

Market Insight Snapshot



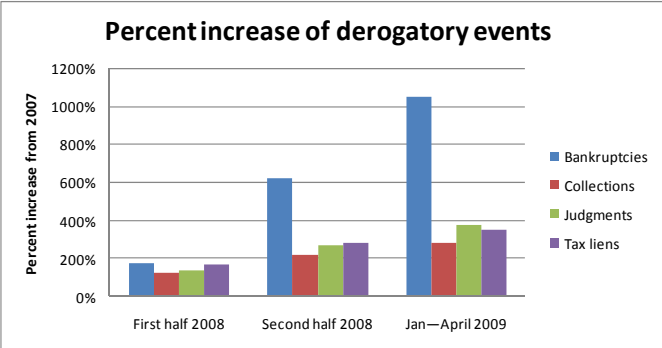
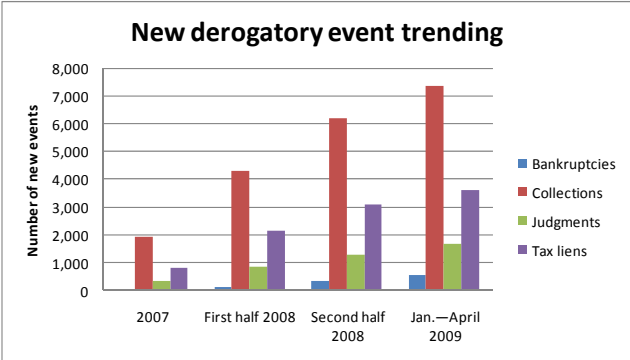
Understanding the state of small-business risk

August 2009

It's no secret that over the last two years, small-business credit risk has increased at a distressing rate. Since 2007, five key measures of risk — bankruptcy, lien filings, judgment filings, collections and severe delinquency in payments — showed a consistent, increasing risk trend. While this study supports the notion that many businesses have struggled to meet their payment obligations, it also shows the overwhelming majority that were healthy at the start of 2007 have remained so throughout the present financial crisis.

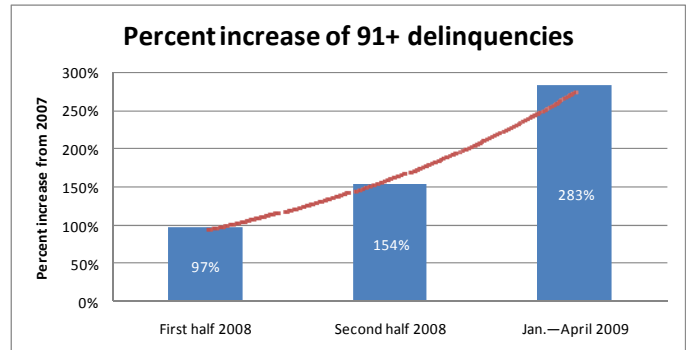
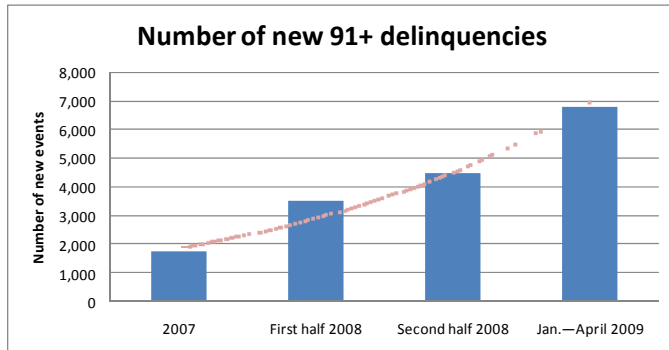
To better understand the financial condition of small business in the United States and develop an accurate snapshot of risk, Experian® examined the rate of new derogatory events (incidence of a new lien, judgment, collection, bankruptcy or severe payment delinquency) for small businesses that were healthy near the beginning of 2007. Experian tracked more than 300,000 small businesses in the United States from April 2007 to April 2009 to examine the emergent trends.

When times are tough



The charts above measure bankruptcies and other key business risk indicators — collections, judgment filings and tax lien filings — between April 2007 and April 2009. As demonstrated above, commercial bankruptcies have increased at an alarming rate, with new bankruptcy filings

increasing more than tenfold from 2007 to 2009. However, to truly understand the condition of small business in the United States, it's necessary to look at other risk indicators, since a significant proportion of small businesses do not file for bankruptcy when going out of business. These other risk indicators validated the troubling signs as well. With a 370 percent increase in judgments and a 320 percent higher rate of collections filings against small businesses over the two-year period, the findings clearly demonstrated a worsening situation for small-business risk and payment obligations.



The above charts show the frequency with which small businesses became severely delinquent (91-plus days late) for the first time in paying their credit obligations during the study period. Following the trend of other risk indicators, severe delinquencies continued to gain momentum from 2007 levels, with a strong uptick in the first half of 2009. Overall, the rate of severe delinquency among businesses that were healthy in April 2007 almost doubled in the first half of 2008 and, by April 2009, was almost 300 percent higher compared with 2007 figures.

A silver lining

As dire as economic conditions appeared to be for small businesses, there were promising signs. Overall, Experian found that “clean” businesses with no derogatory events (incidence of a new lien, judgment, collection, bankruptcy or severe payment delinquency) prior to the downturn have actually fared dramatically better than the overall small-business population.

To demonstrate this finding, Experian compared the small-business “clean” sample with the general small-business population. As shown in the chart below, even though 11 percent of clean businesses had a derogatory event between April 2007 and April 2009, the rate of incidence was less than half that of the general small-business population.

Comparison of negative events in small business sample population		
	Clean businesses	All businesses
Negative event	11.34%	24.05%
91+ Delinquency	5.78%	11.22%
Bankruptcy	0.32%	0.77%
Collections	4.94%	10.68%
Judgments	0.98%	4.94%
Tax liens	2.07%	7.10%

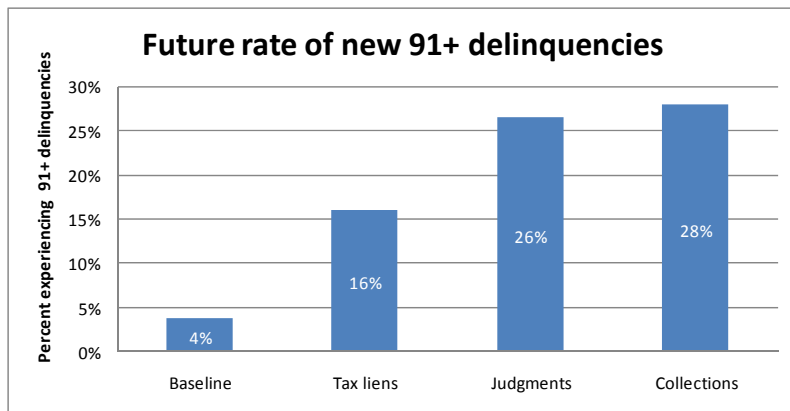
For each risk measure above, the general small-business population experienced dramatically higher rates of incidence over the two-year time span. The general small-business population

had a rate of severe account delinquency almost two times greater, a tax lien rate more than three times greater and a judgment rate more than five times greater than small businesses with no derogatory events prior to April 2007. While “clean” businesses were still being affected by the economy, they were proving to be much more resilient to economic conditions.

Signals of severe delinquency

An incidence of a lien, judgment or collection can signal a dramatic increase in the likelihood of a business becoming severely delinquent. To understand how important these negative events were in predicting future business health, Experian further analyzed the small-business data between January 2008 and January 2009 to capture the most recent, relevant payment trends.

Chart 4a below shows the probability of a business having a new severe payment delinquency within two quarters of a derogatory triggering event. A baseline was also included in the chart to show the likelihood of any business becoming severely delinquent within the same window of time studied.



As demonstrated by the chart, the likelihood of severe delinquency over a two quarter window, increased dramatically when a derogatory event occurred. When compared with the baseline, a new tax lien increased the likelihood of a severe delinquency by 321 percent, and a new judgment increased the likelihood of a severe delinquency by 591 percent — clearly showing the correlation between negative events and a small business’s ability to pay its financial obligations. Further analysis found the likelihood of a small business having a new, severe payment delinquency within two quarters of a derogatory event became even stronger during the second half of 2008 as economic conditions worsened.

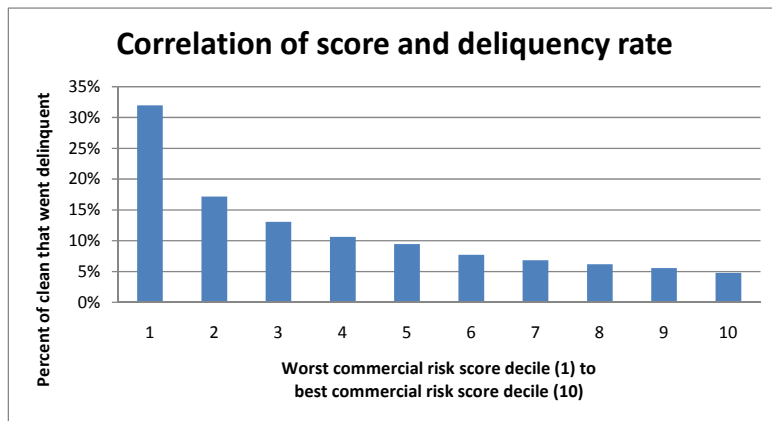
	Tax liens	Judgments	Collections
Rate of severe delinquency (1st half 2008)	12%	22%	23%
Rate of severe delinquency (2nd half 2008)	20%	30%	35%
Percent increase (1st half to 2nd half 2008)	40%	29%	36%

Expected behavior in unprecedented times

The economic conditions of the last two years have disproportionately impacted businesses with previous derogatory events, be it due to unsound payment habits, poor management or a weakened business condition prior to the downturn. The relative success of “clean” businesses (no derogatory event prior to April 2007) surviving this economy underscored the importance of past payments behavior and other risk assessments as indicators of future health and

creditworthiness — even in unprecedented, turbulent economic times. Despite the seemingly unpredictable nature of today’s economy, established risk assessment measures have shown how predictable commercial payments behavior can be.

For example, even within the sample of “clean” businesses, commercial risk scores proved remarkably accurate in assessing which businesses would experience severely delinquent payment behavior during the subsequent two years. The chart below compares the “clean” small-business sample’s delinquency rate between April 2007 and April 2009 with commercial risk scores taken in April 2007. The decile scale at the bottom of the chart indicates commercial risk score bands grouped by 10 percent increments — from the worst-scoring 10 percent at the leftmost side to the best-scoring 10 percent at the rightmost side. As demonstrated by the chart below, a significant correlation was found between the actual delinquency rate of these businesses and the predictive commercial score taken in April 2007. The delinquency rate for the highest-risk businesses within this “clean sample” (band 1 — the 10 percent of businesses with the worst commercial risk score) was markedly higher from subsequent scoring increments.



Conclusion

While small businesses were affected by the economic downturn and represented an overall higher level of risk than they did in 2007, existing risk assessment methods have proved remarkably accurate in identifying the good from potentially “bad” accounts. Caution is warranted, but, depending on one’s appetite for risk, there are tools and practices in place to accurately gauge that risk and better identify businesses that fit within a given lender’s/credit manager’s business strategy.

Due to the number of creditworthy businesses, the apparent opportunity in the market and the success of risk assessment tools in predicting future delinquent payment behavior, the study suggests that credit for small businesses should be more accessible than it has been. However, the study also emphasizes the importance of small-business payments behavior, as it can shape external perceptions on the health of a business and serve as a vital indicator of future delinquent payment activity to lenders and trade credit managers.

Analysis methodology

The purpose of this Experian study was to examine the rate of new derogatory events for small businesses in the United States that were healthy at the start of 2007. Experian tracked more than 300,000 small businesses in the United States from April 2007 to April 2009 to determine the rate of risk trends on multiple measures. Experian applied its definition of a small business — businesses that have fewer than 25 employees and generate less than \$10 million in annual

sales — to establish the study sample population. To determine the trend of newly derogatory events for small businesses, Experian started with a “clean” population that did not have, at April 2007, any liens, judgments, bankruptcies, collections or any trade line more than 91 days delinquent, or overall delinquency average beyond 30 days late.

This was a longitudinal study following these specific businesses over a two-year window, and, as such, the results of this study do not necessarily represent the overall risk trend of all businesses in the United States over the study period.

Experian analyses and studies

To review additional Experian information, including data analysis, research and related information, please visit the following resource: www.experian.com/insight.

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For more information or to speak with a subject matter expert, please contact:

Roslyn Whitehurst
Experian Public Relations
1 714 830 5578
roslyn.whitehurst@experian.com

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