MAIN ST REPORT

Your window into small business health

Q1 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, investments, etc.).

Executive summary

The overall outlook for small-business credit is positive. Outstanding balances rose in the first quarter, as did the average balance outstanding per business. Delinquencies were down and default rates rose slightly, suggesting that credit conditions have peaked as the economy is in a late-cycle expansion. Continuing strength in the macroeconomy will keep small-business credit moving in the near term, along with higher profits from the recently passed tax legislation. Small-business credit will be less certain in the medium to long term as rising wages, interest rates and changes to the tax code take a toll.

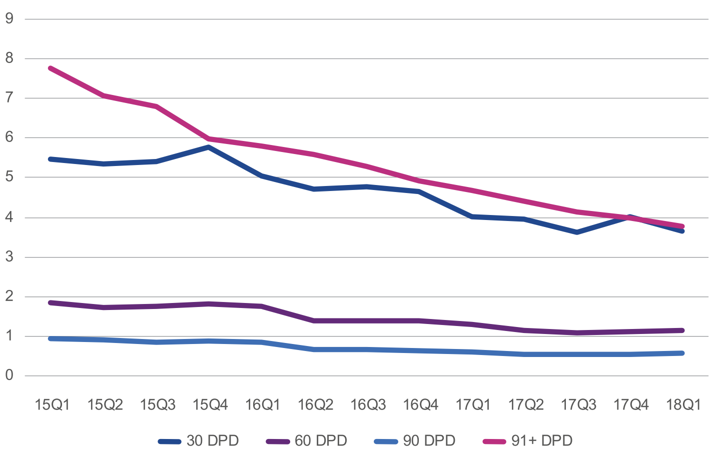
Small-business credit conditions remain positive in Q1

Small-business credit conditions have begun to loosen

Small businesses with fewer than 100 employees saw the downward path of their delinquencies resume in the first quarter of the year, after a respite in the fourth quarter. Taken together with more businesses accessing credit markets, this suggests that credit conditions are finally beginning to loosen. Delinquencies fell in two of the four stages tracked in the first quarter. These declines came from the 1–30 and 91+ day delinquency buckets, which fell by 31 and 20 basis points, respectively. Delinquencies increased in two days past due categories, but the increase was slight, resulting in total delinquencies falling from 9.4 percent to 9.2 percent.

Small businesses continue to enhance performance

Delinquencies for small businesses (% balance)

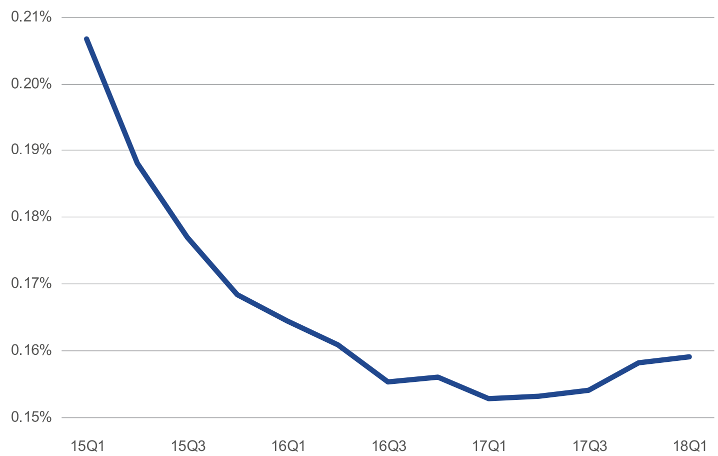


Source: Experian, Moody's Analytics

Bankruptcies continued to rise in the first quarter, following the trend that developed in 2017. Taken in conjunction with the trend of more businesses accessing credit, this lends further credence to the theory of a return to dynamism for small businesses. At this point, only a few quarters worth of data support this notion, so it's too soon to tell whether this is in fact the case. Despite this potential spot of good news, bankruptcies rising for small businesses could lead to trouble down the road. For the time being, though, it looks like nothing more than the bankruptcy rate coming off the floor it touched in the first quarter of last year.

Bankruptcies creeping higher

Bankruptcy rate, % balance

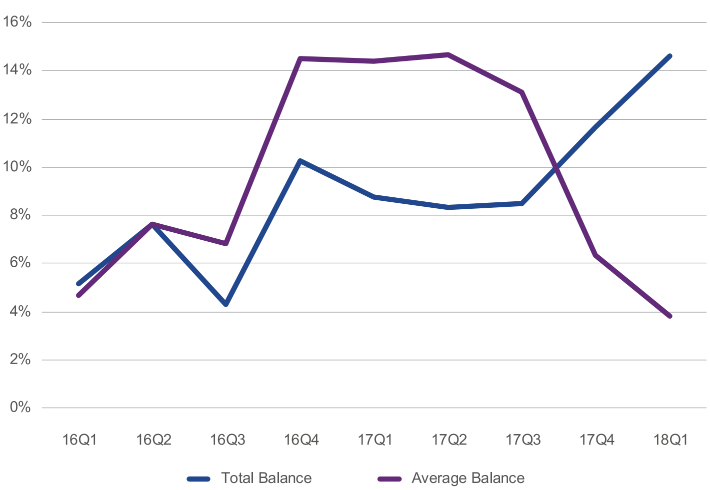


Source: Experian, Moody's Analytics

In the first quarter, balances rose 14.6 percent year-over-year. Balances are still being affected by the entrance of pre-existing businesses into the data set last quarter. Looking at this number alone is enough to set heads spinning, but looking to loans issued by the Small Business Administration (SBA), growth was only 2.3 percent for the first quarter (second fiscal quarter for the SBA) between the 504 and 7(a) portfolios. So the support for balances present last quarter has faded away this quarter. This results in some uncertainty with regard to the balance numbers we're seeing this quarter.

Balances rise as more firms access credit

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

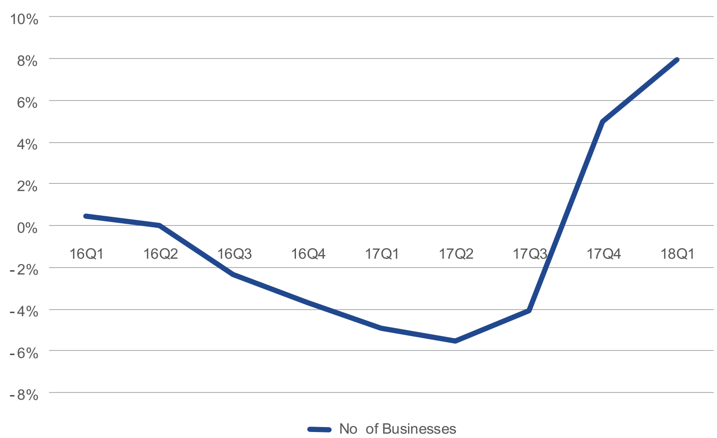


Source: Experian, Moody's Analytics

Balance growth is still a key reason for the small-business credit outlook remaining positive. The double-digit growth in total balances is, to a great extent, a function of the growth in businesses in the data set. We must, therefore, be careful with our examination of balances. The Small Business Administration reports that 2.3 percent more businesses accessed SBA 504 and 7(a) loans as of the end of the first quarter than in the same period last year. Our data shows that the number of small businesses tapping credit markets was up 7.9 percent for the quarter. This may mean that our sample is exhibiting outsized growth. As such, caution is warranted with respect to the balance growth numbers.

More businesses accessing credit in Q1

Change in businesses accessing credit (YoY, %)

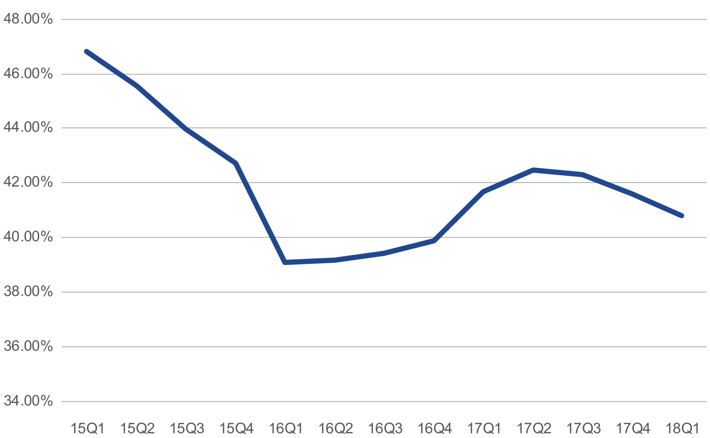


Source: Experian, Moody's Analytics

The utilization rate for credit among small businesses pulled back to 40.8 percent in the first quarter, from 41.6 percent in the fourth quarter of 2017 and from 41.7 percent in the first quarter of last year. This trend, similar to other rates, is being driven by businesses that are accessing credit once again. As businesses return to credit markets, they are borrowing less than their historical peak borrowings, which drives down the overall utilization rate. As businesses continue to return to or enter credit markets, this development looks set to continue in the near term.

Utilization pull-back continues unabated

Utilization rate, % of available credit



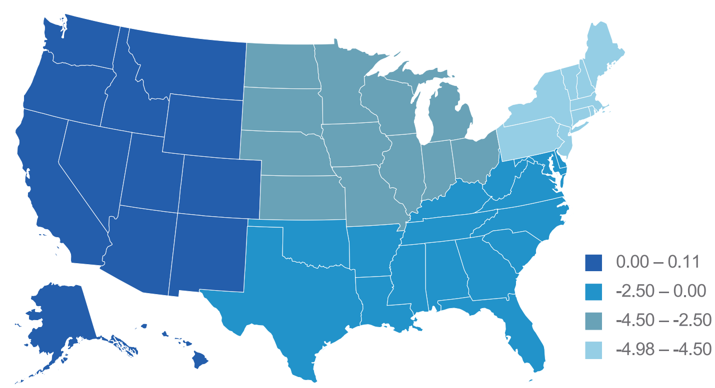
Source: Experian, Moody's Analytics

Taking a regional view

Looking at the data by region, severe delinquencies fell across three of the Census Bureau regions in the first quarter. Severe delinquencies declined the most in New England, followed by the Midwest. The West saw severe delinquencies up a mere tenth of a percent for the quarter, while the South had a decrease of 1.04 percent. Given that the West and the South had the largest increases in total balances outstanding, their trailing performance in severe delinquencies is notable. It suggests that the natural churn in small businesses is more pronounced in these areas, and with what we've noted regarding increased numbers of businesses accessing credit, these regions may be becoming even more dynamic centers for small-business credit.

Severe delinquency down in Q1

Year-over-year change in regional 90 DPD as of 2018 Q1



Source: Experian, Moody's Analytics

Risks to small-business credit begin to even out

Risks for small-business credit remain weighted to the upside in the near term due to the solid performance of the broader U.S. economy and the passage of the tax bill, with changes to the way small businesses are taxed. Many things are going right for small-business credit right now, and this looks set to continue at least through 2018. However, downside risk from owner financing shortfalls and policy uncertainty warrant monitoring.

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. An upturn in volatility in financial markets in the first quarter could result in more businesses demanding small-business loans to bridge any financing shortfalls, but these loans could be of lower quality and drag on performance.

The downside risk from fiscal policy in the first quarter came not from appropriations bills, but from trade policies. As trade policy changes are considered and implemented, volatility stemming from uncertain outcomes arises and presents risks to small businesses. These are, for the most part, minor direct consequences, but they risk damaging the confidence of small businesses to invest, given heightened uncertainty. Changes to the tax code have been eagerly awaited by small businesses seeing a chance to lower their tax rates and allow immediate expensing of capital investments for short-lived projects. Now that tax legislation favorable to businesses has passed, many small businesses will be looking to expand, boding well for the credit market. However, as businesses realize that the deductibility of net interest expense has new limitations, this could pose a serious downside risk to small-business credit. This isn't likely to affect credit origination or outstanding balances for several quarters, though, so the outlook remains upbeat in the near term.

The Federal Reserve will likely increase rates three to four times in 2018. 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 quantitative tightening will cause longer-term interest rates to rise as well, further adding to the cost of borrowing for small businesses. With interest deductibility changes, this could have a major impact on small-business credit. Interest deductibility is an issue that won't be realized by many small businesses for some time, but the effects of rising interest rates will be felt much sooner.

The labor market remains the brightest spot, as the economy has reached full employment. Payrolls grew by an average 202,000 per month in the quarter, with average hourly earnings rising 2.7 percent. With a low unemployment rate of 4.1 percent, the labor market has started to push income gains up, and will continue to do so. This should happen over the next year or so, as we look for an unemployment rate in the 3 percent range and income gains to push past 3 percent. 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.

2018 Q1 outlook remains positive

The year started off much as last year ended, with performance dynamics suggesting conditions are set for small businesses to grow and pursue credit. Given new businesses coming online, balance growth for this year looks set to strengthen. There likely will be slight deteriorations in several measures of credit performance, such as delinquencies, bankruptcies or utilization. Performance shouldn't fall too far, as the economy's late-stage expansion looks set to support the small-business credit market for the near and medium terms.

About Experian's Business Information Services

Experian's Business Information Services is a leader in providing data and predictive insights to organizations, helping them mitigate risk and improve profitability. The company's business database provides comprehensive, third-party-verified information on 99.9 percent of all U.S. companies. Experian provides market-leading tools that assist clients of all sizes in making real-time decisions, processing new applications, managing customer relationships and collecting on delinquent accounts. For more information about Experian's advanced business-to-business products and services, visit **www.experian.com/b2b**.

About Moody's Analytics

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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