Beyond the Trends

Understanding the Commercial Economy

Summer 2021

About this report

Beyond the Trends is a quarterly report written by Experian Business Information Services. The report offers a unique view of the small business economy based on what we see in the data. With up to date information on over 25 million active businesses and how they perform from a credit standpoint. Experian will share insights and commentary on how economic conditions, public policy, and other factors might shape future small business performance.

"Let's crush the new normal" is the U.S. market mantra as the economy heats up and pent-up demand is released for goods and services. Thirty million active U.S. small businesses have traversed 18 months of challenges ranging from zero foot-traffic to anxious credit markets, and they are emerging, like the phoenix, transformed and ready to take risks to invest and grow. The U.S. economy is expected to grow 6.5% in 2021 after losing 3.5% in 2020. Global economies are growing but having to manage supply chain challenges as demand outweighs supply. Four and a half million new businesses in the U.S. will bring innovation and entrepreneurial spark to an already accelerating market. **The insights shared intend to take you from a high-level macro view of the market drivers and U.S. small business commercial credit health to insights we see Beyond the Trends.**

Why are Small Businesses important?

Small businesses in the U.S. (A corporation, limited liability company, or proprietorship with 500 employees or less) make up 99.7% of all businesses in the U.S. employing more than 60 million people in the U.S. according to the Small Business Administration. They generate almost 70% of new jobs as they expand every year, and a large portion of this job growth comes from companies with less than 20 employees. These small businesses provide essential goods and services across industries. They are suppliers, contractors, importers, exporters, services suppliers, retailers, and much more. These businesses are very inclusive of all gender and minority segments which broadens socioeconomic success, independence, and innovation. Small businesses must be more innovative than their large competitors to seek out opportunities and thrive. The creative spark can be empirically demonstrated as small businesses cultivate ideas and move these ideas to design in 13 times more patentable opportunities per employee than their large business counterparts. Innovation is the kindling to market growth and opportunity expansion.

How are environmental conditions changing?

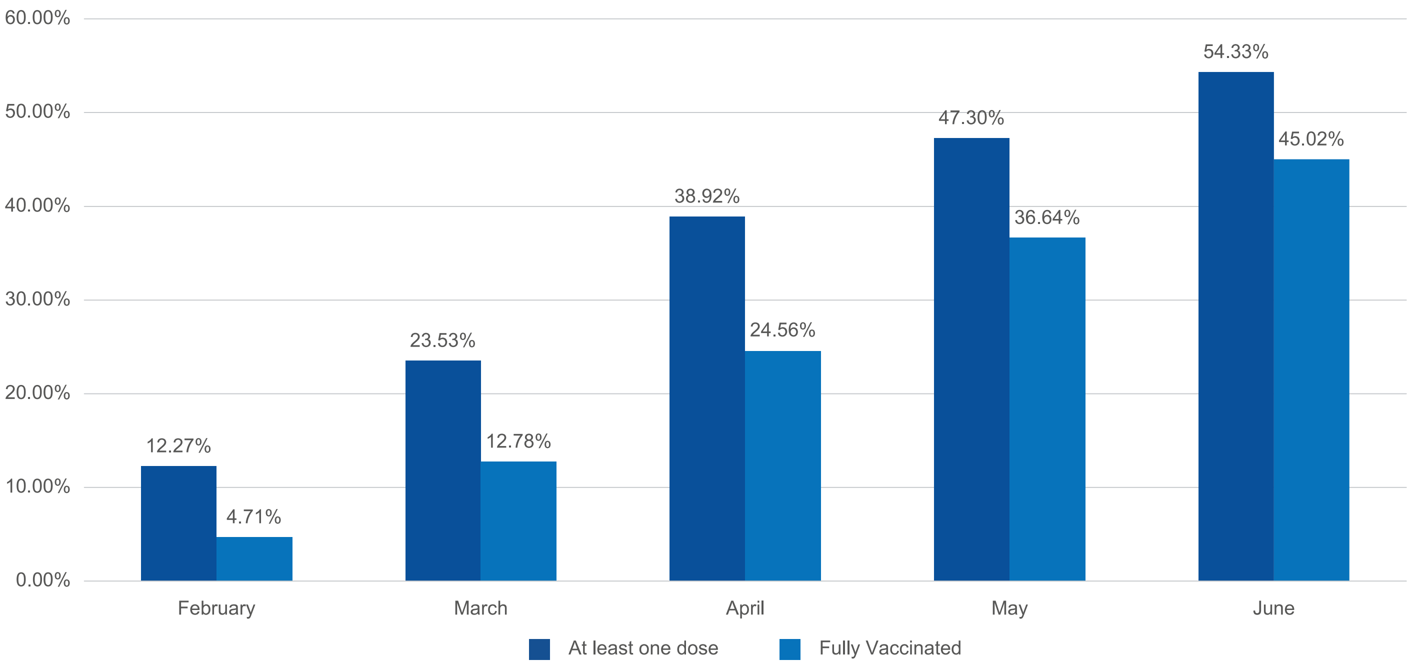
COVID-19 has been the enemy to small business success to most businesses, but some have found success even in the face of adversity. For example, hand sanitizer sales increased dramatically for larger companies like Purell (~600% according to the Wall Street Journal (Jan 22)). Still, smaller boutiques jumped on the demand for masks and specialty hand sanitizer sales to limit the impact on their businesses. These efforts paid off as sales continue even as the vaccines began to roll out in February.

Vaccine distribution and U.S. uptake have made impressive strides toward herd immunity (70% Vaccination target). However, vaccinations have slowed in recent weeks as more anxious citizens slowly adopt.

Immunizations

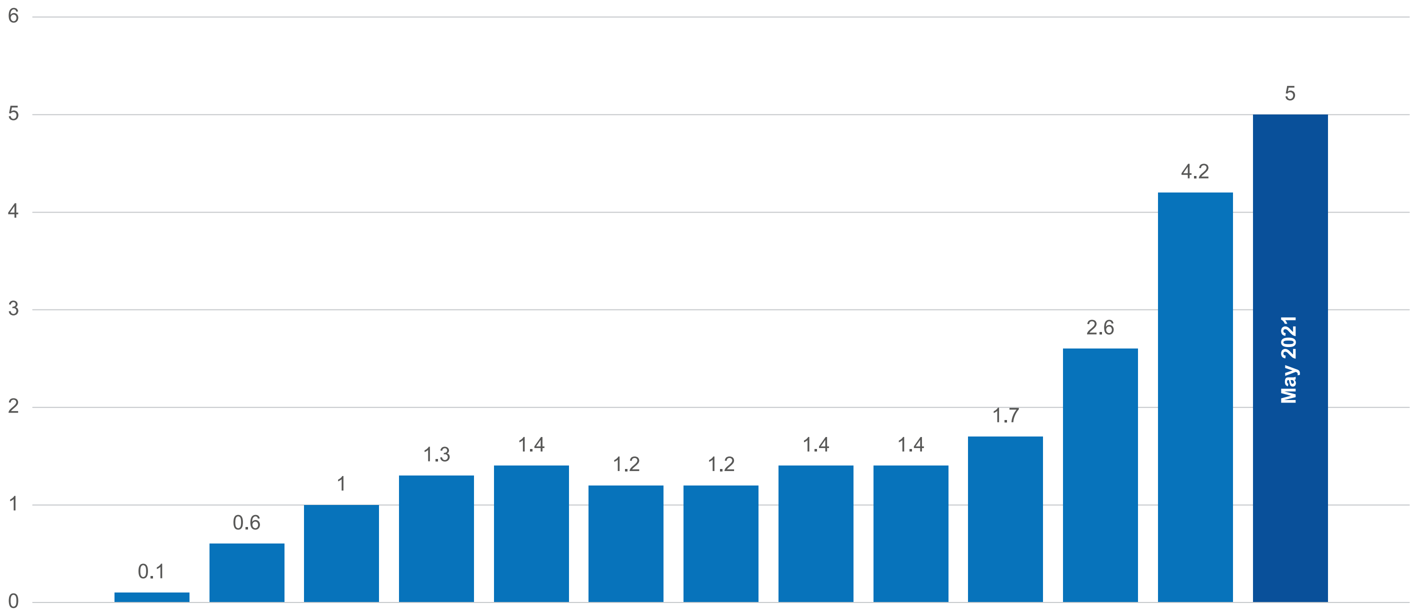
Overall, 151,252,034 people or 46% of the population, have been fully vaccinated. — usafacts.org

The high rate of vaccinations and the continued social distancing protocols are driving the number of new cases down and allowing more regions to fully reopen.



As businesses reopen, consumers are ready to release their pent-up demand for services and goods that seemed a distant dream over the last 18 months. Vacation travel is exploding, pushing demand and prices through the roof. Goods are flying off store shelves as consumers get back out and interact with their neighbors and communities. This excessive demand is creating a shortage in goods and services and driving prices higher. On the other hand, built-up savings, and additional stimulus have created more opportunities for consumers to spend. When demand outweighs supply, we see inflation. Previous quantitative easing was done as markets collapsed, but the current stimulus package comes as markets are improving. This injection of cash, consumers' willingness to spend, and a recent increase in short-term bets in energy and other commodities could increase the velocity of inflations upward trend.

Inflation



Source: U.S. Bureau of Labor Statistics

The U.S. is experiencing heightened inflation approaching rates seen prior to the 2008 great recession. Most economists believe this bump in inflation will last into the fall of 2021 and then slow as stimulus spending runs lien and sellers catch up on the supply side.

How much stimulus is left?

What stimulus is on the horizon?

Stimulus packages still coming

March 2020
$8.3 Billion
Coronavirus Preparedness and Response Supplemental Appropriations Act

March 2020
$3.4 Billion
Families First Coronavirus Response Act (FFCRA)

March 2020
$2.3 Trillion
Coronavirus Aid, Relief, and Economic Security Act (CARES ACT)

April 2020
$484 Billion
Paycheck Protection Program Flexibility Act

Sep 2020
CDC Eviction Moratorium

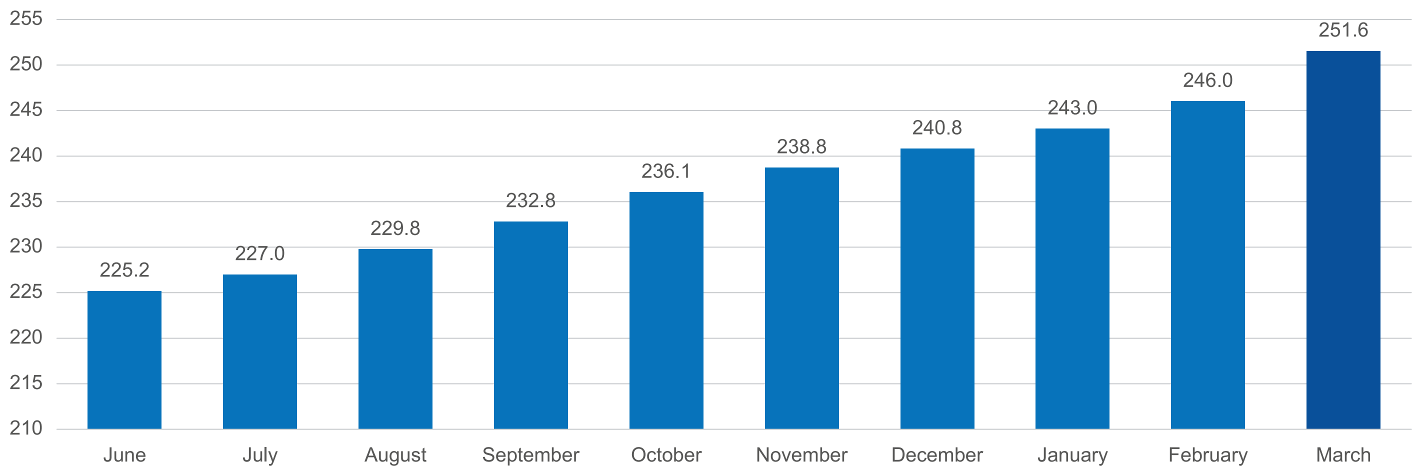
December 2020
$900 Billion
Stimulus and Relief bill

March 2021
$1.9 Trillion
American Rescue Plan Act

Proposed
June 2021
American Jobs Plan **($1.7 Trillion)** and American Families Plan **($1.8 Trillion)**

Foreclosure, eviction, and collection moratoriums run through the fall of 2021, creating a challenge for property managers and smaller mom and pop landlords that have not had cash flow from properties for months but must still provide services for management and upkeep of the properties. However, these moratoriums did help struggling consumers stay in their homes as they were impacted by COVID either physically or financially. As the mortgage moratorium comes to an end in December 2021, agencies have reached out to lenders to get ahead of the potential crisis. They ask the providers to offer modifications and payment plans to stem the volume of foreclosures in the fall. If a large number of foreclosure activity is realized, the real-estate market would be flooded with inventory, and home prices would fall.

Kay Shiller Price Index

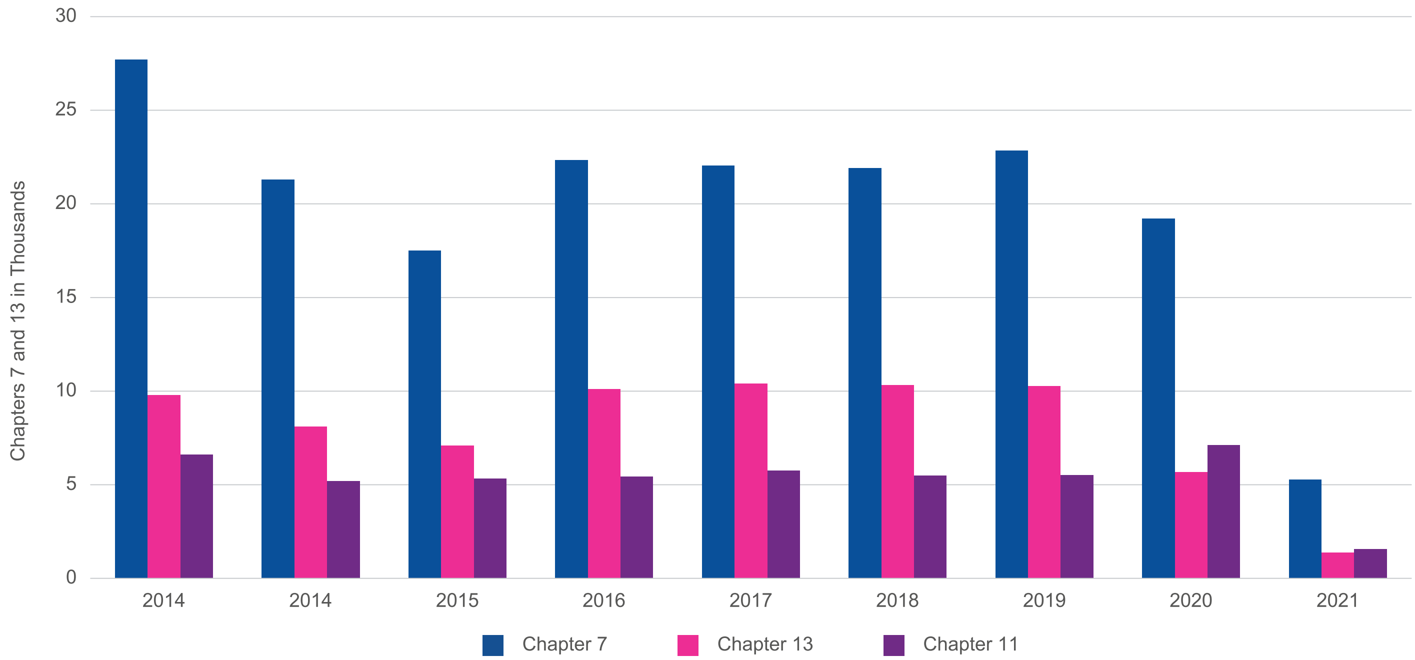


This would put pressure on the construction industry and its supply chain with decreased demand and eliminate equity gains small business owners would have as a cushion, stored in their home's value. This is a risk that could further cool the economy in 2021.

Regional moratoriums on collection activity focused on energy companies that service small businesses and limiting the ability of energy companies to collect or disconnect. Balances in arrear status are rising. These providers are utilizing pre-treatment and segmentation strategies to understand if their delinquent clients have the ability to pay, but are using the moratorium as a cover to dodge payments. Using analytical methods and data reported, companies can understand if a customer has applied for a modification or is simply not paying if they have the ability to pay others but not the provider. These accounts are being approved for collections even under the moratorium. These analytical activities are helping energy providers stay on top of exposure.

When companies get too far behind, the bankruptcy court may be their only option. Stimulus and courts closing due to COVID concerns both played into the bankruptcy rates being slow to return to normal, even as the first quarter of 2021 brought a transition to reopening. Bankruptcy rates were accelerating in 2020 for Chapter 11* as businesses seized the opportunity to restructure. Chapter 7 and 13 bankruptcy activity was lower YOY as government stimulus programs created some stability and cashflow where none was available due to shelter in place directives. Courts were limited on the number of cases that could be reviewed toward the end of the year. Small businesses that saw no chance of recovery or future cashflow closed their doors without filing for bankruptcy. As we continue through 2021, we should expect the trends to return to a more regular cadence, with Chapter 11 bankruptcies slowing and Chapter 7 and 13 returning to normal levels throughout the year.

Bankruptcy Trend



Source: https://www.abi.org/newsroom/bankruptcy-statistics//aacer

*Chapter 11 provides for reorganization, usually involving a corporation or partnership. A chapter 11 debtor usually proposes a plan of reorganization to keep its business alive and pay creditors over time. — USCourts.gov

*Chapter 7 - the bankruptcy trustee gathers and sells the debtor's nonexempt assets and uses the proceeds of such assets to pay holders of claims (creditors) in accordance with the provisions of the Bankruptcy Code. — USCourts.gov

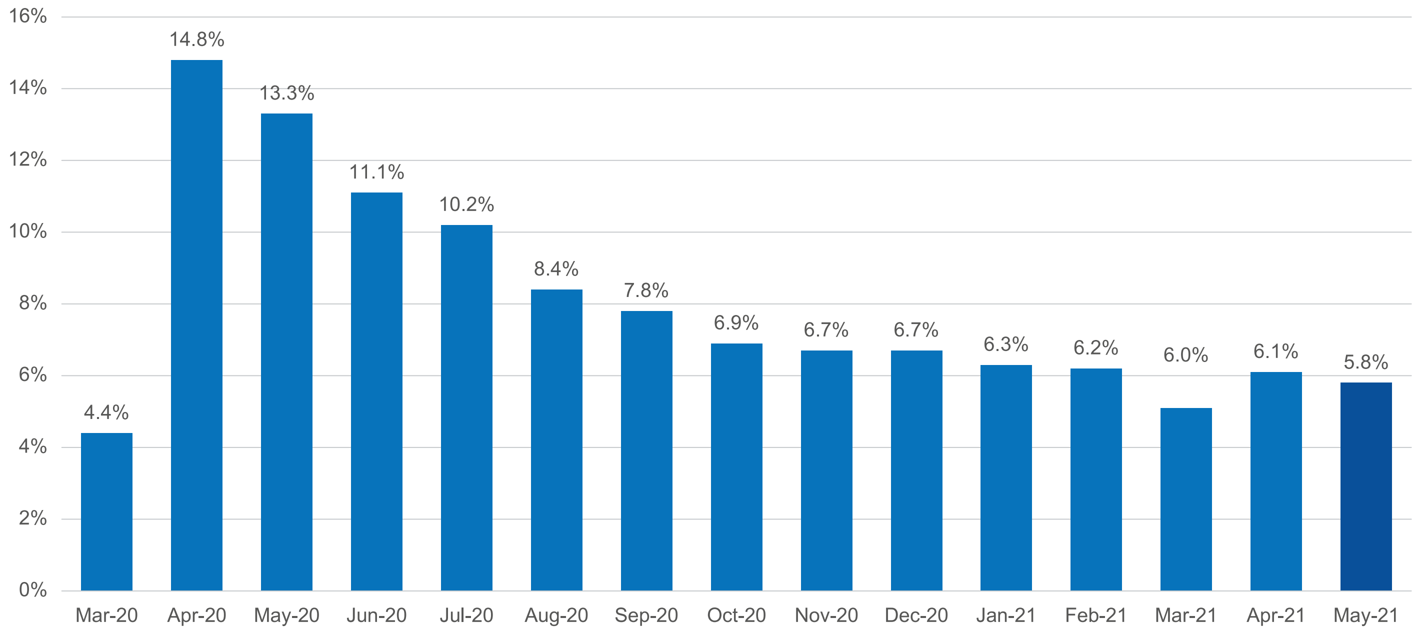
***Chapter 13 enables individuals with regular income to develop a plan to repay all or part of their debts. Under this chapter, debtors propose a repayment plan to make installments to creditors over three to five years. — USCourts.gov

Consumer are faring well

When we think about consumers, we think of them in two simple ways. The first is as a consumer of goods and services. We look at consumer spend as the fuel to a small business ecosystem. The second, is as a business owner, to evaluate how market conditions impact their ability to maintain a healthy small business.

Consumers are fairing well. The employment rate for Americans continues to improve, and more are beginning to return to the labor market as vaccines make them more comfortable and wages start to rise.

US Employment Rate



Source: https://BLS.gov

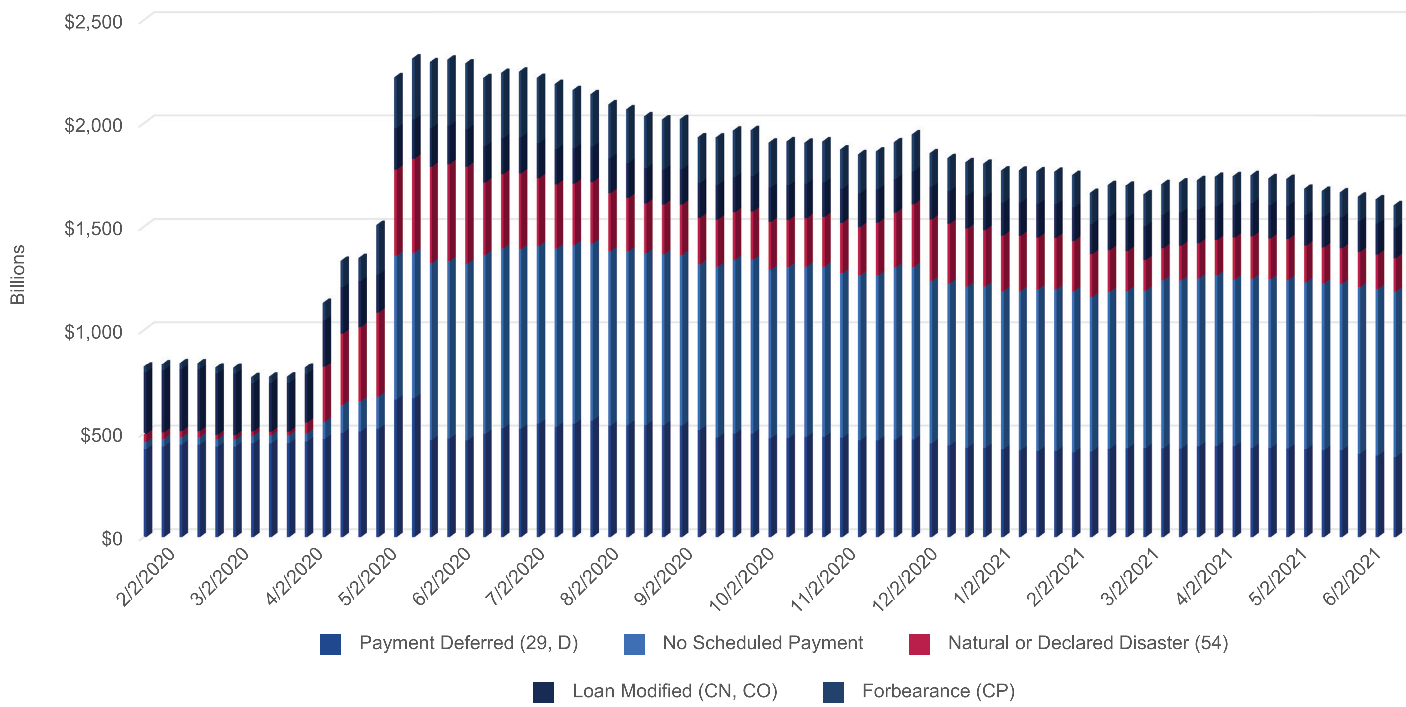
This trend returned the U.S. unemployment rate to single digits in 2020. However, those gains have leveled off in 2021 as businesses look to the future to determine if they are ready to transition from survival mode to a return to a growth mindset.

Consumers were sitting on nearly 2 trillion in additional savings as 2021 started. Explosive growth in e-commerce helped to buoy digital channels for consumer access. Spending on services is approaching pre-pandemic levels rapidly as we enter the summer and domestic and international services begin to become available. Foot traffic to in-person storefronts is almost back to pre-pandemic levels for most industries as consumer are releasing their pent-up demand.

Consumers are out shopping

Experian sees originations at pre-pandemic levels while forbearance and modification requests continue to taper. New originations are slightly more risk-averse, but competition will bring deeper risk tier penetration as stimulus runs lean mid-summer. Direct payments, paycheck protection, and other stimulus programs have provided consumers with cash to pay bills and, for some, pay down debt. Moratoriums on rent, energy, foreclosure, and collections have kept consumers on the fringe afloat. The remaining forbearance and modification activity has settled to the lowest volume since the pandemic began.

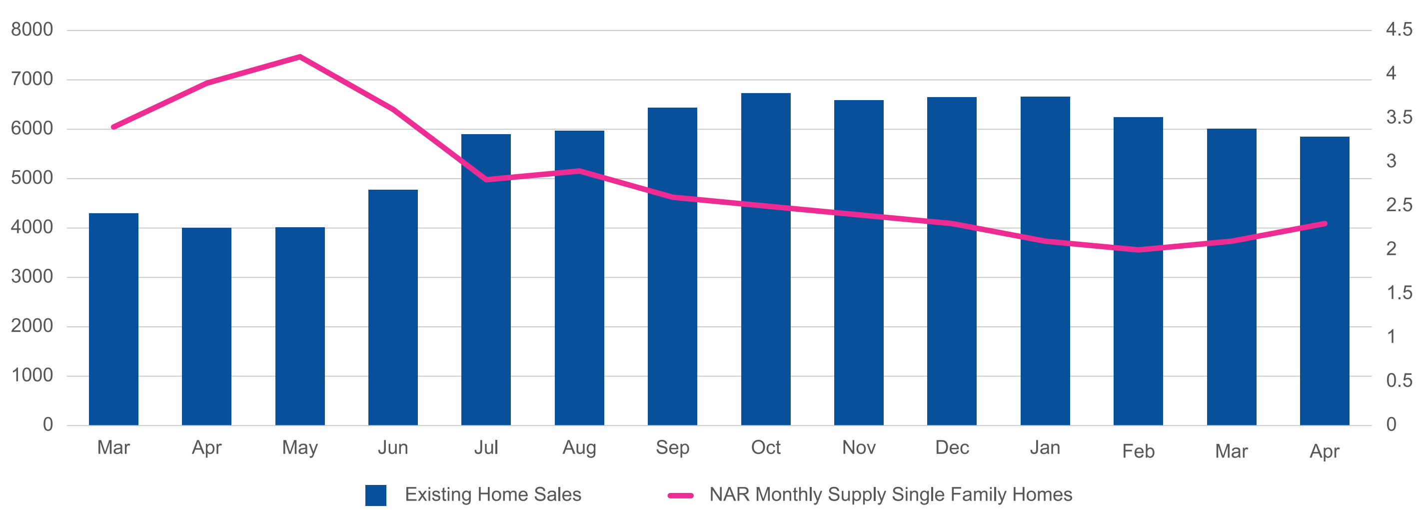
US Change in reported forbearance or deferral by week: Balances



These modifications are expected to last through the end of 2021, when the debt will be reassumed by the consumer or a more permanent modification is put in place. This is another risk that could further cool the economy in 2021.

Low lending rates have led to a boom in refinancing activity and a hot housing market. The housing market is hot in the U.S. as inventory is low and demand is accelerating as consumers spend on homes with more post-pandemic appeal.

Home Inventory



Consumers will look for houses further away from the office as return to work programs offer more flexibility. This change in proximity requirement for consumers means that homes in small towns far from metro areas see a lift in price and buyer appeal. This cushion for consumers is added by increasing home value and equity in the home. This could be short-lived as the potential of a wave of foreclosure activity could flood the market with inventory and eliminate consumer gains.

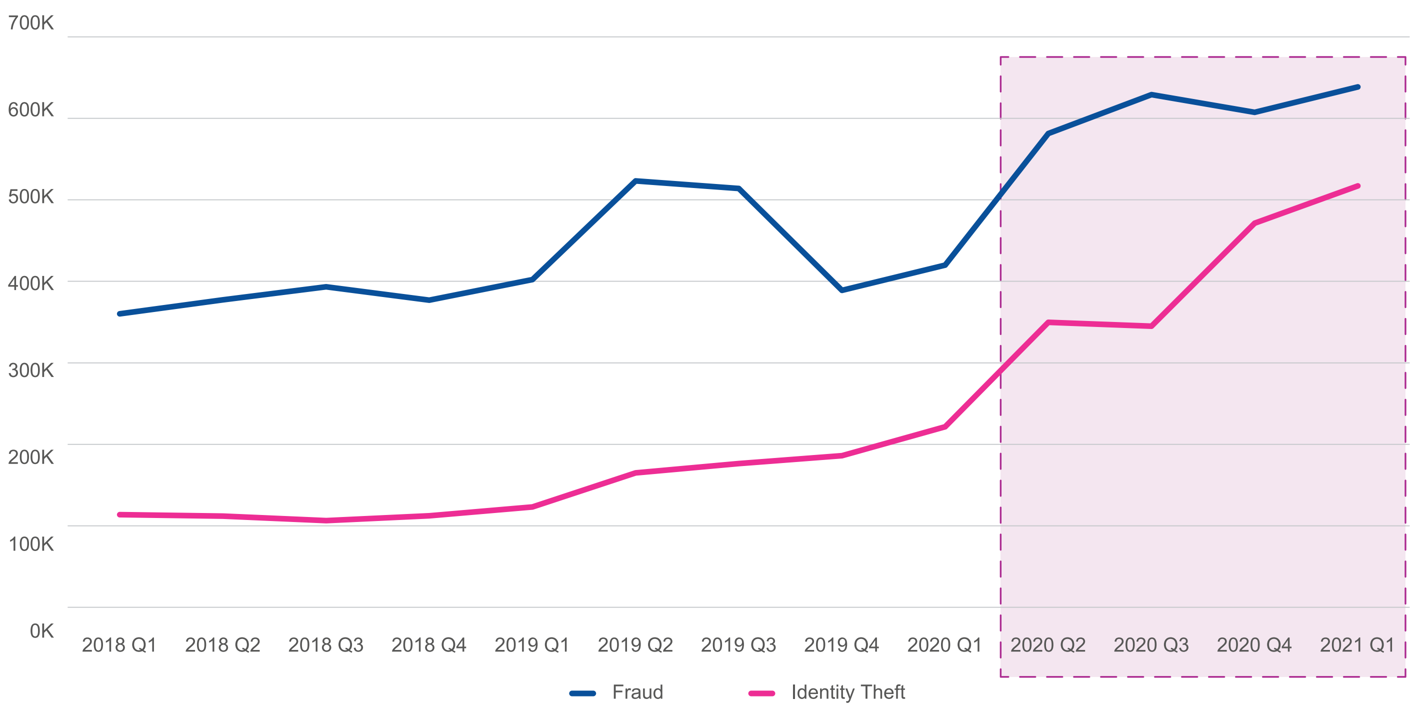
The current state of small business

All the elements for strong small business growth are there. Stimulus is in full force, and consumers are spending. This has caused some complications in some industries where demand has outstripped supply. Store shelves are empty, and car lots are sparse. To keep our U.S. consumer appetite satisfied, supply chains will need to shake off the slow pandemic pace and CRUSH our new...slower normal.

- The COVID-19 pandemic brought with it a perfect storm for fraud. Fear, confusion about stimulus checks, PPP loans, and other benefits created a target-rich battleground for fraudsters to run wild.

Fraud activity has surged since the pandemic started

Number of Fraud and Identity Theft Reports



Source: Federal Trade Commission

As business credit reopens and the economy accelerates, fraudsters, many of whom have embedded themselves in lenders' commercial portfolios through PPP loans, will be eager to capitalize in this expansion phase. The SBA has seen 19,500 percent increase in hotline complaints related to potential fraud in the programs. Greater than 75% of PPP loans originated by commercial fintech lenders were not run through a fraud screening and have a greater probability of containing bad actors. Lenders will need to be more vigilant as they assess these businesses for future offers of credit.

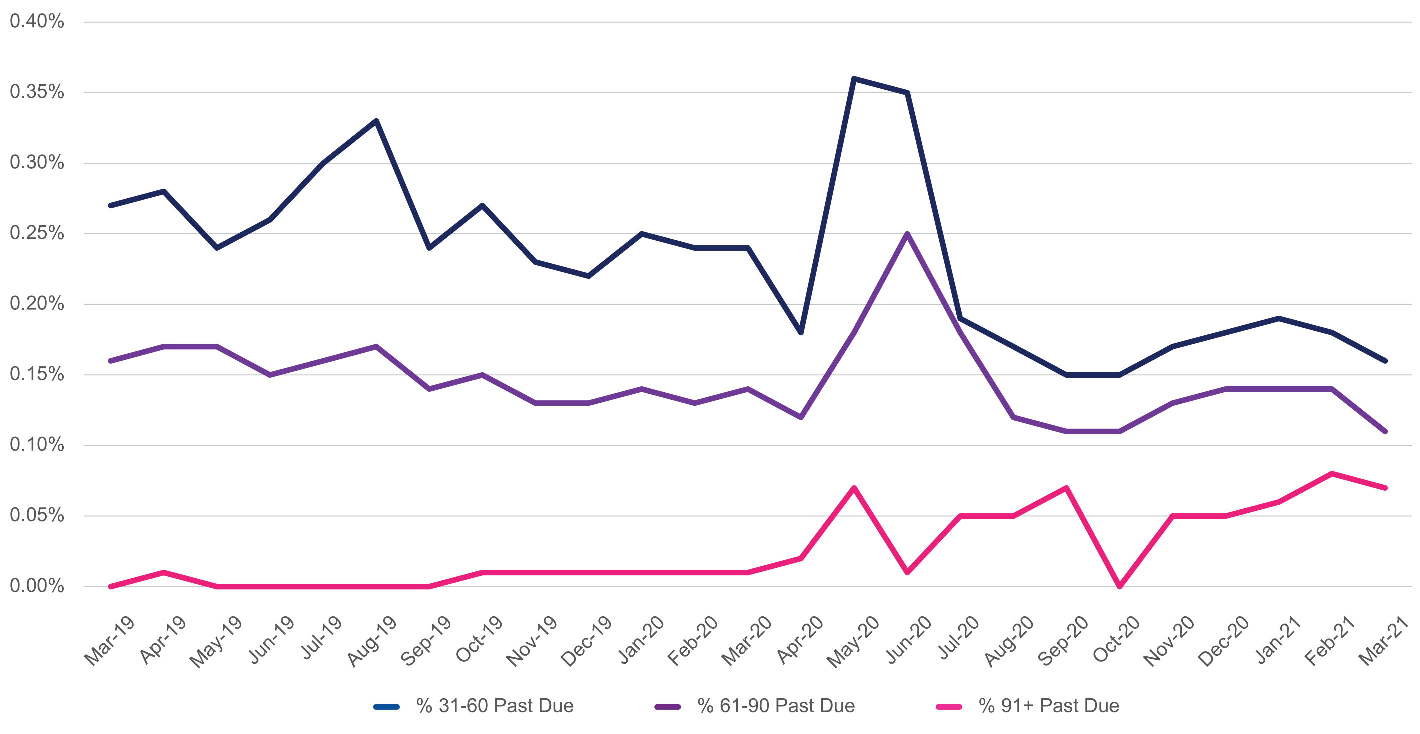
Fraud and attacks not only come at a first-party level but also come from third-party sources. Cyber-attacks have escalated to larger supply chain businesses, recently JBS Meats and Colonial Pipeline, who paid millions in ransom to get their systems back online. Third parties disrupted food and energy supplies within the U.S. These are only two of the more significant attacks that received public attention. Experian has Cyber capabilities that identify companies at higher risk of attack and help mitigate the risk to the company, suppliers, lenders, and insurance carriers as the threat intensifies. Cyber, including targeted malware attacks are becoming a significant challenge for companies in the U.S. as their guard is lowered in a post-pandemic environment where many are green to their new digital commercial persona.

Businesses that are ready to face these new world challenges and return to in-person sales and service face another looming challenge, the 2021 labor gap. Small businesses need to hire or rehire employees, but stimulus programs make the transition back to the labor force less attractive. Companies are struggling to fill positions.

Even with these challenges, investors still have confidence that markets will fully recover and invest in small businesses with a future eye toward imminent growth.

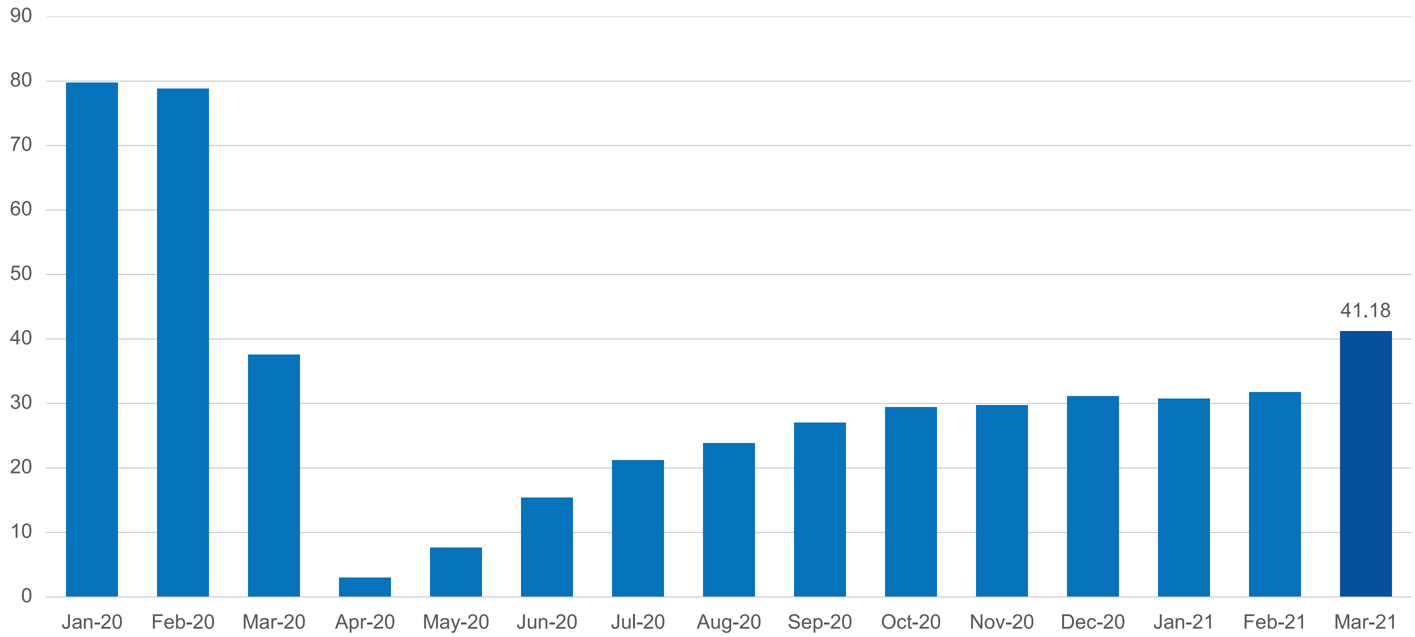
Commercial lending closed out the first quarter of 2021 with low, stable delinquency rates, but portfolio growth was well below annual targets.

Commercial Delinquency Rates



Commercial recovery is in the midst of a K Shaped recovery. Retail and most services industries are recovering more quickly than industries where consumers must be close to using the service. Foot traffic has been slow to return to the travel and entertainment industries, but that trend is quickly changing. With the arrival of summer, the travel industry is pulling planes back into service that have been grounded for months.

Monthly Passengers on U.S. Scheduled Airlines Domestic + International (In millions), Seasonally Adjusted January 2020 — March 2021



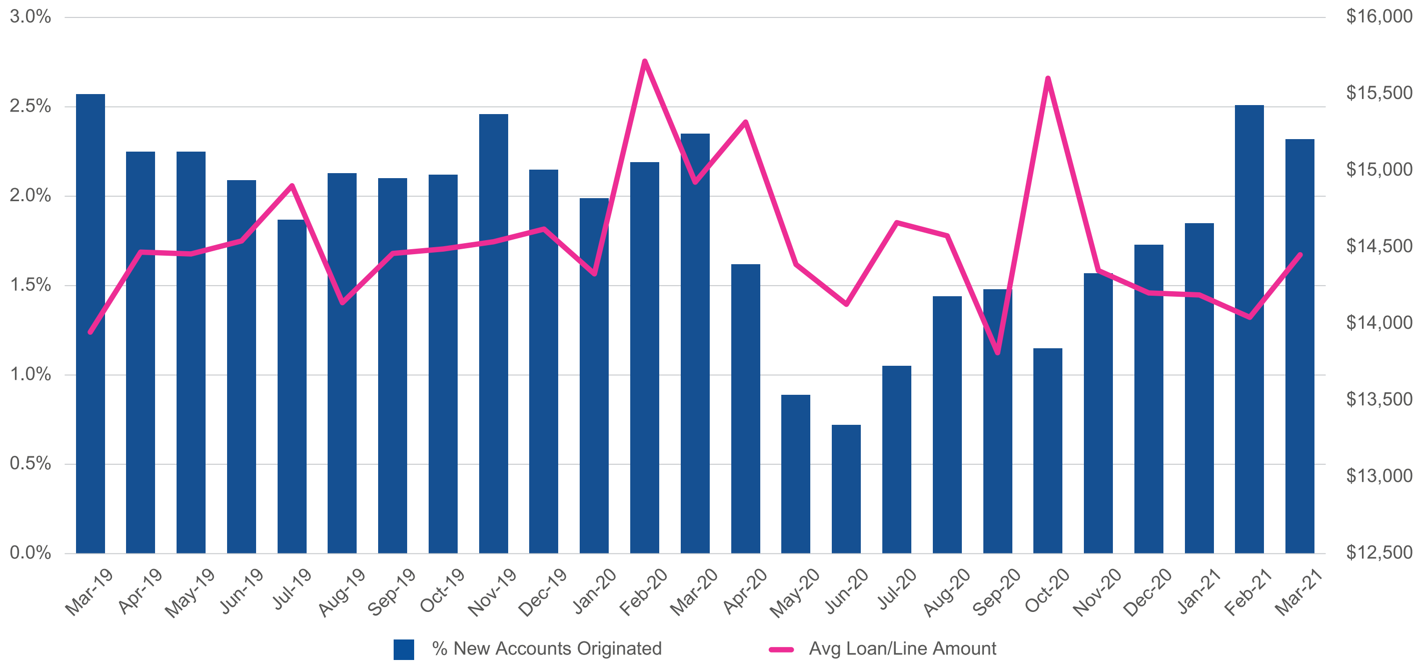
Source: Bureau of Transportation Statistics (https://www.bts.gov/newsroom/march-2021-us-airline-traffic-rose-30-february)

Hotels are opening capacity and rehiring staff to accommodate an increase in demand for recreational travel. The cruise industry is running test routes to prove sea travel can be done safely. These airlines and ships not only carry passengers but cargo as well. Getting these services back to the pre-pandemic level will help release a portion of the pressure on supply chains and local economies that service them. This will create a small business environment that will transition from a security mode to a future investment and growth mode.

Commercial credit has been in recession mode since April 2020, with the expectation that delinquencies would spike as forbearance, loan modification, moratoriums, and stimulus programs come to an end. Extensions to the federal moratoriums pushed the potential impact to the fall of 2021. This future impact on Small business cash flow will mark a reduction in the ability of customers to fulfill invoice obligations. Businesses and their owners will feel the same increased debt pressure by the end of 2021 if lenders and regulators do not take further action to cushion to withdraw of stimulus programs.

The pandemic response has changed the private lending landscape over the last 18 months. Commercial Credit Card origination has bounced back from pandemic levels where they saw growth impacted by 60% or more YOY as low-cost stimulus funding kept small businesses rolling, limiting the need for additional private credit products.

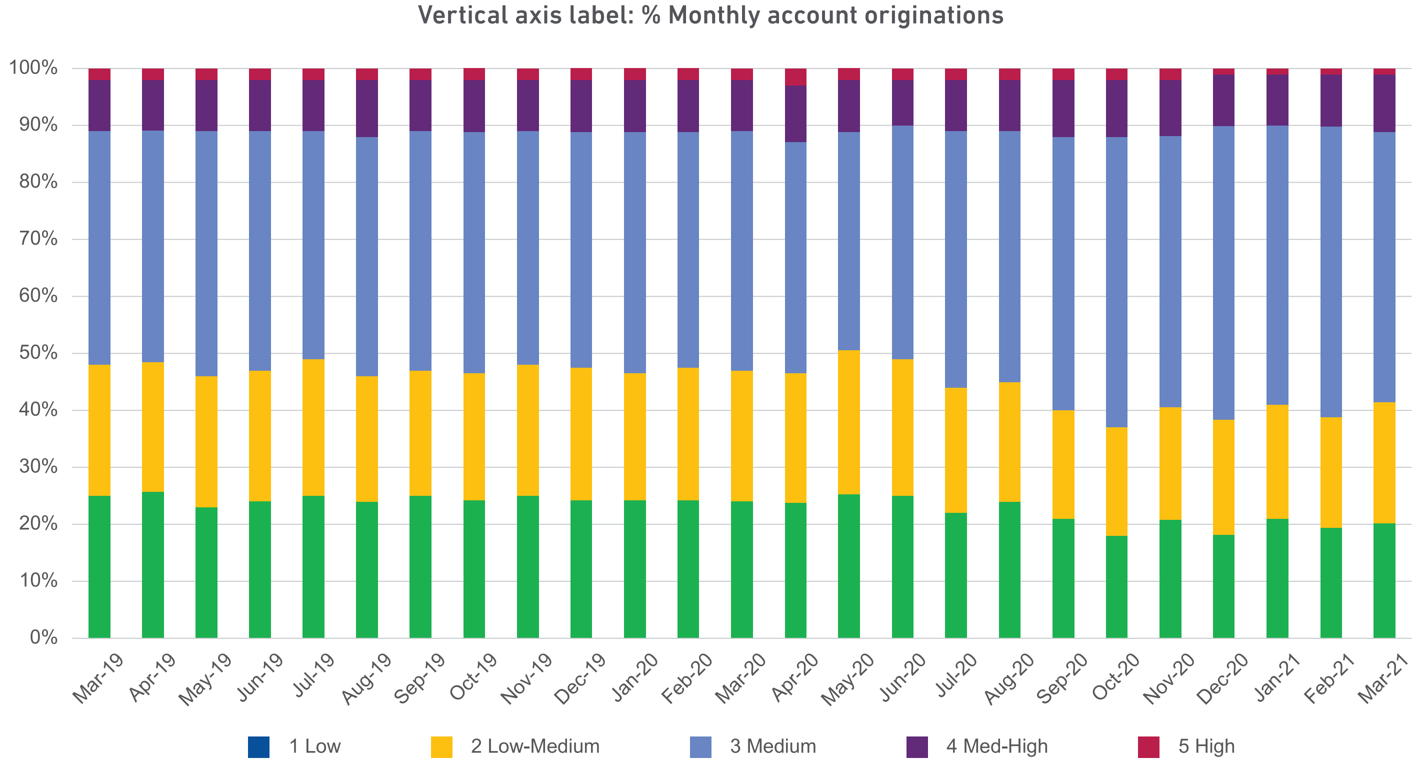
Commercial Credit Card Growth



Commercial lenders are developing more attractive rates, and reward programs as their marketing and origination activities become more aggressive in a competitive growth market 2021, as businesses transform from a survival attitude to growth. A commercial credit card is the first credit source a company will use when unexpected cash flow challenges arise. A noticeable benefit from stimulus programs (PPP, EIDL, etc..) was that these programs provided the cashflow support needed, which would generally be provided through private funding, to keep businesses operating. These programs kept private lending artificially low, but as they provide inadequate funding for growth, small businesses will return to private lenders. Companies were using the stimulus low-cost funding options, in some cases, to pay down balances and stabilize their business until foot traffic returned to a more normal pace. Now that the foot traffic is returning quickly, so is the need for growth and investment-sized private funding.

Large banks were well capitalized going into recession and prepared for the heightened level of loss. This resilience has allowed these large institutions to call down capitalization rates. This created record profits for lenders in the first quarter of 2021. These profits will level out over the remainder of 2021. Underwriting criteria has loosened a bit through the first quarter of 2021, allowing healthy small businesses to continue to have access to affordable funding.

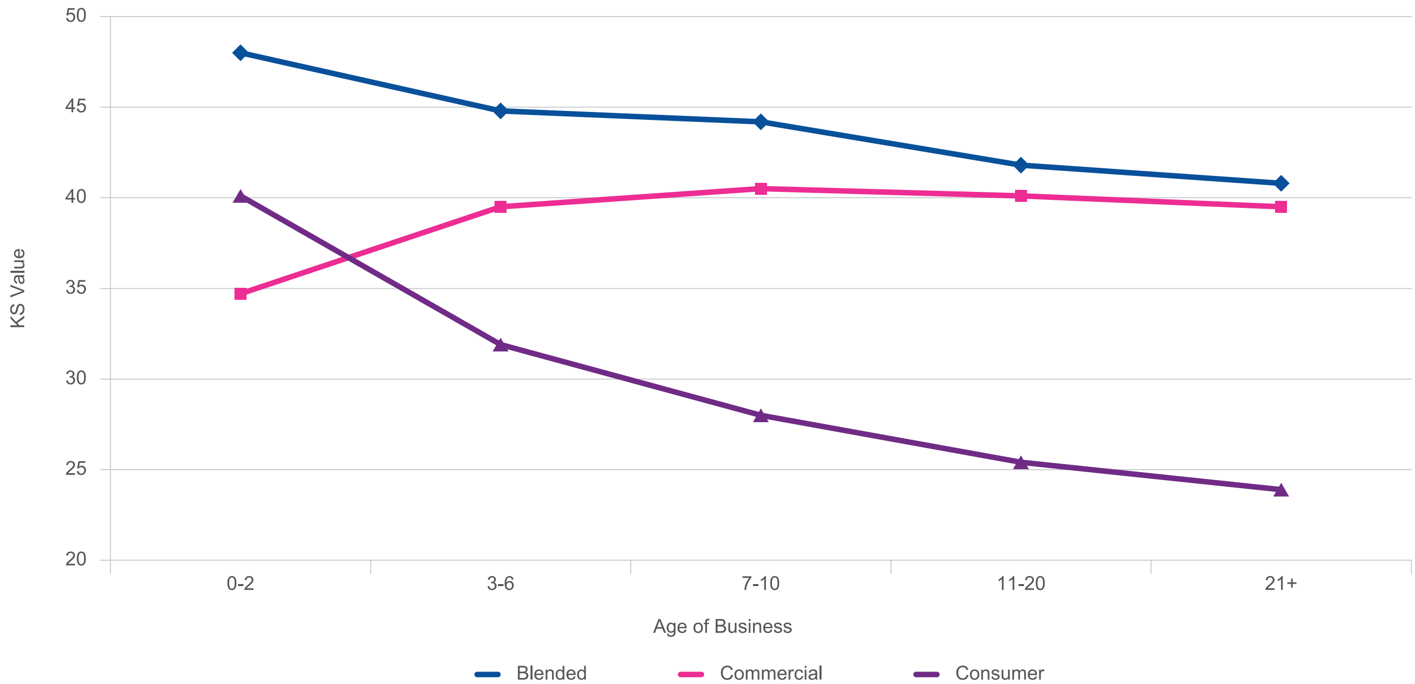
Commercial card underwriting criteria loosening



Pre-treatment strategies are the norm as more forbearance, modification, foreclosure, and collection moratoriums end at a national and regional level. This trend will impact small business owners at the end of the fourth quarter, as the debt or adjusted payments resume on the owner's monthly personal and commercial credit obligation repayment cycle. Banks are changing contact strategies to reach out earlier in the delinquency cycle with pre-treatment options to keep businesses current and healthy. Companies offering trade credit are re-evaluating cutoffs to apply interest on balances, extend credit for profitable customers, and update strategies for attrition as we emerge from the pandemic. With moratoriums in place, the strategies are a greater focus to limit exposure risk. Customers that exceed their ability to repay debt obligations and remain profitable will look for bankruptcy relief in the first quarter of 2022.

As for the new business entrants to the U.S. commercial lending market, ~4.4 million of them in 2020 and continuing the pace into the first quarter of 2021, they do not have the credit history to qualify for a traditional product on their merit and lenders will continue to struggle to assess consumer risk as stimulus keeps delinquencies trends stable. Lenders will find that blending guarantor and small business information into a solution to evaluate credit risk across emerging to mature businesses will help to differentiate risk in a stimulus-driven credit market. In addition, as a small business grows, they utilize more commercial-focused private credit products tied to their business vs consumer-focused products.

Business owner data provides significant lift in young business risk assessment



Lenders will be looking at broader ways to engage these new entities and differentiate risk earlier in the life of a business. Experian clients are excited to enhance their current strategies with non-traditional data on SMB digital availability , geolocation, COVID spread impact, macroeconomic data, social media data, firmographic data, etc. in addition to traditional credit data to differentiate the resiliency risk of a small business. Non-traditional data overlays will become critical in the assessment and pricing of risk in 2021.

The lending environment is amid a digital metamorphosis as banks accelerate the modernization of their online presence to broaden access to products and services. These post-pandemic changes in customer experience and expectations will have a lasting effect on the ways private lenders interact with credit markets going forward.

Commercial lenders will also be looking for more advanced methods for segmentation and automation of processes. Machine learning has been a buzzword in credit risk for several years as lenders looked at the viability and acceptance of these tools. The desperate need for lenders to assess risk more deeply, across many more data points, with broader segmentation, increased accuracy, in an explainable/ familiar way, and with a sub second decision make these new off the shelf machine learned options critical for businesses strategy success and growth. Large lenders that have been well capitalized during the downturn will look for ways to increase their market share and grow even during this rough period. They are prospecting and targeting profitable and resilient businesses to create relationships with business owners that will last well beyond this financial market impact event.

These transformational activities will help small businesses and their lenders/ service providers to have a better tool to differentiate small business risk in this post-pandemic quickly heating economy.

US Small business and consumer sentiment is improving, and growth accelerating, but caution signs are still flashing as we enter the second quarter of 2021

What is on the horizon

Lenders focus on targeting and growth will be fueled by more advanced segmentation, model methodologies, and non-traditional data. Commercial credit portfolios will be tasked with and accomplish accelerated growth at the end of the first quarter and will work hard to increase performance through the second quarter of 2021. Like their customers, lenders and service providers will focus on diversity, equity and inclusion initiatives to create an even more inclusive small business ecosystem. State income tax implications surrounding the participation in the PPP loan program and a corporate minimum tax rate proposed by the Treasury will still be top of mind for businesses as they plan growth expenditures in 2021. An increase in cyber-attacks, COVID outbreaks in/outside the U.S., commodity shortages, trade conflicts will all impact supply chain stability for small businesses and impact their ability to meet consumer demand. Consumer moratoriums and forbearance programs slated to end in 2021 may create ripples in consumers' ability to repay, consumer spending velocity, and return of inventory to markets. These challenges are risks to the U.S. economy and could cause a cooling off in effected industries.

Consumers, and the small businesses that provide them service will be focused on digital experiences that accelerate engagement, sale, and delivery. Consumers are holding tight to heightened customer experience expectations associated the pandemic level digital transformation and engagement.

Recovery is accelerating in the second quarter of 2021 as businesses look to the future to **transition from survival mode to investment strategy for profitability and growth.** "Let's crush the new normal!"

About the author

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As Sr. Director of Analytics Consultancy, Brodie Oldham leads a team of statistical consultants with diverse skills to provide clients with leading edge analytic-driven information solutions, services, and actionable insights. His is an industry expert, who speaks on behalf of Experian at industry conferences.

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