Experian

Moody's Analytics

SMALL BUSINESS CREDIT INDEX

Q2 2014

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Small-business credit conditions bounce back in Q2

Executive summary

In line with expectations, small-business credit conditions improved in the second quarter. The Experian/Moody's Analytics Small Business Credit Index (SBCI) gained 2.4 points to hit 112.2 from a revised 109.8 (previously 110.5) in the first quarter. The index measures credit quality for firms with fewer than 100 workers, and last quarter's move puts it at an all-time high. Credit conditions for small firms deteriorated in the first three months of 2014 as an exceptionally harsh winter hurt business activity. Moody's Analytics estimates weather contributed about 1 percentage point to the 2.1 percent annualized contraction in U.S. gross domestic product in the first quarter.

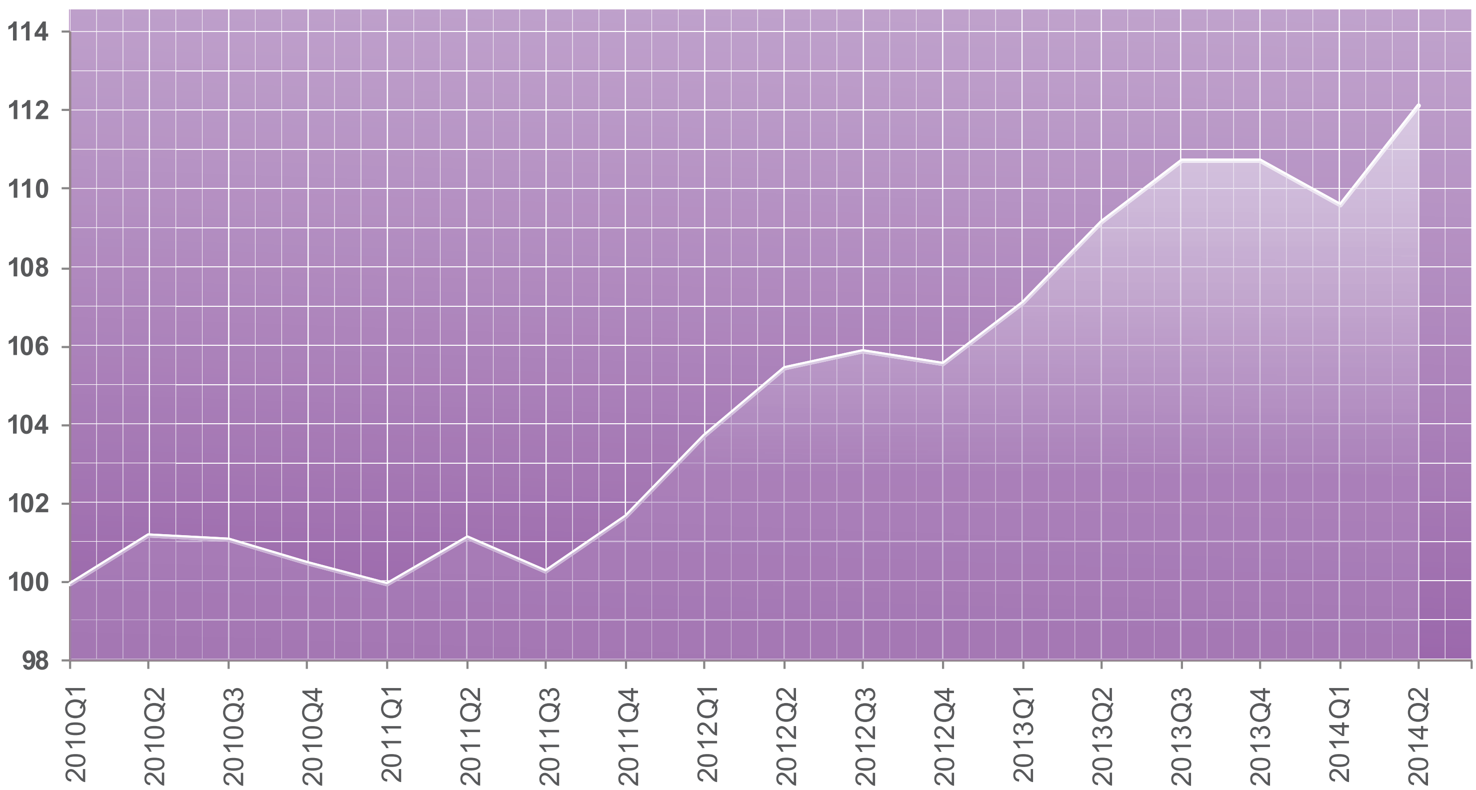
Credit balances and the number of trades each expanded in the first quarter, contributing to the rise in the SBCI. This was accompanied by a decline in the delinquency rate. Additionally, job growth accelerated significantly from the first quarter, and GDP surprised on the upside last quarter, growing at a 4 percent annualized rate.

The big question now is whether the Bureau of Economic Analysis' advance estimate for GDP will withstand revisions, and conflicting signals are creating some confusion. Anecdotal evidence suggests that consumer spending on medical services spiked in the second quarter as more people enrolled in Obamacare, which could mean upward revisions to the advance estimate. However, the hard data does not support that claim, making it tougher to gauge the net impact of expanded healthcare under the Affordable Care Act.

Risks to the outlook have shifted to events overseas and have become less threatening. The labor market is adding jobs at a sufficient pace to lower unemployment, and nascent signs of upward wage pressure are presenting themselves. Consumers are feeling better about their current finances than they have in a long time, a positive bellwether for spending in the next few months. All of the pieces are falling into place for an acceleration in the housing recovery, though the timing is proving increasingly difficult to pin down. Nonetheless, the positives outweigh the negatives, and the blossoming economic recovery will benefit small businesses' finances and, hence, credit quality in the second half of 2014 and beyond.

Revisions include adjustments to the economic data as well as a reclassification of firmographic credit data

Experian/Moody's Analytics Small Business Credit Index



Current quarter (2014 Q2): 112.2 **Previous quarter (2013 Q4): 109.8**

Behind the numbers

The Experian/Moody's Analytics Small Business Credit Index was lifted by numerous factors in the second quarter, erasing the first quarter's loss. Outstanding credit balances grew 4.8 percent annualized. Additionally, the delinquency rate fell from 9.7 percent in the first quarter to 9.3 percent in the second, the lowest rate since the third quarter of last year (see Chart 1). After rising in the first three months of the year, delinquent balances shrank in every bucket (see Chart 2). This verifies that the difficulty paying down balances in the first quarter was a blip on the radar brought on by a tough winter characterized by numerous storms and frigid temperatures.

The monthly pace of job growth averaged 277,000 jobs in the second quarter, far surpassing the 190,000 average monthly job build in the first. The acceleration accounted for nearly a quarter of the index gain. Despite still-weak wage growth, consumers are claiming they feel better about their current finances than they have since the recovery began. The strength in the job market lifted The Conference Board's Consumer Confidence Index to a nearly seven-year high in July.

Recent performance

It appears that small businesses are faring better than they have in years. According to recent business credit performance data from Experian, the average commercial risk score* in the second quarter of 2014 was 61.4, up 5.8 percent from the previous year. During the same time period, Experian data also showed that small business bankruptcies improved by nearly 12 percent from Q2 2013 and small businesses reduced the number of days that they paid their bills beyond contracted terms by 4.5 percent.

Additionally, the NFIB Small Business Optimism Index erased its May gains in June as more respondents became jittery about the recovery over the next six months. However, the three-month moving average is at its highest since the end of 2007, signaling a clearly positive trend in small-business confidence (see Chart 3). Small companies are noting stronger sales, a claim corroborated by a small-business revenue index constructed by payroll processor Intuit.

The NFIB survey details suggest businesses are more worried about an external shock to the economy than anything else as the threat of disruptions in the Middle East and Ukraine looms larger. On the bright side, responses pertaining to domestic economic fundamentals continued to strengthen, especially those regarding hiring and worker compensation. If small firms do what they say they plan to over the next quarter or two, the job market will be closer to realizing the Moody's Analytics forecast for average monthly job gains above 250,000 jobs by the end of this year.

Widespread industry improvement

The improvement in credit quality was broad-based last quarter (see Chart 4). Every industry except Other Services saw a drop in delinquency, with notable improvement in Construction. The share of past-due balances owed by builders fell to 14 percent from 15.6 percent in the first quarter and rose to a peak of 23.3 percent in the final quarter of 2010. The Q2 delinquency rate is a recovery low and reflects gradual progress in the housing revival. Despite a large 1.8 percent drop in June, construction spending ended the second quarter 1 percent higher. Construction spending has risen in 11 of the past 13 quarters, according to the Commerce Department.

Construction is no longer the worst-performing industry in terms of credit quality. Instead, Transportation now holds the dubious distinction of worst credit performance, followed by Administrative Services (see Chart 5). Judging by the swift improvement in delinquency for administrative companies, however, the industry may find itself ranking better in the near future.

Also, despite having the highest delinquency rate among industries, the Transportation industry has made headway after winter storms delayed or canceled shipments from vendors to customers in the first quarter. The share of delinquent balances for that industry fell to 17.5 percent in the second quarter, though this is only a partial reversal of the 1.7 percentage point climb in the first quarter that brought the delinquency rate from 15.4 percent to 18.1 percent.

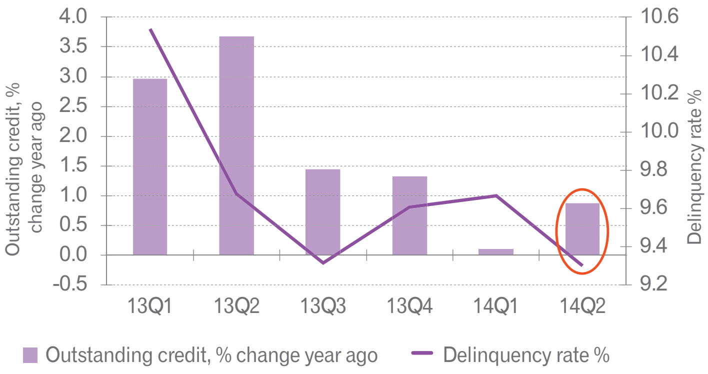
Regional credit divide broadens

Generally speaking, the difference in economic performance across states has become more consistent as the recovery has progressed. Yet the relative credit quality of small businesses has diverged since early 2010. A possible explanation is that, even though the performance of most major state-level economic indicators has converged, the pace of retail sales growth has become more differentiated across states. This is evident when looking at the coefficient of variation, which is the standard deviation

*Based on a scale of 1 to 100 (with 100 being least risky); predicts the likelihood of severe delinquency (more than 91 days past due) within the next 12 months

Chart 1: Credit Conditions Improve All Around

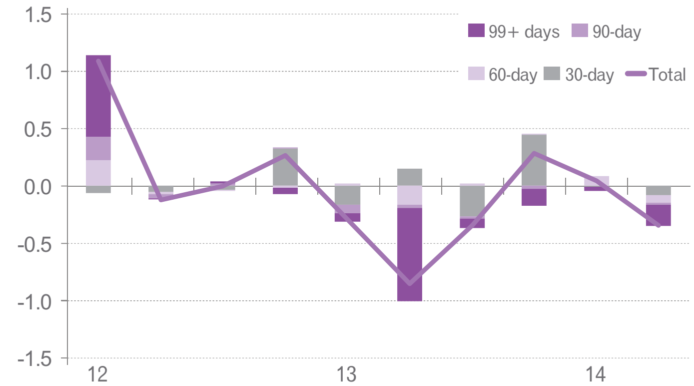
Firms with fewer than 100 workers



Sources: Experian, Moody's Analytics

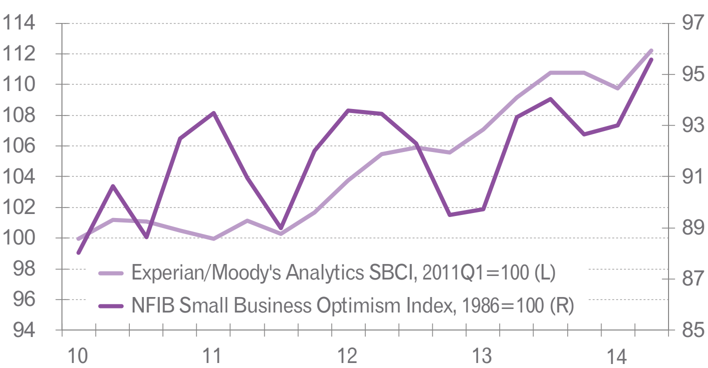
Chart 2: Declines in Every Bucket

Percentage point contribution to change in delinquency rate



Sources: Experian, Moody's Analytics

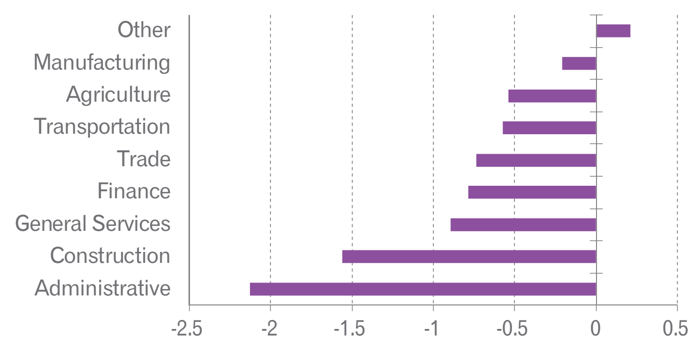
Chart 3: Credit and Confidence Go Hand-in-Hand



Sources: Experian, Moody's Analytics, NFIB

Chart 4: Across-the-Board Credit Improvement

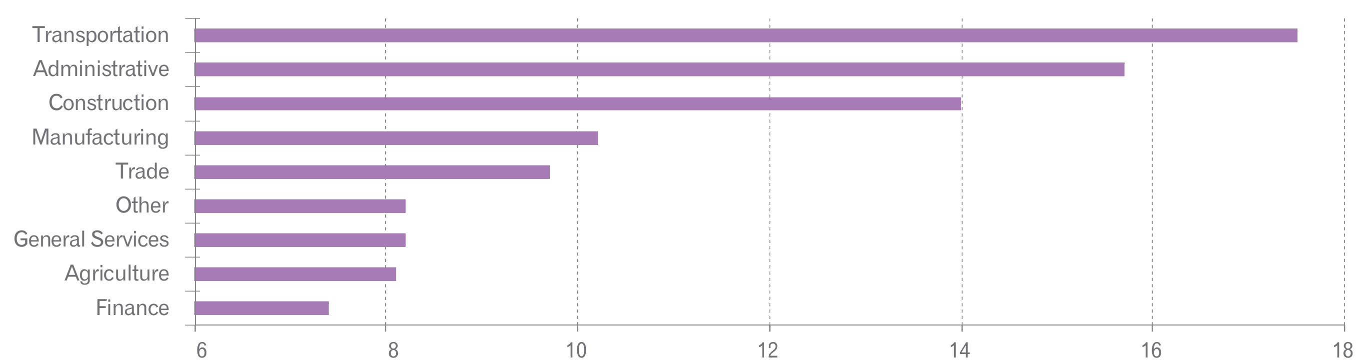
Percentage point change in delinquency rate from 2014Q1



Sources: Experian, Moody's Analytics

Chart 5: Construction Moves Up the Ranks

Share of past-due balances, percentage, 2014Q2



Sources: Experian, Moody's Analytics

of sales growth across states divided by the average sales growth for a given period of time (see Chart 6).

Large companies are able to issue debt to subsidize cash flows during times of economic stress, whereas small companies typically cannot and rely almost solely on consumer spending to support bottom lines, especially in the absence of credit from banks. Therefore, the divergence in retail sales growth across states would imply that cash flows for small firms — and, hence, their ability to pay down debt — would also exhibit a wider gap.

It also is worth noting that the gulf separating credit quality across states is widening for both short- and long-term delinquency. In other words, this is an all-encompassing phenomenon, which supports the notion that the root cause of larger differences in credit quality is a greater dissimilarity in the pace of retail sales growth across the country.

The share of delinquent dollars is widening across states, but the relative performance of states has remained remarkably stable. Overall, the credit health of the country's best performers has improved while the worst performing states show little or no improvement and, in some cases, deteriorating credit profiles.

For the past couple of years, small businesses in Florida and Illinois have been among the worst performing in terms of credit quality. This is due in large part to the disproportionately large impact of the housing collapse on both states' economies.

Illinois looking better

Although there has been a considerable decline in the stock of vacant homes in Chicago, Ill., and Lake County, Ill., the emptying of the remaining foreclosure pipeline will limit opportunities for homebuilding and housing-related jobs. Real estate and leasing have been slower to rebound, and other financial service industries also have hit a snag. Still, the share of balances being paid late by Illinois small companies shrank to 18.8 percent in the second quarter, a recovery low. Also, despite ranking 48th among all 50 states in paying their bills beyond contracted terms, small businesses in Illinois saw the third largest improvement (8.2 percent or 0.69 days) from a year ago, according to recent Experian business credit performance data.

Upstate economies such as Chicago's and Lake County's are performing better than those downstate, but the gap is narrowing thanks to a turnaround in manufacturing. The auto sector is a source of strength, and producers also are benefiting from a stronger global economy. The recent pickup in agricultural exports has broadened to include more manufactured goods, with producers that do a lot of business with China and Canada reaping the biggest spoils. Exports to the two countries are up 22 percent this year, compared with a 2 percent increase to other countries.

Another setback for Florida

After showing signs of improvement, the share of delinquent balances owed by small businesses in Florida ticked higher to 27.9 percent in the second quarter — the highest in a year — as the share of balances being paid 30 to 60 days late ballooned.

Florida's malaise stems primarily from weak income growth, which is limiting consumers' ability to spend. Though total household employment is at an all-time high and rising at its fastest pace in six years, total payrolls are well below their prerecession peak. This suggests that an increasing fraction of the workforce is self-employed or employed in private households or in agriculture — jobs that lack the security and nonmonetary benefits of payroll employment.

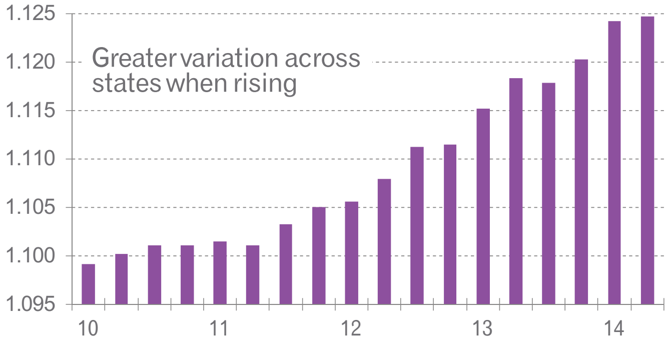
A stronger small-business recovery in the Sunshine State will hinge on a larger number of retirees relocating there, which is something that is expected to happen over the next couple of years after the Great Recession delayed retirement for many seniors.

Fiscal woes in the nation's capital

A new addition to the bottom of the list is Washington, D.C., where federal fiscal austerity has played a disproportionately large role in the local economy's weak performance. The federal budget has fallen out of the national news headlines but is still the most significant impediment to the District of Columbia's economy. December's congressional agreement that funds the government through 2015 is crucial in that it scales back near-term sequestration cuts and limits the chance of another government shutdown, but it is hardly a cure-all. Discretionary spending — what matters most for the local economy — will reach a low in fiscal 2014. The unfavorable budget outlook is the primary reason Washington, D.C., will be an economic laggard over the next few years.

Chart 6: Growing Discrepancy in Regional Sales

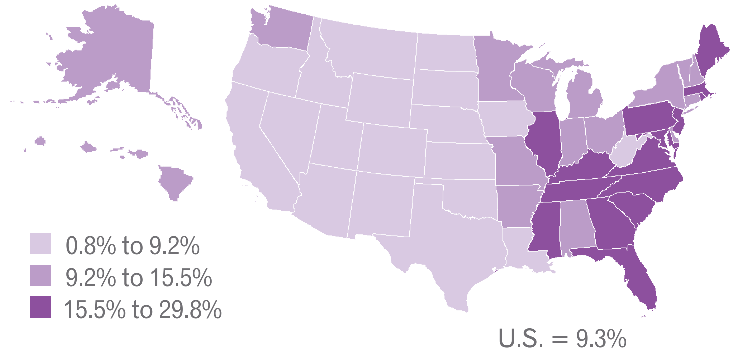
Year-over-year retail sales growth, coefficient of variation



Sources: Census Bureau, Moody's Analytics

Chart 7: Clear Regional Pattern Persists

Share of delinquent balances, percentage, 2014Q2



Sources: Experian, Moody's Analytics

It's still the West versus the rest

As has been the case for several years, the strongest small-business credit profiles exist in the Mountain West, where the housing recovery got an earlier start as people flocked to the region in search of jobs (see Chart 7). Employment growth has been concentrated in numerous high-paying industries, including High-Tech, Aerospace and Mining, thereby boosting consumer spending as workers sport large and growing paychecks.

Utah is the standout; the share of balances paid late by the state's small companies peaked at just 1.7 percent in the doldrums of the recession, compared with 10.8 percent for the nation as a whole and has held steady at just 0.8 percent for the past year.

Looking ahead

The small-business recovery should strengthen this year and next as consumer fundamentals improve. Retail sales snapped back in the second quarter after being frozen out in January and February and are expanding at a 4.3 percent year-over-year pace. This is a moderate pace, which should improve this year as job growth lifts wages. Business confidence is improving for companies of all sizes, and hiring intentions are solid. Household debt-service burdens are the lowest in decades, so consumer spending will accelerate alongside bigger paychecks.

Small-business cash flows also will be supported by easier access to credit. The Fed's Senior Loan Officer Opinion Survey points to less nervousness among banks to originate loans to small companies. Along with healthier consumer spending, small-business credit conditions will improve, running counter to responses in the NFIB survey stating conditions will get worse over the next couple of quarters. Thus, we expect the upward trend in the Experian/Moody's Analytics Small Business Credit Index to continue over the next several quarters.

The greatest risks to the outlook stem from geopolitical tensions in Ukraine and the Middle East. In particular, sanctions on Russia are hurting business activity in Europe, especially Germany. The German ZEW financial markets survey came in well below expectations in August, and a pullback in European trade as confidence weakens would pose the most direct threat to businesses in the Northeast. Also, U.S.-led air strikes being carried out in Iraq may give pause to war-wary U.S. consumers, which could temporarily throw a wrench in the small-business recovery.

Taken together, however, Moody's Analytics believes that domestic economic fundamentals are strong enough that escalating conflicts abroad will not be enough to unhinge the strengthening U.S. recovery, and the baseline forecast calls for continued growth in the second half of 2014 and beyond.

About the index

Experian joined forces with Moody's Analytics, a leading independent provider of economic forecasting, to create a business index and detailed report that provides insight into the health of U.S. businesses. The Experian/Moody's Analytics Small Business Credit Index is reported quarterly to show fluctuations in the market and discuss factors that are impacting the business economy.

Interactive Business Information Map

View a visual representation of business health broken down by U.S. states and Metropolitan Statistical Areas at www.experian.com/ibim.

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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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