MAIN ST REPORT

Your window into small business health

Q2 2020

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 (e.g., credit balances, delinquency rates, utilization rates, etc.) and macroeconomic information (e.g., employment rates, income, retail sales, industrial production, etc.).

Executive summary

Small businesses have turned to borrowing to survive periods of prolonged slumping sales, in many cases from government programs offering loan forgiveness. This increased borrowing has masked rising delinquent balances, but such a solution is a short-term fix. Small businesses will need to find ways to generate revenue to keep their credit current. Defaults are expected to rise in coming quarters as forbearance programs expire and as customers are likely to change their priorities in the wake of COVID-19.

	Bucket	Q1 19	Q1 20	Q2 20
Moderately Delinquent	31-90	1.64%	1.61%	1.66%
Severely Delinquent	91+	3.24%	2.68%	2.33%
Bankruptcy	BKC	0.16%	0.16%	0.16%

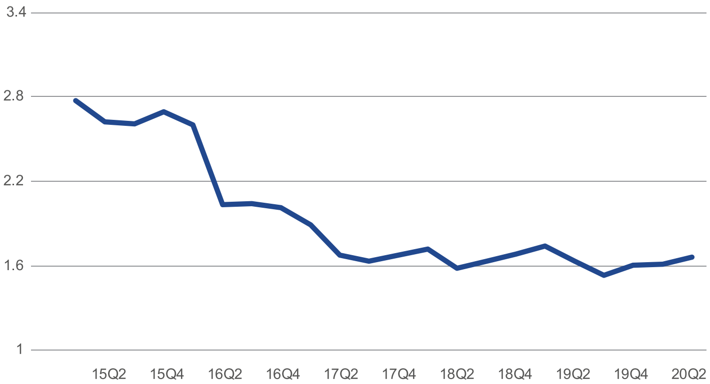
Small-business credit outlook remains negative in a poor sales environment

Uncertainty and Sales

The 31-90 days past due (DPD) delinquency rate on small business credit rose to 1.66 percent in the second quarter. This marked the fourth consecutive quarter of increasing delinquency and the first year-over-year increase since this time last year. The economy is currently caught in the change of trajectory from COVID-19 as infections wax and wane across the country. The failure to contain the virus and rising uncertainty this has caused the primary catalysts of the moderate to high risks we see for the economy and small businesses going forward.

Delinquencies begin to rise, but more are coming...

31-90 DPD for small businesses, % of balance



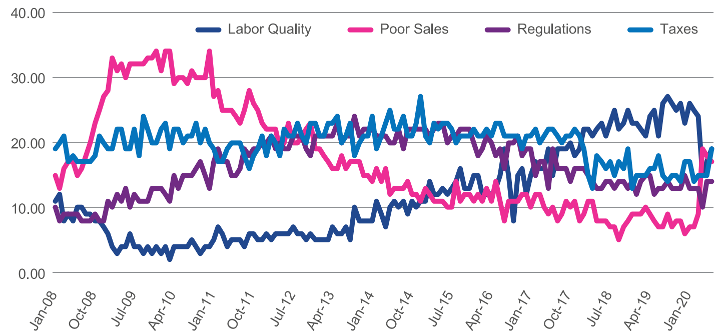
Source: Experian, Moody's Analytics

The closure of many state and local economies in April and the first half of May left many businesses facing severe revenue shortfalls in the second quarter. Even after the re-openings that began in May and June, led to some of the fastest economic growth on record but this was largely a function of the abysmal readings in April and May used for a month on month comparisons. The third quarter also promises to post impressive numbers as Q2 is dragged down by April and May.

This environment has resulted in small businesses listing "Poor Sales" as the second most important problem they are facing, according to the NFIB. This problem is second only to "Taxes," which once again became the most critical problem for small business owners as "Labor Quality" fell to the wayside. The question many are asking themselves now, and which is vital for a sustained recovery, is how many of the people who have found themselves out of work will be able to return? When the pool of available labor is shallow and employers must look hard to find quality employees, it is a good indicator of a strong economy. If small businesses are signaling that they expect the pool of available workers will be deep once again, the economy may be in for more pain than analysts and stock market investors may be expecting.

Poor Sales are on the minds of small businesses again

Net % of firms reporting the most important problem

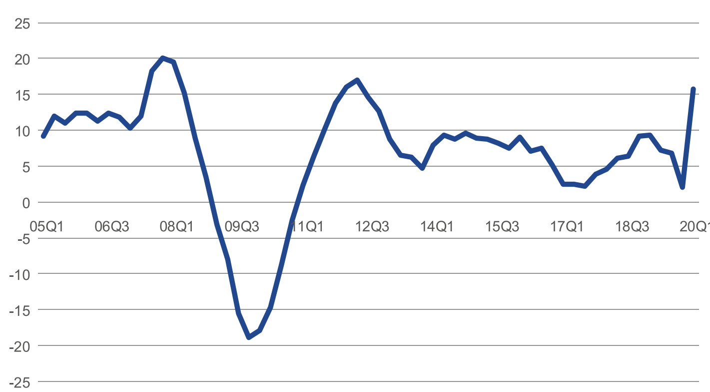


Source: NFIB

There can be no quick recovery and return to normal without credit flowing to businesses. In the last recession, lenders tightened standards resulting in declines in the volume of Commercial and Industrial loans and leases. This pullback served as a strain on the economy as many businesses could not expand or get the credit needed to survive. In response to COVID-19, the government has stepped in to provide loans hoping to help firms bridge the gap between a pandemic and a return to normal. Time will tell if this is successful or merely a delay of the inevitable.

Commercial Lending growth is on the rise

Net C&I Loans and Leases — Commercial Banks, Mil. USD NSA % Chng. YoY



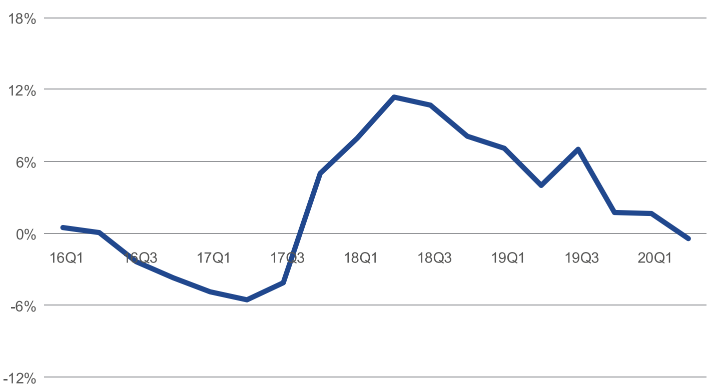
Source: Federal Deposit Insurance Corporation (FDIC)

Shutdowns impacted lenders too

The number of reported small businesses with active credit profiles declined in the second quarter as some lenders couldn't meet reporting deadlines given other priorities and operational issues associated with government-mandated shutdowns. While other lenders reporting in did show an uptick in demand for credit, the failure of several smaller lenders to report in did result in the year-over-year decline in businesses. The last time the number of businesses declined was the energy price collapse of 2014-2015 that led to the failure of a number of energy and energy-related firms. Given the broad nature of the downturn, affecting all industries without discrimination, this temporary disruption is likely a harbinger of businesses closing over the next couple of years as delinquencies rise and lenders eventually begin writing off those businesses that are not able to survive the pandemic.

COVID-19 disrupts business & reporting

Businesses entering the dataset, NSA % Chg. YoY



Source: Experian, Moody's Analytics

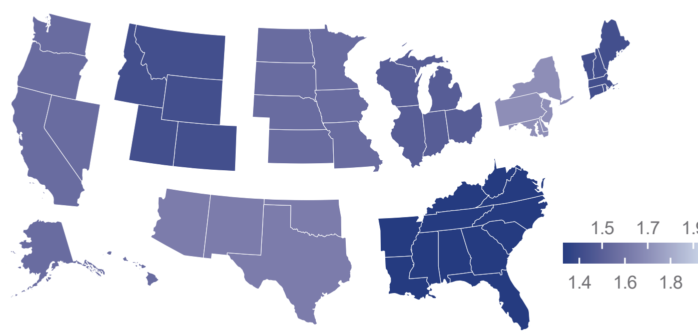
More regions are feeling pain

Moderate delinquency rates were mixed across the country in the second quarter. We focus on the Bureau of Economic Analysis (BEA) regions in this report to reduce some of the noise that would be observed at the state level from quarter to quarter. This allows us to identify trends that are real and developing, rather than one-off events that may turn out to be false signals.

The BEA regions considered are Far West, Great Lakes, Mideast, New England, Plains, Rocky Mountain, Southeast, and Southwest. Performance varied across regions as businesses accelerated their borrowing at different rates across the country in the second quarter. The uptick in delinquencies is a small precursor of what will come in the next few quarters, though, for now, it is confined to a small increase in delinquencies.

The pain has begun to spread

Businesses entering the dataset, NSA % Chg. YoY



Source: Experian, Moody's Analytics

Far West: Moderate delinquencies rose modestly in the second quarter, up from 1.76 percent to 1.81 percent, for the Far West region. Industries such as agriculture, transportation, and retail saw performance deteriorate while other sectors saw improving performance. Moderate delinquencies in the Far West's agriculture sector jumped sharply in the second quarter as sustained low prices collided with pandemic induced shutdowns impacting food supply chains. However, this trouble was confined to a crop or crops exclusive to the Far West as other regions did not experience such jumps in ag-related delinquency.

Great Lakes: Credit performance in the Great Lakes region continued to improve in the second quarter moving from 1.68 percent to 1.61 percent in the moderately delinquent category with transportation and retail the real laggards across industries. There was also a deterioration in the performance of wholesale companies for the quarter. However, with the decline contained at only two basis points, this move is not likely to be indicative of a more significant trend. The Great Lakes region has typically been more conservative with credit usage. The performance improvement during the COVID-19 related shutdowns is a testament to this judicious use of credit.

Mideast: The Mideast saw moderate delinquencies rise from 1.72 to 1.93 percent. This was among the most significant moves for the quarter and pushed the region to be the worst-performing region in the 61-90 DPD category. Deterioration in the region was led by the wholesale, retail, and services industries.

New England: Delinquencies in New England were moderate at 1.59 percent of outstanding balances from the first quarter. Retail and services had the weakest performance. While other industries had mostly lower delinquencies, retail delinquencies were up 100 and 89 basis points from the first quarter and last year, respectively. Delinquencies were stable in 2019 but were up25 basis points over the same time last year in the second quarter. The fallout from shutdowns and stubbornly low consumer confidence will drag on activity until the pandemic passes.

Plains: Moderate delinquencies fell to 1.79 percent this quarter from 2.23 percent in the first quarter. As expected, the Plains region was insulated from some of the worst of the business malaise in the second quarter. The only industry to see rising moderate delinquencies was retail with a 15 basis point increase for the quarter. Future quarters are likely to see pain spread across other industries, but this is not likely to be as severe as in more populous regions.

Rocky Mountain: Moderate delinquency rates fell in the Rocky Mountain region in the second quarter, from 1.83 percent to 1.50 percent. Retail and services, as elsewhere, were the hardest hit industries. However, neither saw particularly large increases in delinquency. Declines across all other industries served to push down the region's delinquency rates.

Southeast: Moderate delinquencies in the Southeast rose from 1.33 to 1.34 percent in the second quarter. As in prior quarters, the Southeast saw only small movements across a broad spectrum of industries. The exception to this was retail, where moderate delinquencies rose 67 basis points from the first quarter and were up 74 basis points from the same time last year.

Southwest: Delinquencies in the Southwest rose to 1.89 percent from 1.78 percent in the second quarter. Transportation, wholesale, and retail were the primary industries driving moderate delinquency. Retail was responsible for most of the performance deterioration, with its moderate delinquency rate rising 203 basis points to 3.55 percent. This was a massive leap, which may be partially reversed in the third quarter's businesses reopen. Risks are elevated to the downside as a rise in COVID-19 cases could cause states to resume or initiate shutdowns.

Even with so many downside risks, some upside risks remain

To assess the risks stemming from COVID-19, we monitor several high-frequency datasets, including Google Mobility, initial claims, and the Census Bureau's Pulse Survey. State economies are feeling the pain from re-openings, which are being paused or rolled back as hot spots of the virus pop up throughout the country. Growth had resumed in the latter half of the second quarter. Still, there is an increasing risk that growth will stumble again as virus hotspots prompt economies to shutter or work at limited capacity once again.

Risks to the retail industry are high, as is shown throughout the regional analysis. This industry is the driving force behind many of the increased delinquency rates observed for the quarter. The pain suffered by retailers is set to continue until COVID-19 is under control. However, the negative impact is not universal across retailers. Some retailers, such as grocery stores and home improvement, are thriving as people are stuck at home. On the other hand, apparel, department stores, and gas stations have been on the losing end of retail thus far. There are signs the trouble for gas stations is fading as people are driving more to get out of the house or avoid public transit.

Retail weakness helps to explain some of the weakness in the labor market. In the latter half of June and early July, the labor market began to weaken again as unemployment insurance claims rose. The recession risk from the unemployment rate remains high, as do many of our business cycle indicators. The number of indicators that remain at moderate or high risk suggests that risks are rising for secondary economic contractions despite strength in the housing and financial markets.

Business Cycle Indicators												
Indicator	Current Recession Risk						Prior to Great Recession*					
	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07
Financial stress index	Low	Low	High	High	Moderate	Moderate	Low	Moderate	Moderate	Moderate	Moderate	High
Housing permits	Low	Low	Low	High	High	High	High	High	High	High	High	High
Yield curve 10-yr minus 3-mo	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	High	High	High	High	High	High
Yield curve 10-yr minus 2-yr	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	High	High	High	High	High	High
TED spread	Low	Low	High	High	Moderate	Moderate	Low	High	High	Moderate	High	High
Consumer confidence	Low	Low	High	High	High	Moderate	Low	Low	Moderate	Moderate	Moderate	Moderate
Jobless claims	Low	Low	High	High	High	High	Low	Low	Low	Moderate	High	High
S&P 500	Low	Moderate	High	Moderate	Low	Low	Low	Moderate	Low	Low	Moderate	Low
ISM manufacturing index	Low	Low	High	High	High	Moderate	Low	Low	Low	Low	Low	Low
Hours worked for production workers	Moderate	Low	High	Moderate	Low	Low	Low	Low	Low	Low	Low	Low
Banks tightening lending standards on C&I	Moderate	Moderate	Moderate	High	High	High	Moderate	Moderate	Moderate	High	High	High
Core capital goods orders	Low	Low	High	High	High	ND	Moderate	Moderate	High	High	High	Moderate
Unemployment rate	Low	Low	High	High	High	High	Moderate	Low	Moderate	Moderate	Low	High
Industrial production	High	High	High	High	High	High	Low	Low	Low	Low	Low	Low
ISM nonmanufacturing index	Low	Low	Moderate	High	High	Moderate	Low	Low	Low	Low	Low	Low
Employment	Low	Low	High	High	High	High	Low	Low	Low	Low	Low	Low
Red monthly GDP	Low	Low	High	High	High	ND	Low	Low	Low	Low	Low	Low

2020 will be the year of the pandemic

The second quarter showed that serious weaknesses are resulting from COVID-19. These weaknesses have, in some cases, been pushed down the road by forbearance programs and expanded unemployment insurance, among other programs put in place to offset the effects of COVID-19 on the economy. Whether such programs remain in place or are expanded will determine the path of small business credit performance for the second half of 2020 and into 2021 as well as the survival of thousands of small businesses.

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