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Moody's Analytics

MAIN ST REPORT

Your window into small business health

Q4 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, industrial production, etc.).

Executive summary

The fourth quarter capped a second year of solid performance and growth for small-business credit, but there are signs that the period of moderation experienced during the past two years is over. Since the government shutdown has the potential to throw small-business lending a curveball in the first half of 2019, the outlook for small-business credit is neutral. Conditions were positive in the fourth quarter, but this may not last long. Delinquency rates remained mostly stable, with pockets of weakness spread out among regions and industries, notably construction in the Plains.

In addition to the 35-day shutdown, rising interest rates, destabilizing trade policy and slowing home-price growth are potential trouble sources that are already starting to impact some regions.

	Buckets	17Q4	18Q3	18Q4
Moderately Delinquent	31-90	1.68%	1.63%	1.68%
Severely Delinquent	91+	4.00%	3.40%	3.49%
Bankruptcy	BKC	0.16%	0.16%	0.16%

Small-business credit conditions are positive, but the outlook is neutral

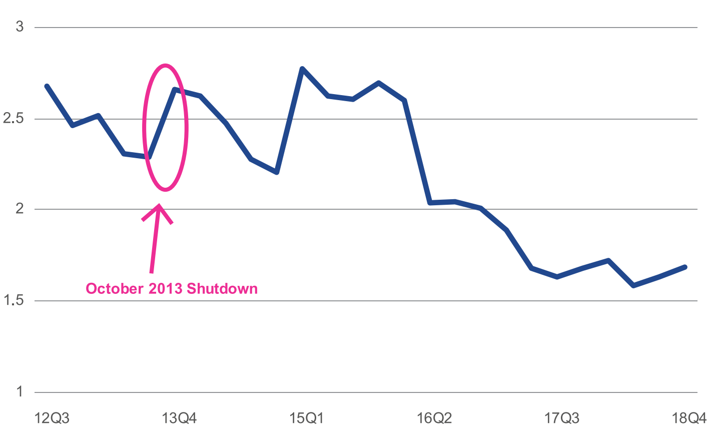
Small-business credit looks set for a shift

For the second straight year, there was a bump in the number of businesses borrowing in the fourth quarter, this year to the tune of 5 percent. Most of the borrowing was for smaller amounts which had the effect of slowing balance growth.

Delinquency rates for businesses with fewer than 100 employees moved up in the fourth quarter. The 31–90 days past due (DPD) rate increased from 1.63 percent to 1.68 percent for the quarter. In itself, this is not concerning. The Main Street performance data starts in the second half of 2012, allowing us to examine the 16-day shutdown of October 2013. The 31–90 DPD delinquency rate increased by approximately 20 percent from pre-shutdown levels and required two quarters to recover from. While anecdotal, it suggests that with one shutdown and the threat of another if a budget deal is signed by Feb. 15, we experience a similar or larger jump in delinquencies for the first quarter and require several quarters to recover current performance levels. This would raise the delinquency rate to more than 2 percent, which is reflected in our shifted outlook from positive to neutral.

Delinquency was at a floor, will the shutdown push it up?

31-90 DPD for small businesses, % of balance

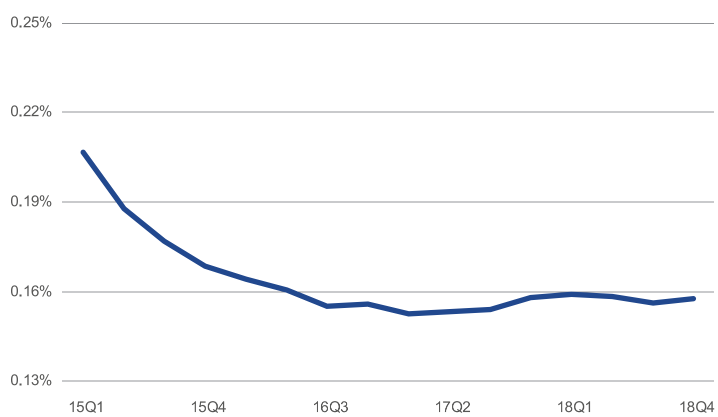


Source: Experian, Moody's Analytics

The bankruptcy rate fell slightly in the fourth quarter. Since the economy is currently in a late-cycle expansion, the 16-basis-point bankruptcy rate isn't a source of concern, as it is low by historical standards and has moved sideways for more than two years. With a solid macroeconomic environment, bankruptcies shouldn't be an issue even if volatility from an uncertain stock market and government shutdown result in slightly elevated rates in the first half of 2019.

Bankruptcies tick up in Q4

Bankruptcy rate, % count

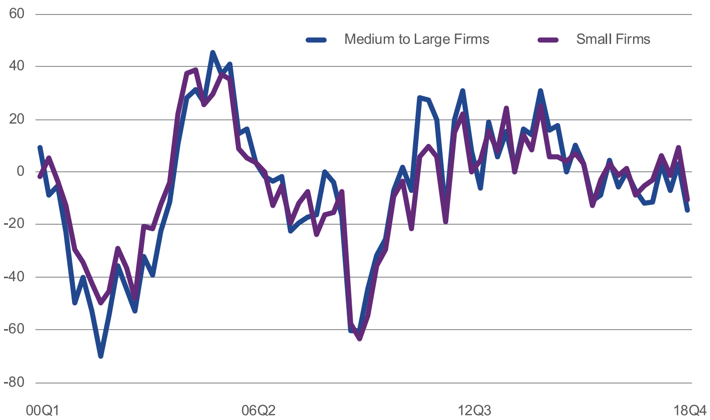


Source: Experian, Moody's Analytics

The Senior Loan Officer Opinion Survey (SLOOS) hit a low last seen in late 2011. This number looks at the net response of loan officers and discounts banks reporting steady demand. The trend is more informative than the quarterly value. A two-year moving average shows that the SLOOS trend has been negative since mid-2017. Small businesses have not seen the need to increase their borrowing for more than a year.

C&I demand suggests a fourth quarter slowdown

Senor loan officer reporting higher demand for C&I lending, % Net



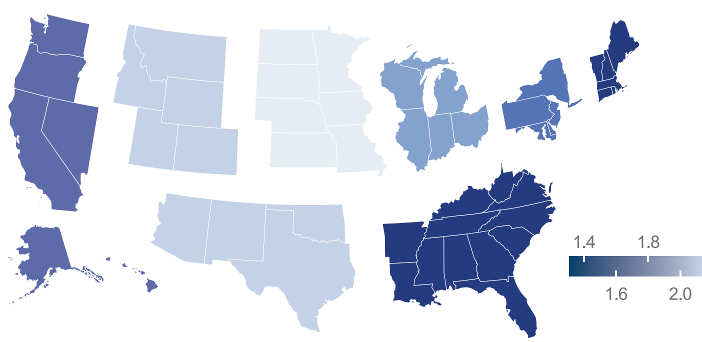
Source: Experian, Moody's Analytics

The Plains have a construction problem

Moderate delinquency rates — defined as 31–90 DPD — came in mixed in the fourth quarter. Most regions saw a drop in performance which was attributable to businesses in the construction industry. We used 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 we use are Far West, Great Lakes, Mideast, New England, Plains, Rocky Mountain, Southeast and Southwest.

The Plains states have a construction problem

31-90 rate across all small business credit accounts, % of balance



Source: Experian, Moody's Analytics

Far West: Moderate delinquencies in the Far West dipped in the fourth quarter, with delinquencies rising from 1.82 percent to 1.86 percent. Performance deterioration impacted most industries in the region. Notable among the industries with rising delinquencies was agriculture, as it bucked the national trend for performance improvement. Agriculture delinquencies rose from 1.13 percent to 1.49 percent.

Great Lakes: Credit performance in the Great Lakes region continued to deteriorate in the fourth quarter, with 31–90 DPD delinquencies rising to 1.63 percent from 1.52 percent in the third quarter. Construction firms in the region saw their performance decline in line with the national trend. More consequentially, the services industry saw delinquencies rise from 1.15 percent to 1.38 percent. Since services tends to represent the largest number of businesses and borrowing share among small businesses, this can have an outsize impact, offsetting improvements in other industries.

Mideast: The Mideast gave up improvements from the third quarter in the fourth. Delinquent balances 31–90 DPD rose from 1.69 percent to 1.77 percent. Similar moves occurred for severe delinquency and bankruptcy rates. Results across industries were mixed, but the consistency in services helped to keep things on an even keel. Construction in the region did surrender to the broader trend, with balances in the 31–90 DPD bucket rising from 2.65 percent to 3.00 percent.

New England: New England's small-business credit performance for the fourth quarter held steady from the third quarter, at 1.39 percent for 31–90 DPD. Results across industries were mixed, but construction followed the broader national trend of deteriorating performance, with the 31–90 DPD rate rising to just below 3.00 percent for the fourth quarter.

Plains: The Plains region had the highest 31–90 DPD rate in the fourth quarter, coming in at 2.13 percent, as a result of delinquency rates increasing in a mix of industries. The mining, construction, wholesale and services industries all saw performance deterioration in the fourth quarter.

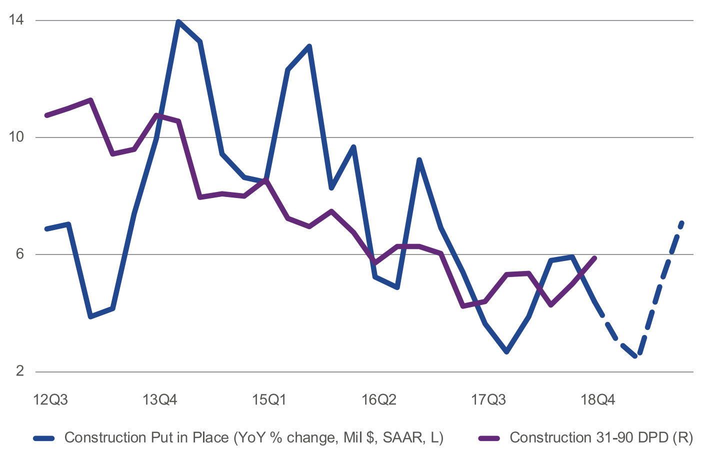
Rocky Mountain: The Rocky Mountain region saw an improvement in performance for the fourth quarter, the result of improvement in the wholesale and services industries. Balances 31–90 DPD came in at a rate of 2.05 percent, down from 2.12 percent in the third quarter. Construction bucked the national trend, with delinquency declining 7 basis points, from 3.90 percent to 3.83 percent. Ag performance followed the Far West in deteriorating for the quarter, with the delinquency rate rising from 1.44 percent to 1.69 percent.

Southeast: The Southeast had the lowest delinquency rates in the fourth quarter, but it wasn't insulated from weakness in select industries, particularly construction. If this continues, the Southeast could lose its status as the best-performing region. Results across industries were mixed, and most industries saw transitory shifts of a few basis points in delinquency, but construction jumped 25 basis points to 0.84 percent of balances in the 31–90 DPD bucket.

Southwest: The Southwest continued to feel the pain from the third quarter's jump in delinquency rates. Although the 31–90 DPD rate dropped from 2.1 percent to 2.03 percent, 91+ DPD balances rose 9 basis points to 4.03 percent as more balances moved to a default status. The largest move into defaults occurred for the construction industry, as the 91+ DPD rate rose to 4.75 percent from 4.13 percent, in line with the move in severely delinquent accounts the quarter before.

Construction pain likely to last a while longer

31-90 DPD for small businesses, % of balance



Source: Experian, Moody's Analytics

The construction industry has reached a new pressure point, as delinquencies rose throughout most regions of the country. Until this point, performance had improved even as the value of construction spending growth has slowed. With construction spending expected to continue to slow further in the first half of 2019, the construction industry will face more challenges. Materials costs are rising due to trade policies. Labor costs are growing as the labor market tightens. Obtaining new construction permits is challenging given zoning restrictions put in place after the housing market crash and local government staff reductions.

Services set for moderation

31-90 DPD for small businesses, % of balance

Source: Experian, Moody's Analytics

Most small businesses are in the services sector. In general, the services industry has helped to insulate regions from more volatility in other industrial classes. This looks set to remain the case in 2019, as small service businesses continue to expand. This is on the back of a strong labor market. As individuals have jobs and receive pay increases, they demand more services which small businesses can fulfill.

Risks from trade policy warrant scrutiny

A new risk for small-business credit: government shutdowns. Other risks to small business credit still include rising interest rates, market turbulence due to trade policy, and a cooling housing market.

The latest risk to small-business credit seemed avoidable. The 35-day partial government shutdown shuttered several government agencies responsible for overseeing small-business and agriculture loans, most notably the Small Business Administration (SBA). Although the government has reopened, another shutdown is possible, since funding is set to expire again in mid-February. The backlog of loan applications created by the shutdown will hit new originations for the quarter, and the instability of government payments, particularly to farmers relying on trade assistance, will cause delinquency rates to rise.

In this climate, small-business borrowers may choose to delay their plans to expand using credit until they can be certain that agencies will be open to receive their requests. This will contribute to the expected slowdown in small business credit the first quarter.

The Federal Reserve raised rates in December bringing the federal funds rate to a range of 2.25 percent to 2.5 percent by year's end. This happened in spite of financial market turbulence, but was likely given labor market conditions and signaling by the Fed prior to the meeting of the Federal Open Market Committee (FOMC). 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 in specific industries such as construction and financial services. The Federal Reserve is more likely to pause interest rate hikes in early 2019 until the data confirms that inflation is accelerating.

Trade negotiations pose a risk to small businesses as tariffs on imported goods could affect their bottom lines. Additionally, market volatility stemming from trade conflicts can hamper confidence and spending and depress small-business owners' ability to obtain financing. This could generate additional demand for borrowed funds, but more likely than not would encourage small firms to hold off on planned investments.

Home-price growth deceleration and declining mortgage applications have continued for more than half a year now. Delinquencies for small firms in the construction industry were up across most regions of the United States in the fourth quarter. If the trend of slowing home prices continues, if could push up delinquencies for construction firms in the next few quarters.

2019 will bring trouble

Despite market volatility, 2018 was another solid year for Main Street. Lending was prudent with lenders making sure their cash flows could sustain additional borrowings. Pockets of weakness expanded in the fourth quarter given volatility in financial markets. Small businesses had a difficult time finding financing in January, as the SBA was shut down — and not originating new loans — for all but the last few days of the month. In conjunction with the hit to balance growth, a jump in delinquencies in the new year is likely as workers impacted by the shutdown cut back on their spending. In additional to this bumpy start, the impact of trade and the slowdown in the global economy will weigh on small businesses in 2019.

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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