MAIN ST REPORT

Your window into small business health

Q2 2017

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About the report

Developed by Experian and Moody's Analytics, 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

Small-business delinquency rates experienced broad-based improvement in the second quarter. With job growth expected to continue, putting more money in consumers' pockets, small businesses will continue to outperform in the short term. As performance on small-business loans and lines of credit improves, credit is expected to flow more freely as banks and other lenders compete for business. Although tax reform and infrastructure investment could provide an additional boost to small-business activity, consumer spending will be the driving force for small-business credit over the next quarter — and throughout the rest of the year.

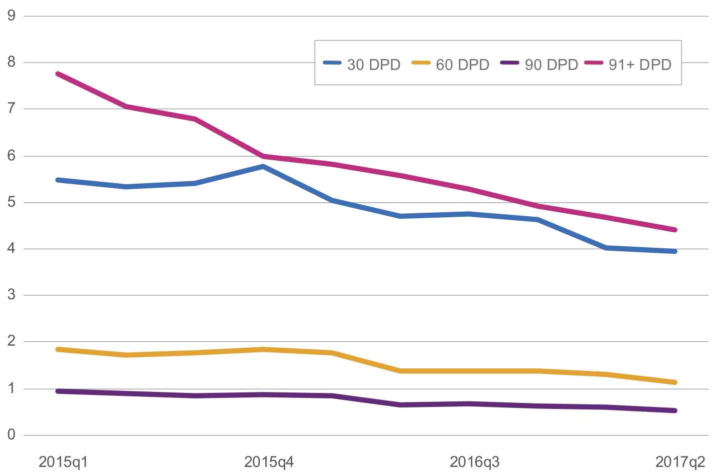
Small-business credit conditions improve across the board in Q2

Delinquency rates decline broadly

Small-business delinquencies continued to trend downward in the second quarter. Both early- and late-stage delinquency rates saw improvement over the quarter. This trend has been firmly in place over the last two years and was expected given the continued slow but steady growth in the economy.

Business delinquencies push lower

Percent of credit trades delinquent for small businesses



Source: Experian, Moody's Analytics

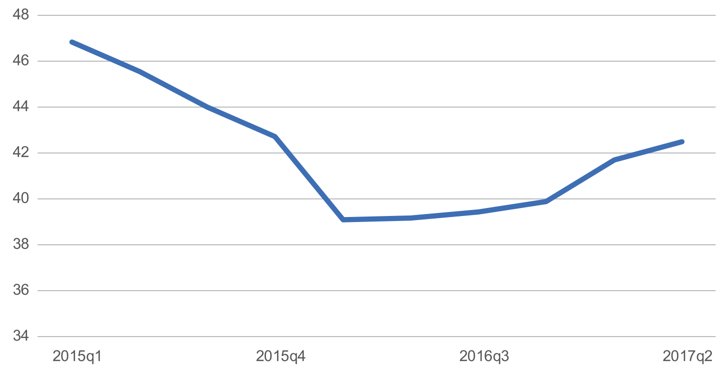
In addition to improving performance, credit utilization rates grew at a slower year-over-year pace in the second quarter than in the first quarter, rising from 41.7 percent to 42.5 percent. Some of the deceleration may be attributable to a decrease in the rate of inflation in the second quarter, leading to slightly higher real income growth and less need to tap credit lines.

Although the credit data doesn't reveal how small businesses are spending their additional funds, complementary data suggests that some businesses may be using some of their available credit to attract and retain talent. The National Federation of Independent Businesses announced that 24 percent of the small businesses it surveyed reported increasing compensation in June, down from 28 percent in March.

Consistent with this finding, detailed payroll numbers from ADP showed small businesses adding 112,000 workers over the past quarter. Small-business owners appear to be confident enough in their future sales prospects to be hiring at a healthy pace.

Credit utilization continues to rise, albeit slowly

Utilization rate, Percent of available credit



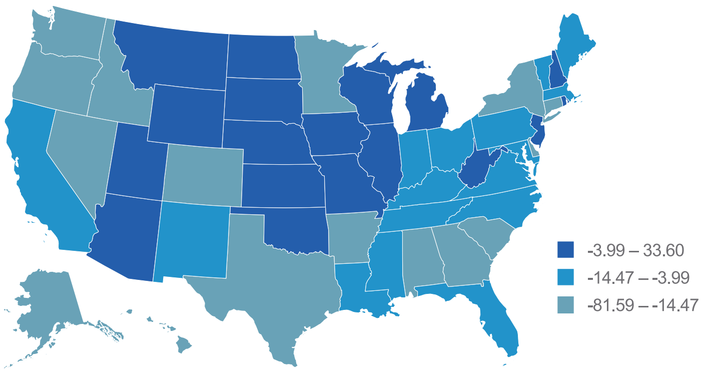
Source: Experian, Moody's Analytics

Improvement is not universal

Rates of severe delinquency, defined as 91+ days past due on loan obligations, increased in the Upper Plains states in the second quarter. Rates in the Mid-Atlantic, New England and Southeast regions were relatively steady. Results in the West were mixed: Coastal states experienced declines, while some inland states — such as Arizona — saw increases.

The Upper Plains underperform…

Year-over-year change in small businesses 90 DPD as of 2017Q2



Source: Experian, Moody's Analytics

Ranking the states from lowest to highest, Georgia had the lowest 90-day delinquency rate in the second quarter — displacing Nebraska — while Kansas maintained the highest severe delinquency rate in both the first and second quarters.

Southeast tops performance in Q2

Ranking of States and DC By Lowest 90 Day Delinquency Rate

Rank	2016 Q2	2017 Q2
1	NE	GA
2	MI	AL
3	NH	SC
4	WV	NC
5	WI	MI
47	SD	MT
48	WA	SD
49	ND	HI
50	HI	ND
51	KS	KS

Source: Experian, Moody's Analytics

As evidence of the evolving nature of small-business credit, we observe that the five states with the best performance changed from 2016 to 2017. Declines in the agriculture, construction and transportation industries over the past year provide the most likely explanation, given the exposure of Kansas, North Dakota and other states to these industries.

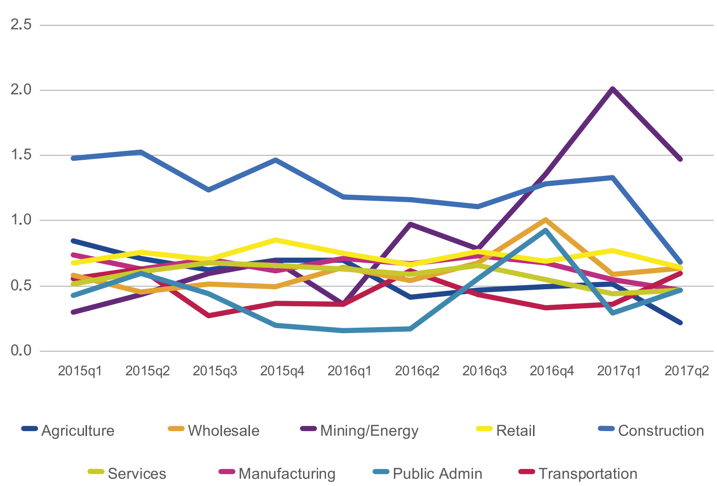
At the other end of the spectrum, Georgia replacing Nebraska as the best-performing state had less to do with deterioration in Nebraska and more to do with rapid improvement in Georgia. Georgia's severe delinquency rates declined across several industries, while Nebraska saw very little movement. Particularly noteworthy: Georgia's construction, manufacturing, transportation and retail industries experienced double-digit basis point declines in their delinquency rates. Beyond Georgia, the Southeast as a whole experienced strong performance over the last few quarters, a trend that is likely to continue due to faster growth in the region relative to the United States overall.

Mining turns a corner?

Colorado's mining industry caught a break in the second quarter as delinquencies declined for the first time in a year. Although there will likely be some payback in the third quarter, given the size of the decline in delinquencies, small Colorado miners may be set to stabilize their credit performance. As firms are adapting to a lower-price environment and other industries throughout the state are improving their credit performance, mining may be at the cusp of a new dynamic in Colorado.

Is Colorado mining set for a course change?

Percent 90 DPD



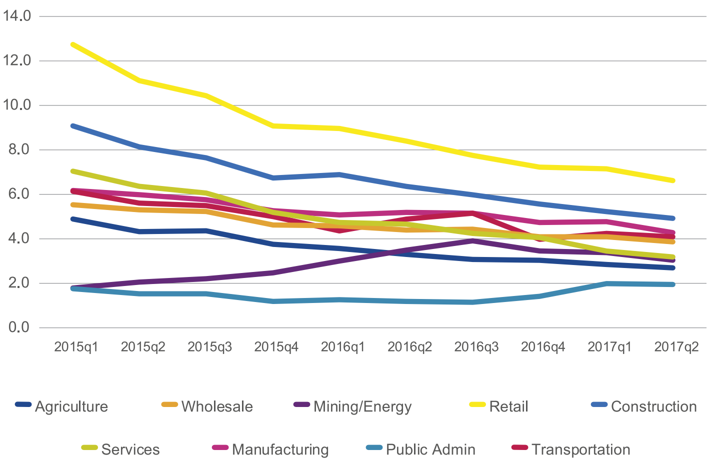
Source: Experian, Moody's Analytics

Agriculture performance stands firm

Further adding to the optimism around small-business credit, severe delinquency rates improved across all industries in the second quarter — at least at a national level. Agriculture in particular has remained surprisingly resilient following four years of declining incomes for farmers. With banks in healthy condition, they are focused on originations, which should result in continued strong performance, as well as a loosening of lending standards on farm loans in the second half of the year.

Severe delinquencies down across industries

Percent 91+ DPD



Source: Experian, Moody's Analytics

The severe delinquency rate on small-business loans in the agriculture industry fell to 2.67 percent of outstanding balances in the second quarter. Prices on agricultural commodities have started to recover only recently, forcing farmers to deal with reduced incomes and cash flow. Borrower liquidity has suffered as a result. Even as lenders grow more confident about the economy overall, financing for small businesses in the agriculture industry may be harder to come by for borrowers without sufficient liquidity, substantial net worth or pristine credit histories.

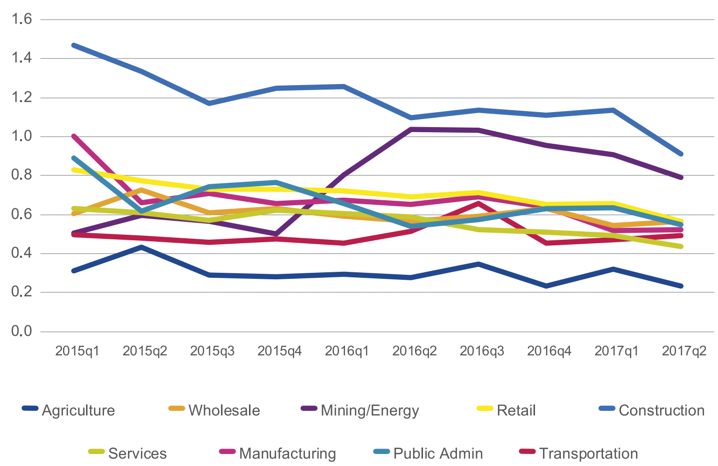
Retail remains risky

The retail sector has seen some improvement in the delinquency rate over the past two years, but the industry still has the highest severe delinquency rate. Following the downward trend started in February and March, retail sales continued to decline in May and June. Only April showed a gain in the second quarter. As a result, retail sales are up only 2.8 percent year over year, the weakest performance since last August. Some of this weakness is undoubtedly due to shifts in consumer preferences and the rise of online shopping. Increased competition has pushed prices down, leading to deflation in some sectors.

Weak but positive sales growth, has allowed most retail firms to continue paying back their outstanding loans and lines of credit. While performance is improving, delinquencies are likely to remain higher than those in other industries until the current cycle of consolidation and reorganization is complete.

Construction delinquencies improve

Percent 90 DPD



Source: Experian, Moody's Analytics

90-day delinquencies point to future improvement

Overall performance in the 90-days-past-due category improved slightly in the second quarter from a rate of 60 basis points to 54 basis points. While the retail industry had the worst performance based on a measure of severe delinquency (90+ days), the construction industry had the highest 90-day delinquency rate at 91 basis points. Retail had a 90-day delinquency rate of 56 basis points, only slightly above the national average.

While the severe delinquency measure identifies firms experiencing critical, non-temporary issues in paying back their debt obligations, it doesn't measure the length of time borrowers are in this category. Some borrowers may have been delinquent for quite some time, having received multiple extensions from their creditors seeking to avoid a costly default. As a result, the measure may be influenced by lender behavior as much as borrower behavior.

The 90-day delinquency measure may be more representative of the underlying credit risk stemming from borrower behavior. Although the ordering of industry performance changes with this measure, the fact that 90-day delinquency rates are flat or declining across all industries is an encouraging sign.

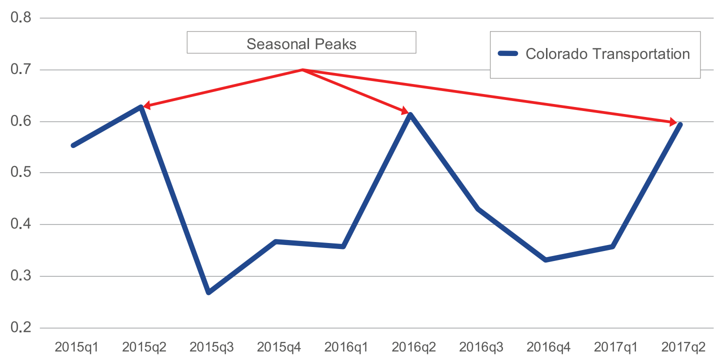
Although the construction industry appears to be risky relative to other industries given its high 90-day delinquency rate, the industry is on sound footing when compared with its own prior performance. As the economy has continued to improve and demand for housing remains robust, delinquencies for construction firms have been declining in line with other industries across the small-business spectrum

What's new with the data?

Being relatively new, the Main Street Report has focused primarily on interesting and evolving trends in small-business credit by geography and industry within a given quarter. As the data series has lengthened over time, the effects of seasonality are becoming more visible and measurable. For example, the 90-day delinquency rate in the Colorado transportation industry now demonstrates a clear seasonal trend, with higher delinquencies reported systematically in the second quarter relative to other quarters of the year. As the available history continues to grow, these patterns will be incorporated into future analysis and forecasts.

Performance is seasonal

Percent 90 DPD



Source: Experian, Moody's Analytics

Outlook upbeat, but policy risks emerge

The outlook for small-business credit formation and performance over the next 12 months is positive. The national economy is improving, with the labor market at or near full employment across most industries. Consumer demand for goods and services remains strong and will gather steam as wages rise in the face of tight labor markets. Even the mining and agriculture industries will benefit as commodity prices rise.

Although the risk of recession is low for the economy overall, small businesses are particularly 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. In the event of a downside shock to the economy, these firms will be particularly vulnerable, as they may not have the financial cushion enjoyed by larger businesses.

The two most important downside risks for small businesses over the next few quarters are rising interest rates and fiscal policy uncertainty.

The Federal Reserve has raised the federal funds rate 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 will likely increase rates one more time in 2017, followed by three more 25-basis-point rate increases in 2018. In addition, the Fed has indicated that it may begin reducing the size of its balance sheet later this year. 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.

So far, businesses have been able to digest rate increases gracefully given increased demand for their goods and services. However, if the economy should start to overheat with rising inflation, the Fed may be forced to increase rates more aggressively. Businesses would pull back on their borrowing as a result, increasing the risk of delinquency as the economy slows.

As mentioned in the first quarter report, our assessment is that risks from fiscal policy will remain an issue throughout the rest of the year. Unless Congress acts, the federal government is scheduled to hit a debt ceiling at the end of September. Growth in small-business credit balances could be hampered in the fourth quarter if the government shuts down and the staff of the Small Business Administration is furloughed. Even a short shutdown could result in credit growth being pushed into next year.

A shutdown would profoundly impact the Mid-Atlantic region, given the number of small businesses that have government contracts or rely on spending by federal employees.

Commodity prices have come to a fork in the road. Oil prices are still fluctuating around $50 a barrel, while prices for agricultural commodities are still low but rising. While oil prices are helping to improve the credit position of small businesses in the mining and transportation industries, low prices for agricultural commodities could hit agriculture credit. There may be some payback in the manufacturing industry, as oil and metals are large inputs. As a result, rising commodity prices could cut into profits for manufacturers.

The labor market remains the brightest aspect of the current economic climate. Payrolls grew by 222,000 in June, while personal incomes rose 2.4 percent over the past year. With an unemployment rate of 4.4 percent, the economy is either at or near full employment. 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.

2017 a year for steady improvement

With the year half over, 2017 looks set to be a year of continued stability for small-business credit, with delinquencies declining and utilization rates moving up gradually. Although utilization rates have risen, small businesses are still reporting that they don't have adequate credit to expand at their desired pace. Solid balance sheets, increased levels of capital and improving economic conditions will motivate financial institutions to further open the credit spigot and meet more of the demand for credit from small firms. The risk profiles of small firms have improved across industries and geographies, giving lenders reason to expand.

Barring the downside risks from fiscal and monetary policy, small businesses and their creditors should continue to perform through the end of the year.

About Experian's Business Information Services

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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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