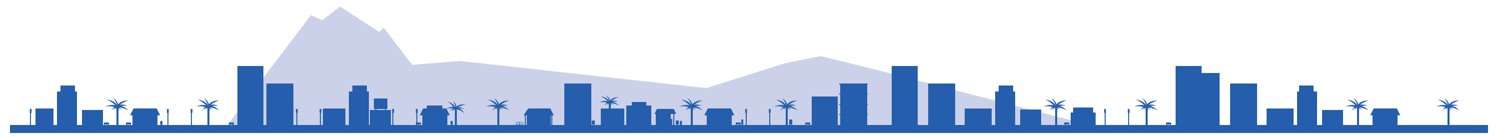
MOODY'S
ANALYTICS

MAIN ST REPORT

Your window into small business health

Q1 2016

Experian® Moody's Analytics



MAIN ST REPORT

Your window into small business health

About the report

Experian,® the leading global information services company, and Moody's Analytics have teamed up to develop the new Experian/Moody's Analytics Main Street Report. Unlike previous quarterly analyses, the new report brings deeper 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 as a whole. Key factors of 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 credit conditions continue to improve. Delinquencies and bankruptcies have declined in most industries and regions of the country over the past year. Agriculture and service industries enjoy particularly good credit conditions. Given the collapse in oil prices, it isn't surprising that the only exceptions to good credit conditions are in the energy industry and in the energy-producing regions of the country. Credit growth remains modest, although the recent increase in credit limits suggests that lenders are optimistic on small businesses. There are threats to the positive outlook, including prospects for rising interest rates and volatile financial markets, but those threats appear modest. Despite these risks, the sector remains stable and well-positioned for growth.

Delinquencies

Findings from the report indicate that overall small-business delinquencies decreased slightly from last quarter, carried lower by falling delinquency in the 61–90 and 90+ days past due categories, while 1–30 and 31–60 days past due rates remained fairly constant. There was a slight decrease in the total bankruptcy rate, which has leveled off from its decline over the last year. While current conditions are relatively stable, we are seeing mixed signals from a regional perspective, shifting industry patterns, and credit quality.

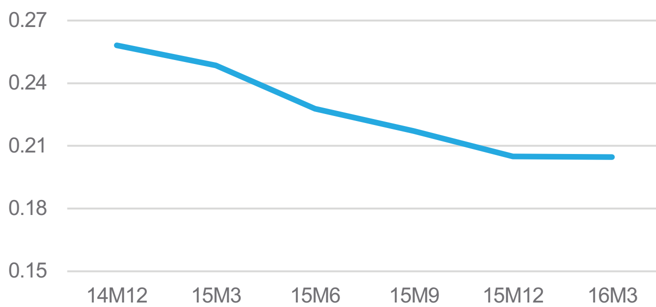
Regional perspective

States in the Southwest and West experienced some of the highest rates of small-business bankruptcy in the country. This is somewhat surprising, given the strength of these western economies in recent years. In the first quarter, New Mexico, Oregon and Nevada had some of the lowest rates of small-business bankruptcy nationally. North Dakota also held up surprisingly well, with a small-business bankruptcy rate of 0.07 percent. Conversely, Texas' bankruptcy rate is just under 0.25 percent. That said, Texas typically has a higher bankruptcy rate than other states.

Surprisingly, emigration from oil-patch states (such as Texas, Oklahoma, Kansas and North Dakota) has been low, which could precipitate an increase in business delinquencies as local economies adjust to lower oil prices. Contrary to expectations, population has grown in these areas, suggesting people still see the oil patch as a place of growth in the future. In fact, the populations of North Dakota and Texas grew approximately 2.3 percent and 1.8 percent, respectively, in 2015. Although this is below the growth of just a few years ago, it is still above growth for the United States as a whole.

Total Bankruptcy Rate

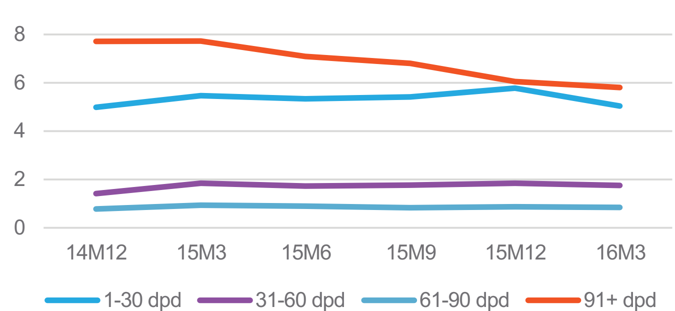
% total businesses



Source: Experian, Moody's Analytics

Total Delinquency Rate Across Buckets

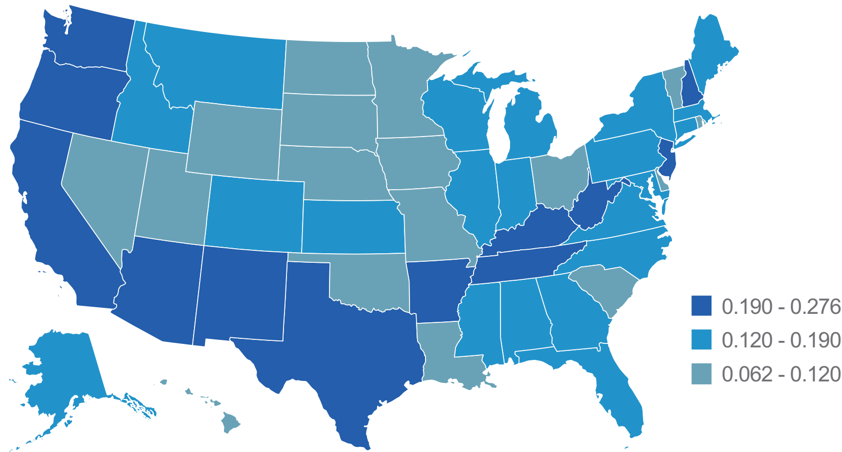
% total credit trades



Source: Experian, Moody's Analytics

Bankruptcies

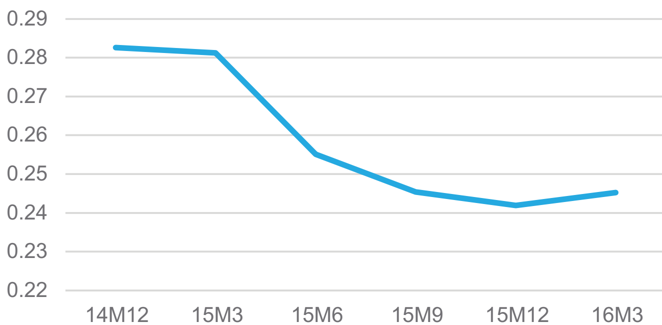
% bankruptcies by state



Source: Experian, Moody's Analytics

Texas Bankruptcies

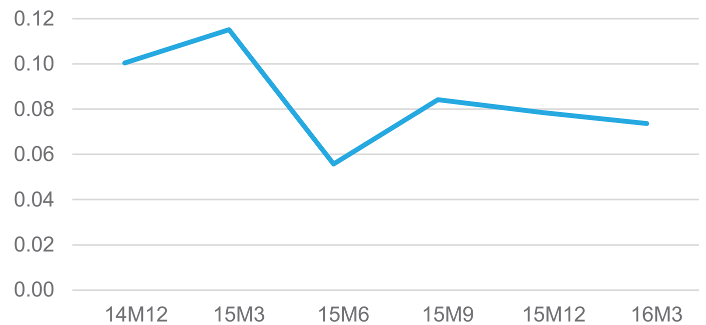
% total businesses



Source: Experian, Moody's Analytics

North Dakota Bankruptcies

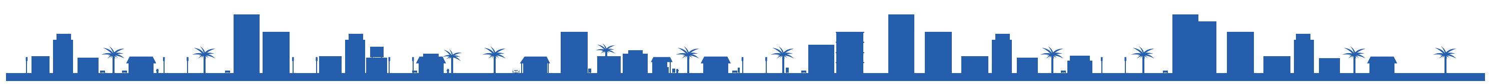
% total businesses



Source: Experian, Moody's Analytics

Bankruptcy rates were elevated in the Southwest and West — running counter to what may have been expected, given that western economies have performed well relative to the rest of the country. In the last several quarters, bankruptcies in the mining sector have risen as small firms have found it more difficult to pay their debts. This could be a sign of more bankruptcies to come for states such as Texas and North Dakota. These states have largely avoided sharp rises in small-business bankruptcies, but if prices for oil and other commodities remain depressed, small-mining-sector producers may run out of options.

The oil industry, a subcategory of mining, has been quick to respond to softening in global oil prices, laying off more than 300,000 workers worldwide, with an estimated 170,000 of these layoffs occurring domestically. Despite this weakness, the credit data suggest that — at least for the time being — the industry has managed to preserve itself by responding quickly and cutting costs aggressively. While this has helped to prop up the industry, it also has spread the pain to other sectors. Layoffs in oil states could impact service and retail industries negatively, as affected workers reduce spending on nonessentials and delay major purchases. Should oil prices remain low, the pain will not be limited to oil firms, but will spread throughout the affected local economies.



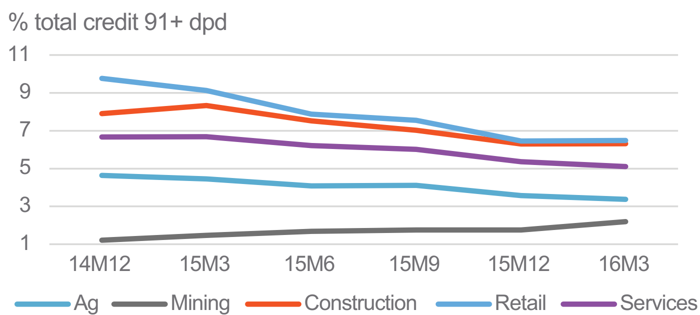
Shifting industry patterns

In March 2016, U.S. retail sales fell by 0.3 percent from the previous month. With wages expected to rise as the labor market tightens, stronger consumer spending should provide most small retailers with sufficient cash flow to avoid delinquency and bankruptcy. Some of the weakness seen over the past quarter was seasonal, as a warmer winter depressed apparel sales. This may slow the inventory correction for some retailers and push it out into the second quarter of 2016.

Retail delinquencies ticked up ever so slightly in the first quarter, but remain at approximately 6.5 percent. This may be due in part to weak retail sales in the first quarter. Although seasonal factors drove some of the recent weakness in retail sales, growth has been running below trend over the last year. Retail sales grew by an annualized 2.2 percent on average over the past four quarters, compared with average growth of 3.5 percent since 2000. This, however, is not the whole picture. Excluding gas stations from retail sales, growth has averaged 4.7 percent over the last four quarters. In spite of gas stations' drag on retail sales, sales growth has remained positive. Therefore it is difficult to explain the uptick observed in retail industry delinquencies.

91+ DPD for selected industries

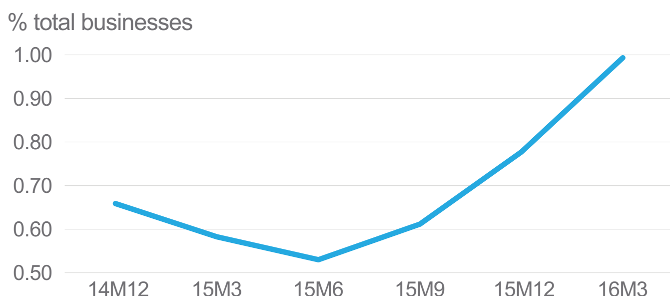
% total credit 91+ dpd



Source: Experian, Moody's Analytics

Mining Industry Bankruptcies

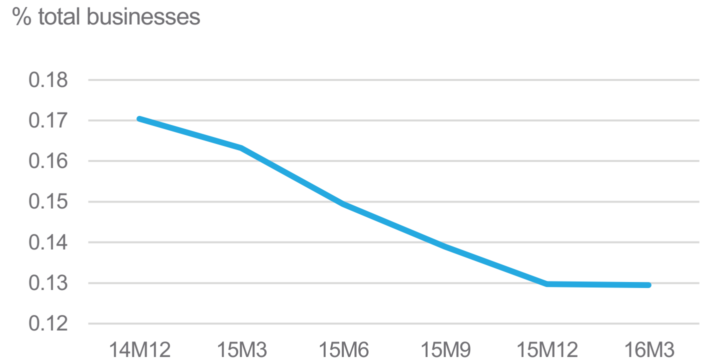
% total businesses



Source: Experian, Moody's Analytics

Services Industry Bankruptcies

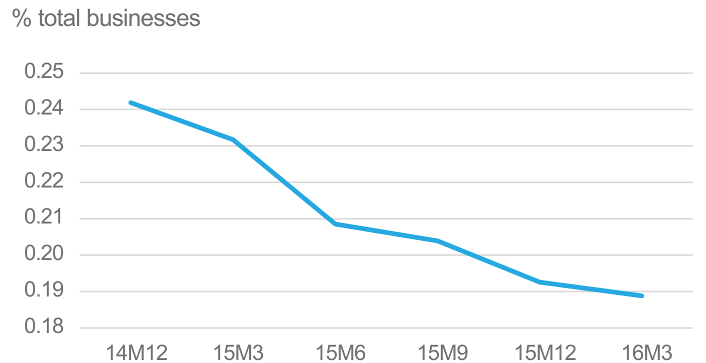
% total businesses



Source: Experian, Moody's Analytics

Retail Industry Bankruptcies

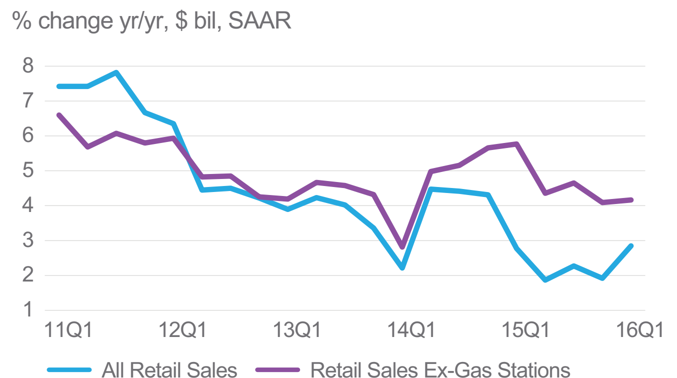
% total businesses



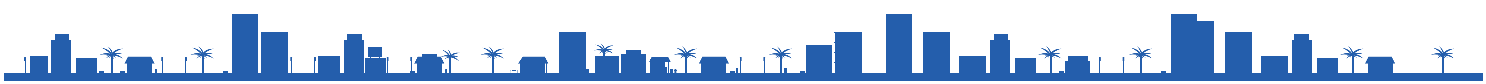
Source: Experian, Moody's Analytics

Retail Sales

% change yr/yr, $ bil, SAAR



Source: US Census Bureau, Moody's Analytics

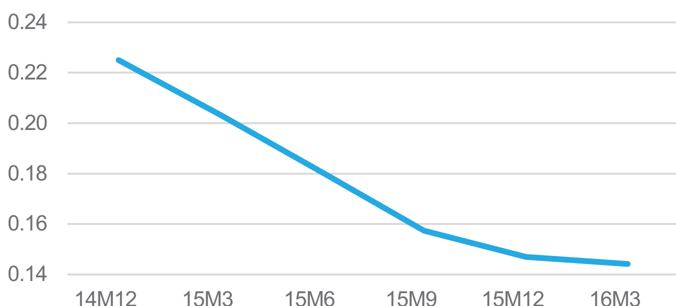


Despite the dip in commodity prices over the last year, business credit delinquencies in the agricultural sector remain low, as do bankruptcies. Agriculture has been one of the strongest credit sectors among small businesses, with some of the lowest delinquency and bankruptcy rates across industries. Although delinquencies in the agriculture sector have been falling over the last year, there are headwinds coming into 2016 that could impact the sector negatively.

The biggest threat to agriculture lenders is the falling incomes of farm proprietors nationally. Farm incomes have been hit hard by falling commodity prices. They are down from $93.9 billion in the first quarter of 2013 to $58.4 billion in the fourth quarter of 2015. This decline bodes ill for delinquencies and bankruptcies in 2016. If prices remain low throughout the year, agricultural business delinquencies are set to rise.

Agriculture and Forestry Industry Bankruptcies

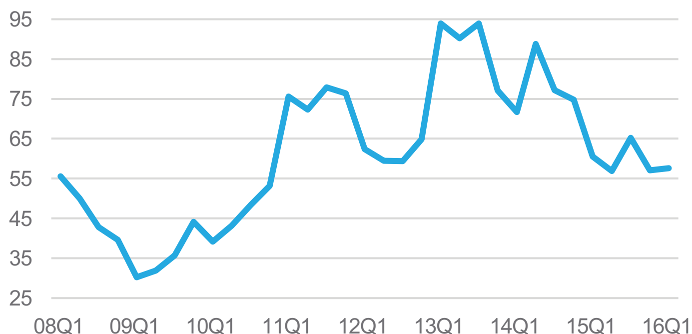
% total bankruptcies



Source: Experian, Moody's Analytics

Farm Proprietor Income

$ bil, SAAR



Source: BEA, Moody's Analytics

Credit quality

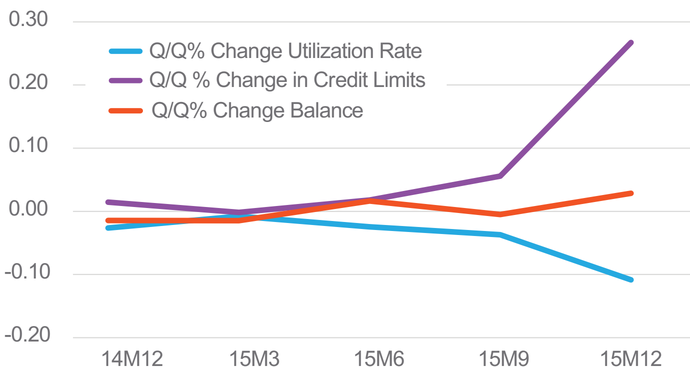
Small businesses have been expanding their credit lines without drawing on them. The average credit line increased 27 percent in the fourth quarter of 2015 and was up nearly 36 percent from the year before. This could be a result of increased competition in the market for small-business lending. As noted by the Federal Reserve Bank of Philadelphia and other analysts, the online marketplace for small-business loans is experiencing a boom. As lenders look to diversify with small-business loans, they are increasing the services they offer online. This has enabled more small businesses to increase their available credit.

In March of 2016, the National Federation of Independent Businesses reported that around 9 percent of small businesses were planning to increase employment and 25 percent were planning to increase capital expenditures. This is down from 10 percent for employment and up from 23 percent for business expenditures. Given the market correction that began this year, these trends are not surprising. The number of small businesses looking to increase employment is above its 10-year average of 6 percent, while the number of small businesses planning to increase capital expenditures is above its 10-year average of 23 percent. Once recent financial market volatility subsides and consumer confidence improves along with the labor market, small businesses will be able to draw on their increased credit lines to expand their operations, both by hiring and purchasing capital goods.

The average credit utilization for small businesses declined in the first quarter of 2016, dropping nearly 11 percent from the previous quarter and nearly 17 percent from a year earlier. The decline in utilization is likely the result of a large increase in credit availability compared with small gains in balances. This could signal that businesses are preparing for expansion in the coming quarters as the labor market continues to tighten and household incomes rise.

Small Business Credit Trends

qty/qtr % change



Source: Experian, Moody's Analytics

Risks

Risks permeate the small-business credit market at the moment, both to the upside and the downside. Looking first at the downside, the risks to the outlook include heightened financial market volatility and weak commodity prices. Upside risks include rising interest rates and the strengthening labor market.

First and foremost among the downside risks is the market volatility that has come with a stock price correction. All three major U.S. stock indexes started the year down as investors feared that global economic uncertainty would impact growth prospects for U.S. companies. Wealth effects have played a nontrivial role in spurring consumption over the last several years. This has made the recent correction quite damaging to confidence in the economy. While markets have improved more recently, they remain volatile.

Small businesses have been particularly vulnerable to falling commodity prices over the past year. Not only has the price of oil fallen more than 60 percent from its prior peak, but agricultural commodity prices have been hard hit as supplies remain high and investors shift their focus to other assets. This has hit millions of small U.S. farm businesses and halted the decline in agricultural business delinquencies. If commodity prices remain low throughout the summer and harvest seasons, we may see rising delinquencies as agricultural businesses experience reduced cash flows.

The Federal Reserve began raising interest rates in December and will likely raise rates two or three times in 2016, presenting what is — in the short term — a slight upside risk. While rising rates will increase the cost of capital and quell demand in the long term, they could lead to a temporary boost in spending as consumers look to take advantage of cheap financing before it evaporates. Also, banks and financial services companies may benefit from higher returns on short-term deposits and reserves. Overall, rising rates could provide a short-term jolt, lifting cash flows to firms and helping to alleviate rising delinquencies in some sectors.

The labor market is currently a bright spot for the economy and small businesses specifically, and therefore it is a strong upside risk. The labor market has continued to show resilience in the face of recent headwinds, adding 215,000 jobs in March 2016, while weekly unemployment insurance claims fell to 247,000 for the week ending on April 16. The stronger labor-market data has dispelled fears of a recession in the near term and added to confidence in the economy. Ultimately, positive labor-market trends should boost small-business confidence as well.

The risks to small business are numerous this year, but the resilience of the job market will serve as a strong buffer. We expect the labor market to continue its upward trajectory, pushing up wages and small-business confidence along with it.

Outlook

Main Street businesses are shoring up their credit positions, possibly gearing up to guard against continued volatility or preparing for renewed expansion. Several industries, including services and agriculture, have experienced a drop in their bankruptcy rates. Further monitoring of this trend is required to see whether this is a natural level for bankruptcies or if it represents a turning point in the health of small businesses. As financial market volatility eases, small businesses are left with large amounts of available credit, which could be used to fuel growth as the labor market and incomes rise. Overall, the outlook for small-business credit is stable. The upside and downside risks are fairly well-balanced and should remain that way for the foreseeable future.

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About Moody's Analytics

Moody's Analytics, a unit of Moody's Corporation, helps capital markets and credit 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 offering leading-edge software and advisory services, as well as the proprietary credit research produced by Moody's Investors Service, Moody's Analytics integrates and customizes its offerings to address specific business challenges. Further information is available at **www.moodysanalytics.com**.

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