MAIN^ST REPORT

Your window into small business health

Q3 2018

experian

MOODY'S ANALYTICS

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Your window into small business health

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, but some industries such as construction have a negative outlook. Outstanding balances rose in the third quarter, as did the average balance per business. Delinquency rates are stable around their current levels, but this could change quickly if risks mount for certain industries. Continuing strength in the economy should keep small-business credit performance in check through the fourth quarter and early next year. Rising interest rates, destabilizing trade policy and slowing home-price growth are potential sources of trouble that are already starting to impact some regions.

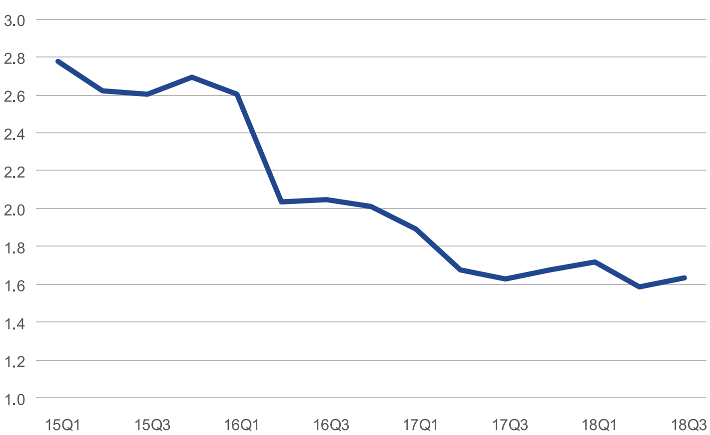
Small-business credit conditions are positive, but headwinds are building

Small-business credit looks set for a shift

Delinquency rates for small businesses with fewer than 100 employees continued their decline in the third 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 delinquent accounts dropped from 8.8 percent to 8.6 percent. Previously, this trend looked likely to continue, as the improved performance wasn't entirely the result of accounts leaving the 91+ days past due category. However, this was no longer the case in the third quarter. This quarter saw the rate for accounts 31 to 90 days delinquent increase slightly. This slight increase is, in itself, not enough to warrant concern. But the period of consistent declines in delinquency rates for small businesses may be near its end.

Has delinquency improvement bottomed out?

31-90 DPD for small businesses, % of balance

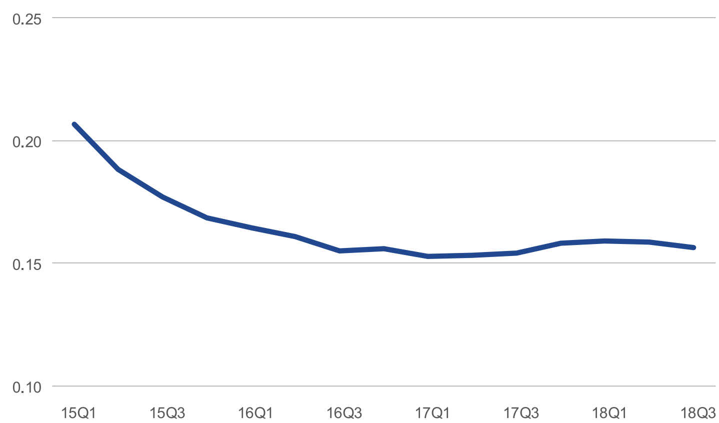


Source: Experian, Moody's Analytics

The bankruptcy rate fell slightly in the third quarter, further easing speculation from the end of 2017 about what a sustained increase in bankruptcies could mean for small businesses. Given that the economy is currently in a late cycle expansion, the 15-basis point bankruptcy rate is no source of concern as this rate appears low by historical standards and has moved sideways for some time now.

Bankruptcies move lower again in Q3

Bankruptcy rate, % count

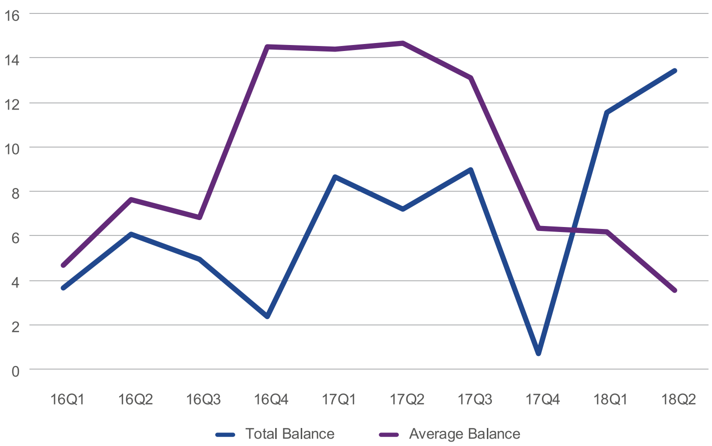


Source: Experian, Moody's Analytics

Average balances rose 7.4 percent year-over-year in the third quarter. Total outstanding balances continued to grow at a healthy clip, up slightly less than 16 percent from a year ago. Combined with the already rapid growth in balances, a reduction in business counts helped to push up average balance growth. Some businesses left the data set in the third quarter, as fewer firms accessed credit recently. Looking to the future, the Federal Reserve's Senior Loan Officer Survey (SLOS) hints that this pullback may be a transitory condition, and more businesses will access credit in the fourth quarter.

Fewer firms using credit pushes up average balances

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

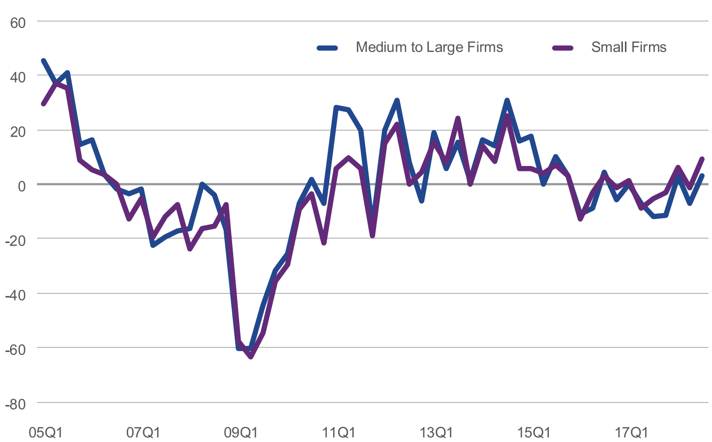


Source: Experian, Moody's Analytics

Last quarter's Senior Loan Officer Survey, which indicated that fewer banks reported increases in businesses seeking credit, was borne out this quarter, as the number of businesses accessing credit declined 0.6 percent. However, the SLOS indicated that more businesses were seeking credit in the third quarter. This suggests that the decrease in small businesses accessing credit is likely to be reversed next quarter and is nothing more than noise.

C&I loans hint at higher demand

Senior loan officers reporting higher demand for C&I lending, % Net

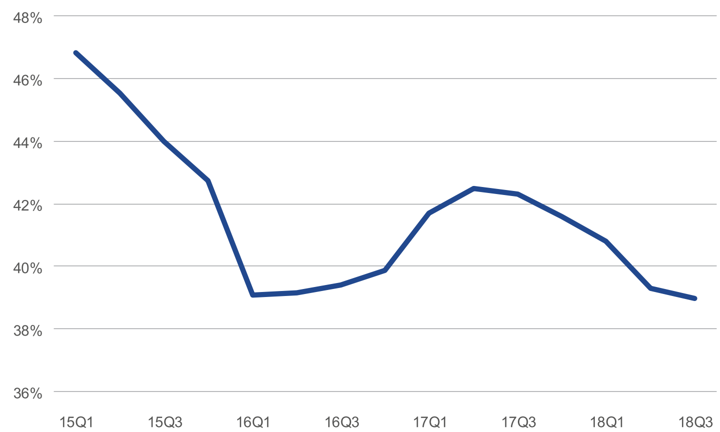


Source: Experian, Moody's Analytics

Utilization rates fell to 38.9 percent in the third quarter from 39.3 percent in the second quarter. This marks a new low in utilization and suggests that businesses that are able to access credit have room to take on additional capacity and therefore may be lower-risk borrowers. Since many small businesses rely on their owners' balance sheet for capital, it's expected that the market correction early in the fourth quarter may induce more borrowing as owners look to stave off selling financial assets in a down market.

Utilization pull-back continues unabated

Utilization rate across all small business credit accounts, % of available credit



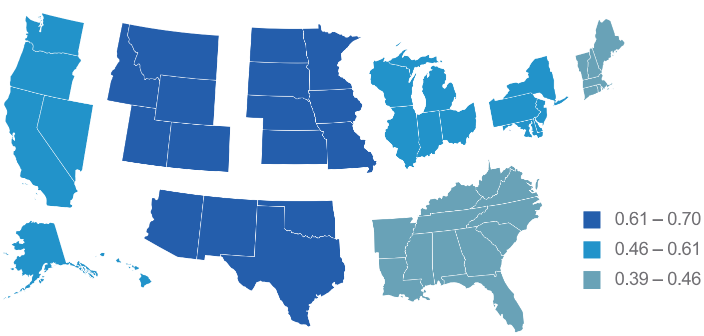
Source: Experian, Moody's Analytics

A Mississippi split

Severe delinquency rates — defined as 61 to 90 days past due — came in mixed in the third quarter. Regions west of the Mississippi — specifically, the Far West, Southwest, Rocky Mountain and Plains regions — saw a mild deterioration of their credit performance, while regions east of the Mississippi saw mild improvements. We've introduced Bureau of Economic Analysis (BEA) regions into this report to help tamp down some of the noise that would be 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 use are Far West, Great Lakes, Mideast, New England, Plains, Rocky Mountain, Southeast and Southwest. The map below identifies the states in each region.

New England and Southeast continue to out-perform

90 DPD rate across all small business credit accounts, % of balance



Source: Experian, Moody's Analytics

Far West: The Far West experienced a mild deterioration in credit performance in the third quarter as the severe delinquency rate increased from 54 basis points to 58. Delinquency rates fell for companies in mining and retail, two industries usually noted for rising delinquencies. But, all other industries in the region performed worse. Risks to businesses are more on the supply side than the demand side, as high labor costs and rents take a toll on the potential labor pool.

Great Lakes: Credit performance in the Great Lakes region improved marginally in the third quarter, with the severe delinquency rate coming in at just 0.5 percent. The deterioration in the region was driven by wholesale businesses, which continued to experience the volatility seen all year. Severe wholesale delinquencies jumped from 54 to 74 basis points in the quarter. For the year, though, the Great Lakes experienced a decline of almost 10 percent in the rate of severely delinquent balances.

Mideast: The Mideast's credit performance in the third quarter saw the undoing of the small bump in the second quarter, as severe delinquencies fell from 59 to 57 basis points. This move is almost identical to the change and level in the third quarter of 2017. Agriculture in the region experienced declining delinquencies, while retail went on a bit of wild ride, only to end up back where it started. Year-over-year, at an aggregate level very little changed in the region.

New England: New England had a severe delinquency rate of 44 basis points, down 1 basis point from last year. Delinquency rates for services, finance and transportation each dropped about 4 basis points, which proved to be just enough to offset the rise in manufacturing and wholesale.

Plains: The Plains region had the third highest 90-day delinquency rate in the third quarter, but still came in at a low 62 basis points, nearly unchanged from the second quarter. The transportation industry gave up some of the improvement it saw in the second quarter, which accounted for part of the weakness in the third quarter. The other factor that held the Plains region back this quarter was the increase in agriculture delinquencies, since agriculture accounts for a large portion of the businesses in the Plains region.

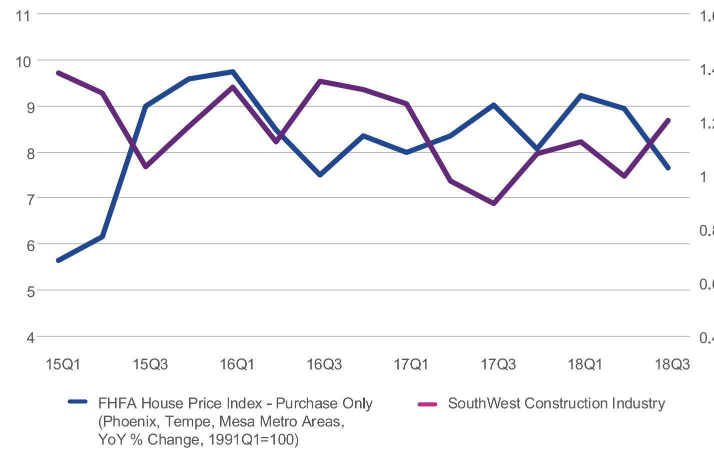
Rocky Mountain: The Rocky Mountain region had the second highest delinquency rate among regions in the third quarter, coming in just below 65 basis points. There was general improvement across industries including services, retail, wholesale and finance, while construction and manufacturing saw performance deteriorate. Agriculture in the Rocky Mountain region bucked the trend in other regions, with the delinquency rate declining from 43 to 34 basis points.

Southeast: The Southeast had the lowest severe delinquency rate in the third quarter, moving down from 41 basis points in the second quarter to 39 in the third quarter. The intra-region industry analysis showed little of note for the quarter, with results across industries coming in mixed. The only change of note here is that agriculture delinquencies moved up sharply, from 11 to 21 basis points. Coming off such a low base, it isn't an overly concerning shift, and it's likely just a normalization from an abnormal low — but it's something to watch over the next few quarters if agriculture is hit by tariffs or demand trails off due to existing trade actions.

Southwest: The Southwest had a reversal of fortune in the third quarter as severe delinquencies jumped from 62 to 69 basis points, making it the worst-performing region in the quarter. This is the highest rate for the Southwest since the first quarter of 2017. Leading the decline was the construction industry, which saw its severe delinquency rate jump 20 basis points in the quarter to 1.2 percent. Services also stumbled as severe delinquencies rose 13 basis points to 0.65 percent. The services industry was an even harder hit to the region, as services firms outnumber construction firms 3.5 to 1.

Housing weakness hits Southwest Performance

90 DPD rate across all small business credit accounts, % of balance



Source: Experian, Moody's Analytics

Risks from trade policy warrant scrutiny

Last quarter it looked like rising interest rates and trade disruptions would be the primary factors impacting the small-business credit market this year, but slowing home prices may need to be added to this list.

The Federal Reserve has raised rates three times so far in 2018 and looks set to raise rates once more before the year is out, bringing the federal funds rate to a range of 2.25 percent to 2.5 percent by year's end. 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. Any sign of a brewing recession may discourage small businesses from borrowing to fund operations or expansion — or from forming in the first place. Although a recession in the next few quarters is unlikely, the impact of rising rates will be felt in small-business credit through targeted industries such as construction and financial services.

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 can be attributed to trade actions, which could be aggravated by 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, it could dampen the positive labor market outcomes that are starting to result in faster wage growth, reducing demand from consumers. More likely than not, trade will remain a small fish in the credit risk pond, but it's a risk that bears watching, especially given heightened trade tensions.

Home prices and sales have begun to slow. Delinquencies in the construction industry for small firms were up nationally in the third quarter and sharply up across several regions. This coincides with a slowdown in transaction prices for homes in some of the larger metro areas of these regions. If the trend of slowing home prices continues, which it looks set to do as builders transition away from luxury and multifamily dwellings, it could push delinquencies for construction firms up in the next few quarters.

A slowing housing market, rising interest rates and a return to volatility in financial markets driven by these trends as well as trade disputes may be the end of the steady performance of small-business credit observed over the past three years.

Q3 was a mixed bag; Q4 could be as well

The third quarter brought confined pockets of weakness to small-business credit. Performance across most industries was mixed, but agriculture, construction and financial services had a rough go of it. Agriculture likely felt the first effects of tariffs imposed by China in an escalating trade conflict, though it's still too early to tell if this will have a permanent affect or be a fleeting phenomenon. The construction industry faces headwinds to credit performance from rising interest rates, a low supply of lots for affordable housing, and a lack of impetus to move from luxury and multifamily housing into entry-level housing. Volatility in financial markets rose in August and September and will likely continue to rise in the fourth quarter following October's stock market corrections. Although credit performance remains strong, gathering headwinds could change the nature of this market materially in the next few quarters. While much of this seems to be out of the hands of small-business owners, it may be time for lenders to re-evaluate which industries pose the greatest risks in their regions.

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About Moody's Analytics

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