MAIN ST REPORT

Your window into small business health

Q4 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 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 fourth quarter, as did the average balance outstanding per business. Delinquency and default rates rose slightly, suggesting that credit conditions have loosened. Continuing strength in the macroeconomy will keep small business 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 and tax code changes take a toll.

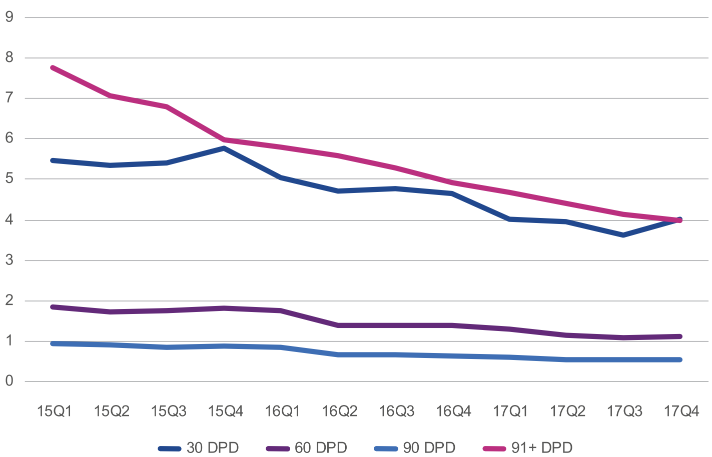
Small-business credit conditions positive in Q4

Conditions finally shift in small-business credit

Small businesses with fewer than 100 employees saw the downward path of their delinquencies interrupted in the fourth quarter. Taken together with growth in businesses accessing credit markets, this suggests that credit conditions are finally beginning to loosen. Delinquencies rose across three of the four stages tracked in the fourth quarter. Only the most severe, 91+ days past due (DPD), category saw delinquencies decline. Though the increase in delinquencies was broad-based in DPD categories, it was slight, pushing total delinquencies only to 9.6 percent from 9.4 percent.

Small businesses enter 2018 with good credit performance

Delinquencies for small businesses (% balance)

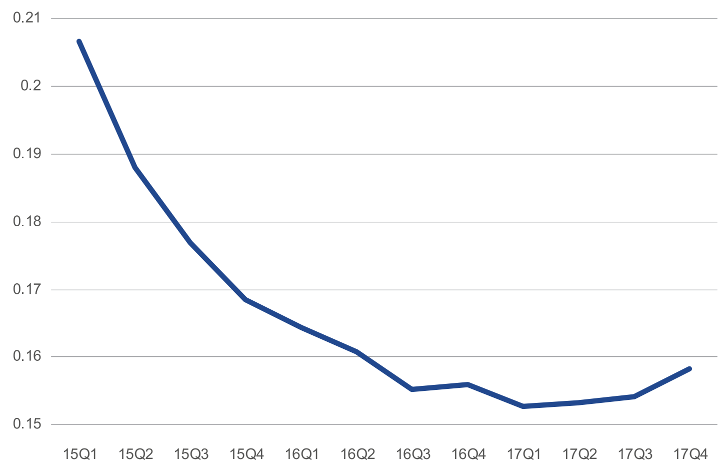


Source: Experian, Moody's Analytics

Bankruptcies continued to rise in the fourth quarter, making 2017 a full year in which bankruptcies increased every quarter. Taken alone, this isn't good news, but bankruptcies are coming off historical lows. So rising bankruptcies are a sign that creative destruction is at work and that activity is picking up. Bankruptcies would need to rise to levels not seen in several years for this to become a point of concern. This is a metric to watch carefully, however, to ensure that the upward trend doesn't pick up steam, but rather rises gradually as small-business activity rises.

Bankruptcy rises again in Q4, more to come

Bankruptcy rate, % balance

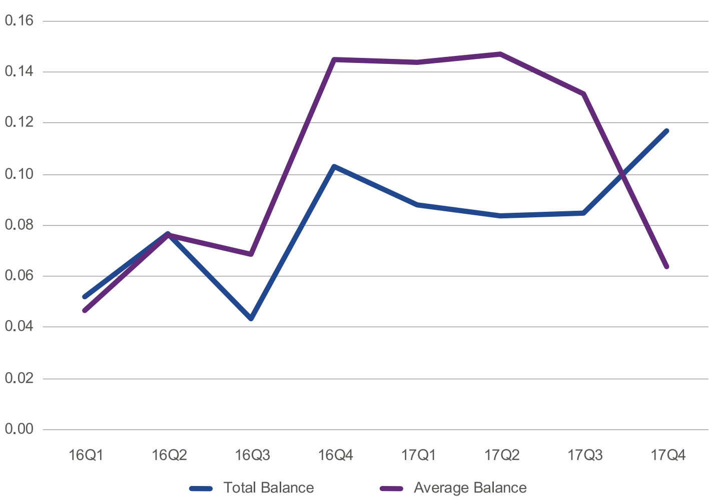


Source: Experian, Moody's Analytics

Balance growth is the primary reason for the outlook in small-business credit markets becoming positive this quarter. But the initial look at the balance numbers must be taken with a grain of salt. In the fourth quarter, balances rose 11.7 percent year-over-year, but new pre-existing businesses entered the data. Looking at this number alone is enough to set heads spinning, but looking to loans issued by the Small Business Administration (SBA), growth was nearly 17 percent for the fourth quarter (first fiscal quarter for the SBA) between the 504 and 7(a) portfolios. So there is support for this number. Taking a closer look, it seems that this balance growth comes mostly from the growth in average balance per small business. This growth came in 6.4 percent for the quarter, putting average balances at just over $21,000.

Balances rise, but organic growth slows

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

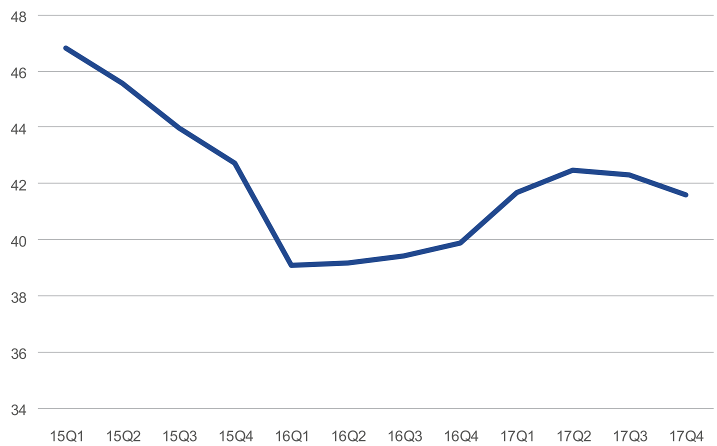


Source: Experian, Moody's Analytics

Utilization rates were lower for the quarter, as businesses that came back to, or entered, credit markets used less of their available credit than businesses that had accessed credit previously. This trend helps to strengthen the argument for upbeat small-business conditions, as businesses are taking a measured and reasonable approach to credit utilization. We will be looking for utilization to rise as conditions continue to loosen in the small-business credit segment.

Utilization pulls back as more businesses come online

Utilization rate, % of available credit



Source: Experian, Moody's Analytics

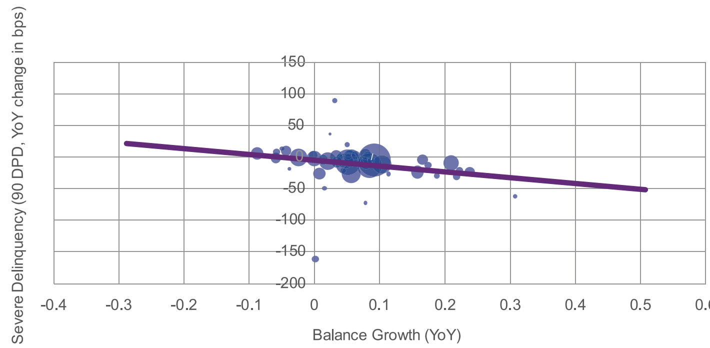
Balance growth is performance positive

Growth in balances has the effect of pushing down severe (90+ DPD) delinquencies across various breakdowns. The chart below illustrates the relationship between year-over-year change in balances and year-over-year change in severe delinquencies at the state level. The bubbles shown are weighted by total balances outstanding. The relationship between outstanding balances and performance is intuitive, but it's vital to understand as a credit market shifts conditions. As balances grow in an environment where credit is flowing, the lender portfolios can improve performance as nonperforming assets are pushed into an ever-smaller corner by new credit coming onto balance sheets. Conversely, as credit conditions tighten, this effect is reversed. Right now, the economy is in the upswing for small-business credit, and we are seeing conditions loosen.

The offset to this effect is that new balances can also go delinquent. And in a market like the one for small-business credit, this can happen quickly as businesses are filtered out through competition. This is felt in the earlier stages of delinquency, and thus allows for the trend we see now, where delinquencies rose in the earlier categories in the fourth quarter and fell in the severe category.

Balance growth pushes down severe delinquency

Balance growth and severe delinquency, by total balance (YoY, % balance)



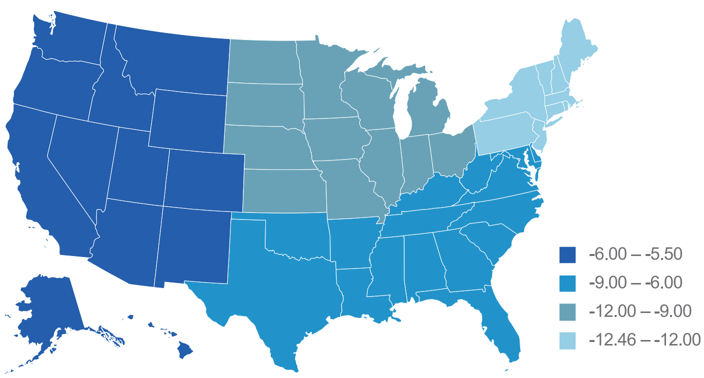
Source: Experian, Moody's Analytics

Taking a regional view

Looking to the data by region, we see that severe delinquencies fell across each of the Census Bureau regions in the fourth quarter, but the New England region saw the greatest decline in severe delinquencies. The South and Midwest saw improvement for the quarter, as credit among several industries drove performance gains. Using the Census Bureau definition of the four regions of the United States, the Northeast region stands out for its performance, particularly in credit among construction firms. Severe delinquencies fell 25 basis points in the quarter, leading performance improvement among regions.

Small business severe delinquency down in Q4

Year-over-year change in regional small businesses 90 DPD as of 2017 Q4

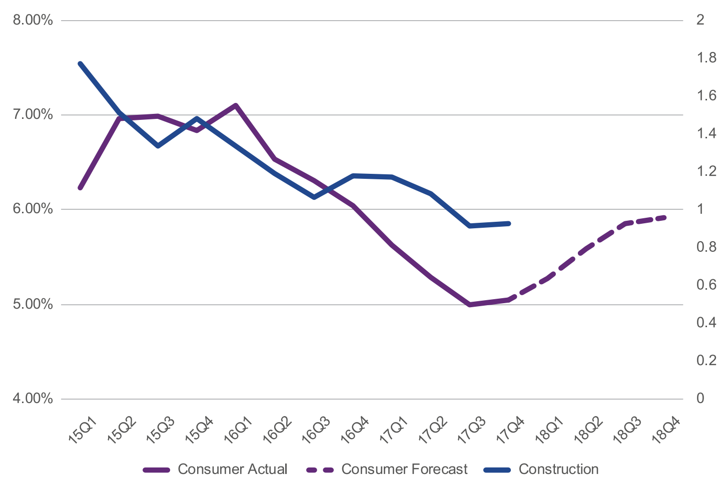


Source: Experian, Moody's Analytics

The Northeast saw the steepest declines in severe delinquencies in the fourth quarter, and construction was one of the industries responsible for that trend. Many small construction firms have a focus on residential projects, making consumer credit growth an ideal metric to use as a basis for understanding what's happening and what will happen in the industry. The relationship between the two, in the Northeast, is evident from the chart below, which shows a positive correlation between the two metrics. The forecast for consumer credit growth in the Northeast is shown on the right axis and indicates that the Northeast's construction industry is set to continue to see a slight decline in credit performance in 2018, driven by demand for working capital as individuals increase demand for construction services. This will play out through residential housing demand as homes are built and refurbished.

Northeast's consumer and SME credit growth align

Northeast: Balance growth in consumer and SME construction credit (% balance)



Source: Experian, Moody's Analytics

Risks are tipped to the upside, but avoid overexuberance

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 a tax bill that changed the way businesses are taxed. Many things are going right for small-business credit right now, and this looks set to continue at least through 2018. But there are downside risks that bear 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 mid-sized 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 loans could be of lower quality and drag on performance.

The downside risk from fiscal policy going into the first quarter of 2018 is likely to be short-lived, as Congress appears set to strike a budget deal and raise the debt ceiling with one bill. This should help to boost confidence among businesses that rely on federal spending for their revenue. Small businesses have eagerly awaited changes to the tax code, 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. But as businesses realize that the deductibility of net interest expenses 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 and portend rising rates throughout the year. 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. But it's an effect that will take more time to materialize.

The labor market remains the brightest spot, as the economy has reached full employment. Payrolls grew by 200,000 in January, with average weekly earnings rising 2.9 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. 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.

A new outlook to kick off a new year

Last year ended well, as the credit spigot for small businesses seems to have shifted from a mere trickle to a steady stream. It was also a bumper year for small-business credit, and 2018 looks set to rival it. A more favorable tax code and a strong macroeconomy will enable small firms to enter the new year with confidence levels high and a desire to invest and grow. Our outlook going into 2018 is upbeat, as small businesses are well-positioned to step back into credit markets in a way they haven't done for years.

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**.

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CONTACT EXPERIAN BUSINESS INFORMATION SERVICES

T: 1 877 565 8153
W: experian.com/b2b

CONTACT MOODY'S ANALYTICS

T: 1 866 275 3266
E: help@economy.com
W: moodysanalytics.com

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