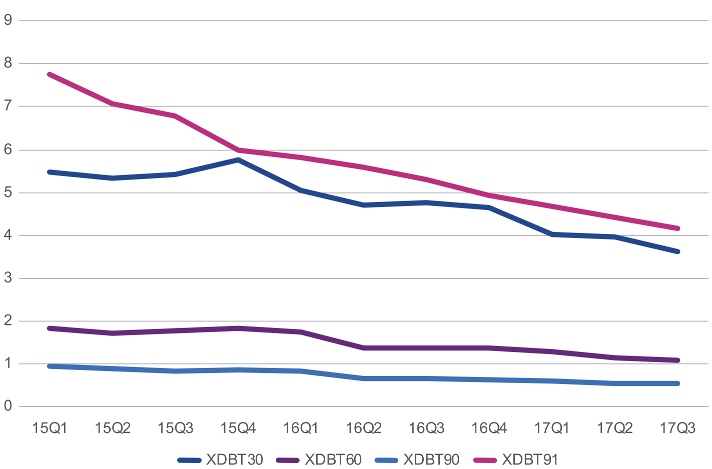
The overall outlook for small-business credit is stable. Outstanding balances on small-business credit declined slightly in the third quarter, continuing a two-year trend. Delinquency and default rates were steady to declining, and business balance sheets continue to improve. Continued improvement in the labor market and economic growth bodes well for credit performance in the short term. Despite the overall optimism, pockets of localized weakness are developing and will warrant observation over the next few quarters.

Small-business credit conditions stable in Q3

An expanding economy supports positive credit performance

Small businesses with fewer than 100 employees saw delinquencies overall continue their trend downward in the third quarter. Early-stage delinquency rates improved, while the 90 days past due (DPD) delinquency rate experienced a slight (5 basis point) increase. The most severe delinquency category, 91+ days past due, declined as some distressed credit was charged-off. The decline in late-stage delinquency was offset somewhat by an increase in bankruptcy rates.

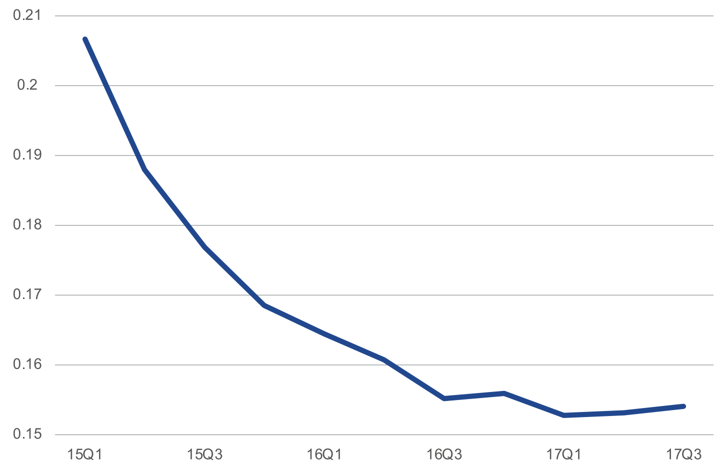
Bankruptcy clears away non-performing credit
Delinquencies for small businesses, % balance



Source: Experian, Moody's Analytics

While an uptick in bankruptcy is never positive, the bankruptcy rate remains low relative to history and seems to have found a floor at around 15 basis points. The slight increase, however, does have the positive effect of removing bad debt from creditors' books, improving loan portfolios and leading to lower delinquency rates as borrowers with higher credit quality continue to perform.

Bankruptcy rises, clearing some 91+ DPD balances
Bankruptcy rate, % balance

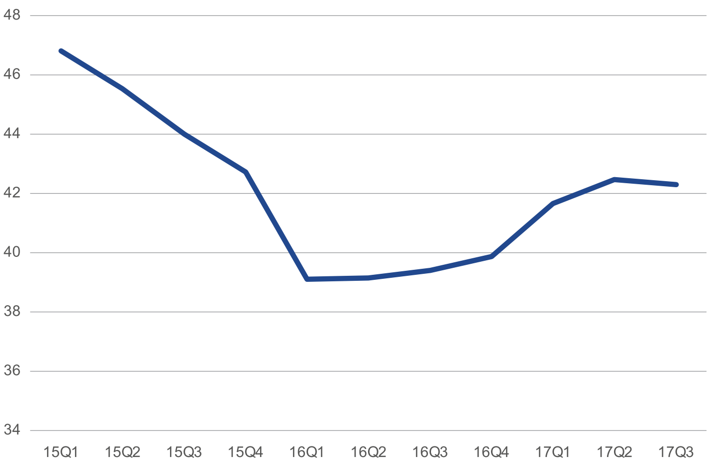


Source: Experian, Moody's Analytics

In addition to improving payment performance, credit utilization rates were down slightly from the second quarter. The average utilization rate fell from 42.5 percent to 42.3 percent, but is still up 7.4 percent from the third quarter of 2016. In the latest survey conducted by the Federal Reserve, a net 5.5 percent of senior loan officers reported reduced demand for commercial and industrial loans in the third quarter. This is consistent with the decline in utilization rates for the quarter as businesses use less of the credit made available to them. As small businesses increased their utilization in the prior two quarters, some payback was to be expected.

Utilization pulls back quarter-over-quarter, but up year-over-year

Utilization rate, % of available credit



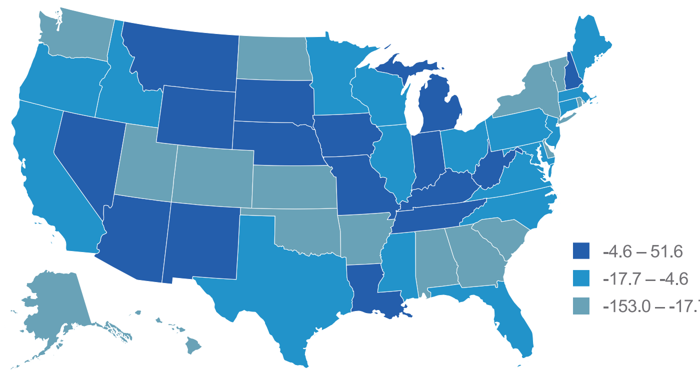
Source: Experian, Moody's Analytics

Some states have a tough go of it in Q3

The third quarter held several surprises for Wyoming, as four industries saw increases in 90 DPD delinquencies: mining, construction, transportation/utility and retail. These increases were large enough to push the state-level delinquency rate up by almost half a percentage point. Wyoming's severe delinquencies, as measured by the percent of balances 90 DPD, has been on a steady upward trend since the first quarter of 2015. Offsetting some of this weakness, the bankruptcy rate has been relatively low at around 11 basis points versus the national average of 15 basis points. The deteriorating performance of credit in the state could lead to an increase in bankruptcies in coming quarters as some of the 90 DPD balances become 91+ DPD and are eventually charged off. Given these trends, Wyoming is a state to watch carefully over the next few quarters.

Wyoming had a rough quarter

Year-over-year change in small business 90 DPD as of 2017Q3



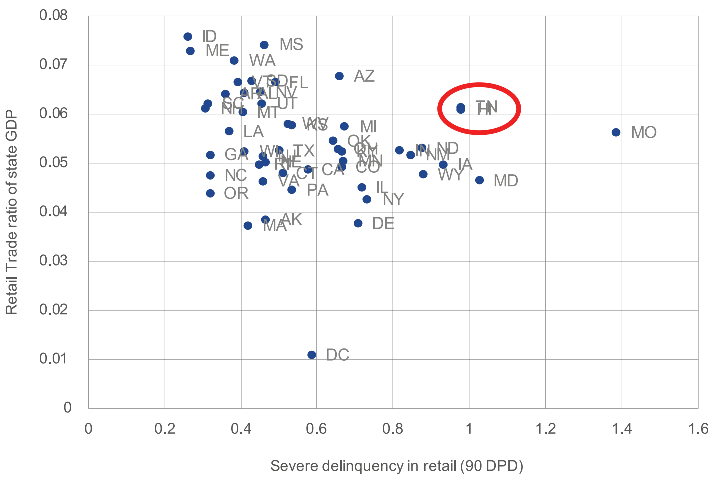
Source: Experian, Moody's Analytics

Small retailers in the spotlight

Given the recent troubles in the retail industry, this analysis focuses on the credit performance of small businesses in the retail sector. The retail industry has been plagued by price deflation in recent years and is just beginning to see some relief, though it isn't clear how long that will last. Regional retail analysts have been particularly concerned with Hawaii and Florida recently, given their large exposure to tourism. Smaller retailers in these areas may be vulnerable to the impact of hurricanes and other tropical storms. With just over 6 percent of its output derived from retail sales, Hawaii's retail sector is larger than most states. In addition, slightly less than 1 percent of Hawaii's small retailers were 90 days delinquent on their credit accounts in the third quarter versus 63 basis points for the U.S. overall. The only other state with a retail trade to GDP ratio of more than 6 percent and a 90 DPD delinquency rate close to 1 percent was Tennessee.

Hawaii's retail credit lackluster given retail dependency

Ratio of retail trade to state GDP and 90 DPD (% balance) 2017Q3



Source: Experian, Moody's Analytics

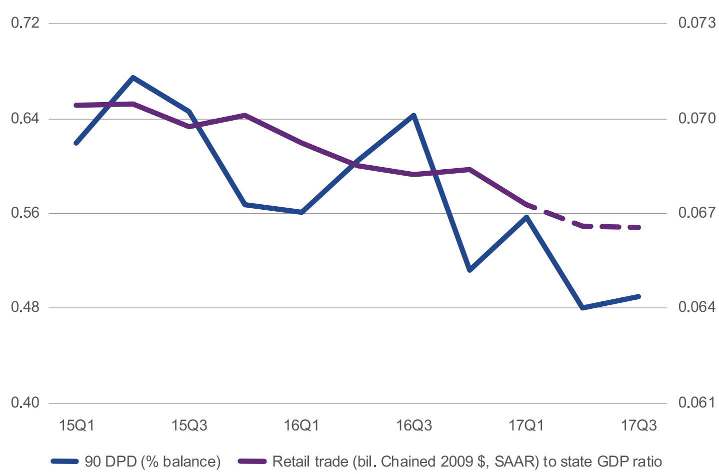
The other retail-heavy state considered in the analysis is Florida, which gets 6.7 percent of its GDP from retail trade. Florida's small retailers have a considerably better credit profile than Hawaii, with a 90 DPD rate of 49 basis points.

The delinquency rates on credit to small retailers in Florida have been highly correlated with the state's retail share of output, with a correlation coefficient of 0.74. This is one of the highest correlations in the nation, reflecting Florida's outsized sensitivity to retail sales. As the state has diversified away from a retail-driven economy, credit to small retailers has taken on a more conservative credit profile, leading to better performance. While the relationship isn't necessarily causal, the correlation suggests that diversification of the state's economy may be leading to improved credit quality.

To clarify, the current retail sales data at the state level is only available through the first quarter of 2017, so there is room for deviations from what is presented as figures are revised and confirmed. For example, hurricanes Irma and Maria struck Florida in September. The storms likely had a large negative impact in the quarter, and may have thrown a curveball to small retailers throughout the state, as they would have likely had to close their businesses during and after the storm. At the same time, we expect retail sales to recover and even accelerate over the next few months as households and businesses look to rebuild following significant natural disasters.

Florida delinquency tied to retail's share of economy

Florida: 90 DPD (% balance) and ratio of retail trade to GDP

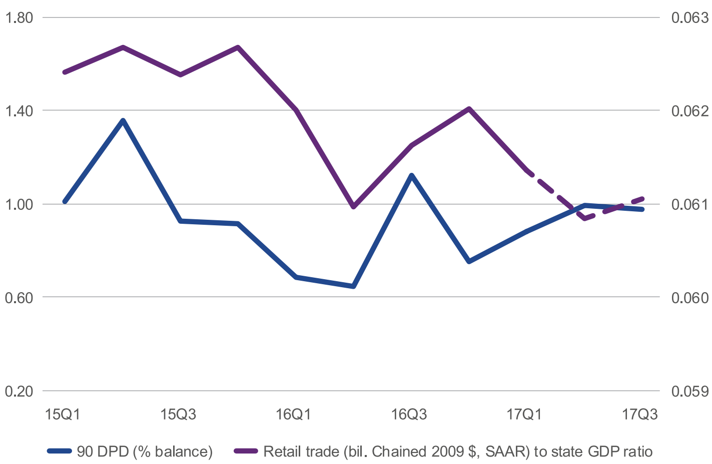


Source: Experian, Moody's Analytics

In contrast to Florida, Hawaii has a much lower correlation between its 90 DPD delinquency rate and retail share of output, with a correlation coefficient of 0.32. Hawaii's retailers appear to be more insulated from shifts in the broader state economy. As the state diversifies away from retail, delinquency rates may not experience much improvement, as borrower credit quality may improve only modestly.

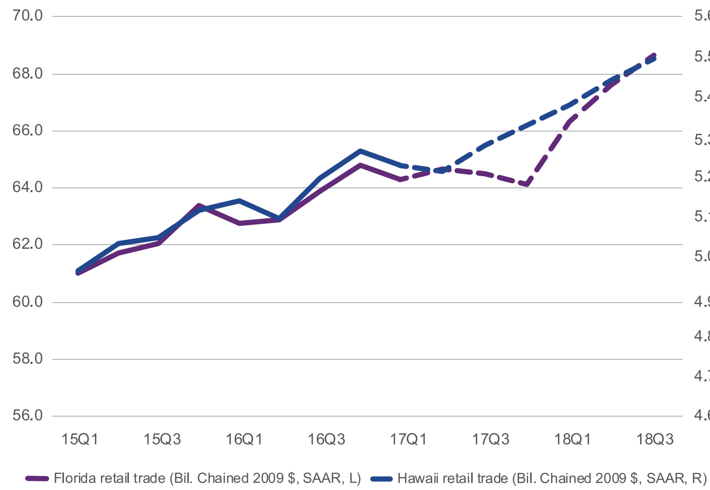
Hawaii retail credit less dependent on retail share

Hawaii: 90 DPD (% balance) and ratio of retail trade to GDP



Source: Experian, Moody's Analytics

Florida retailers could be set for a gain in 2018



Source: Experian, Moody's Analytics

The overall outlook for small retailers in the fourth quarter is positive, though headwinds will hurt them in some areas. Longer term, retail sales will gain from continued strengthening of the job market as the unemployment rate falls below the level consistent with full employment. Wealth will also be a factor in retail sales. Recent data from the Federal Reserve's triennial Survey of Consumer Finances reported large gains in household wealth in 2016. Prior work on the wealth effect from Moody's Analytics has found a significant, positive relationship between gains to wealth and consumer spending.

Performance is solid, but risks remain

Risks for small-business credit remain weighted to the upside due to positive performance of the broader U.S. economy. Despite the optimism, uncertainty stemming from pending fiscal changes is expected to be a drag on credit formation as small-business owners wait for clarity before making major investment decisions.

Although the risk of recession is low for the economy overall, small businesses are vulnerable to any weak performance — particularly at a local level. Unlike midsize to large businesses, small businesses tend to rely on the personal wealth and credit of business owners as primary sources of financing. Such financing would face large shortfalls in the event of a market downturn, as owners would struggle to draw on personal means for funding. This could result in more businesses demanding small-business loans, but these could be of lower quality and a drag on performance.

Risks to the mining and transportation/utilities industries are fading. Energy commodity prices have stabilized, and most companies have either failed or adapted to these prices. Retail deflation remains a worry for small retailers, but consumer spending, driven by tight labor markets and easy access to multiple forms of consumer credit, should make for a good fourth quarter for small retailers.

Risks from fiscal policy will remain an issue throughout the rest of the year. Congress has passed a budget that will provide some stability for industries — particularly public administration — but there is still a cloud hanging over small businesses. Changes to the tax code have been eagerly awaited by small businesses, as they see a chance to lower their tax rates. This would allow small-business owners to see their incomes rise and increase investment in their companies. It's possible that small-business owners have been waiting to take out credit until any potential tax legislation is passed, as any changes could have significant implications for how those businesses access capital.

The Federal Reserve has raised the federal funds rates twice so far this year, increasing costs to consumers and businesses alike by around 50 basis points for short-term loans and lines of credit. The Fed is likely to increase rates one more time in 2017, followed by three more 25-basis-point rate increases in 2018. In addition, the Fed has begun reducing the size of its balance sheet. This move toward quantitative tightening will cause longer-term interest rates to rise as well, further adding to the cost of borrowing for market participants.

The drawdown of the Fed's balance sheet has begun and will increase progressively over the next several quarters, until its desired levels are reached. In the short term, this is a relatively minor risk for small-business financing. As rates continue to rise, however, small firms must determine whether they want to borrow at higher rates. After becoming accustomed to a low-rate environment, potential borrowers may have a case of sticker shock as rates move back to more "normal" levels.

The labor market remains the brightest aspect of the current economic climate as the economy has reached full employment. Payrolls grew by 274,000 in the third quarter, with average weekly earnings rising 2.5 percent. With a low unemployment rate of 4.2 percent, the labor market is set to start pushing income gains higher. A strong labor market will generate increased demand for goods and services provided by small firms, though the higher wages paid to keep employees will cut into profit margins. Netting out the two effects, the outlook for small-business credit is positive over the short term.

Steady as she goes

Three-quarters of the way through, the narrative summarizing 2017 is nearly complete. The year will be remembered as one of steady performance, with utilization rates climbing above 40 percent and bankruptcies finding a floor. The economy at large has continued a slow and steady path — and small-business credit has been no exception. As the economy improves, and credit conditions along with it, small-business credit is positioned to perform well.

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Moody's Analytics helps capital markets and risk management professionals worldwide respond to an evolving marketplace with confidence. The company offers unique tools and best practices for measuring and managing risk through expertise and experience in credit analysis, economic research and financial risk management. By providing leading-edge software, advisory services, and research, including the proprietary analysis of Moody's Investors Service, Moody's Analytics integrates and customizes its offerings to address specific business challenges. Moody's Analytics is a subsidiary of Moody's Corporation (NYSE: MCO), which reported revenue of $3.5 billion in 2015, employs approximately 10,900 people worldwide and maintains a presence in 36 countries. Further information is available at **www.moodysanalytics.com.**

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