Beyond the Trends

Understanding the Commercial Economy

Summer 2022

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.

When sprinters stumble, precious time or even the race can be lost

Small businesses owners have been in a sprint to get new ventures up and running. Some businesses are breaking free from the grips of the pandemic and racing to grow and strengthen their business before the next big event. That big event is closer than some would have hoped. A stumble now may hamper a small business from capturing critical market share or even being able to finish the race at all. For the next 12-18 months the track will be littered with pebbles and hazards for small business owners to avoid.

The U.S. economic environment for growth has been strong as consumers continue to spend pent up demand. Retail sales continue to be stronger than expected through the first quarter, up 28% from pre-pandemic levels and accelerating. Inflation is changing the product types consumers buy which will impact higher end brands which depend more heavily on discretionary spending.

Small businesses have found little consumer push back to price increases as they build in expected cost challenges forecast for mid-2022.

Business owners continue to struggle to access quality labor, strengthen operations, and create backup supplier networks as supply chain disruption and inflation hamper delivery. Diesel prices are up 71% YOY according to the U.S. Energy Information Administration and the higher cost of energy is resulting in lower margins and impacting delivery of goods and services. These costs have been rising sharply since February 2022 and exacerbated challenges already being addressed by business owners in the 1st quarter of 2022 commodity, component, and inventory shortages. Small businesses are adjusting to a high-demand low supply market through 2022.

The stumble: U.S. small businesses face an extended period of higher costs and weakening demand. They are watching the Federal Reserve actions to slow U.S. economic growth, which is fueling small business development, as the focus will be on cooling inflation in the next few years.

Supply chain challenges stemming from heightened global tensions are slowing production and raising the costs of materials and inventories. Orders continue to be up as businesses fight to keep the product on the shelf through the following year. All this activity will lead to irregularity in product inventory as consumer behavior adjusts to higher prices and wage growth stumbles to keep up with inflation. The increase in borrowing costs, a change in consumer spending behavior, and continued global and domestic supply chain challenges will put additional pressure on small business cash flow. Owners will make choices as to how debts are repaid. **Lenders and creditors will need to assess how they will respond to struggling small businesses in 2022.**

The insights shared in this report are presented 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 to the market?

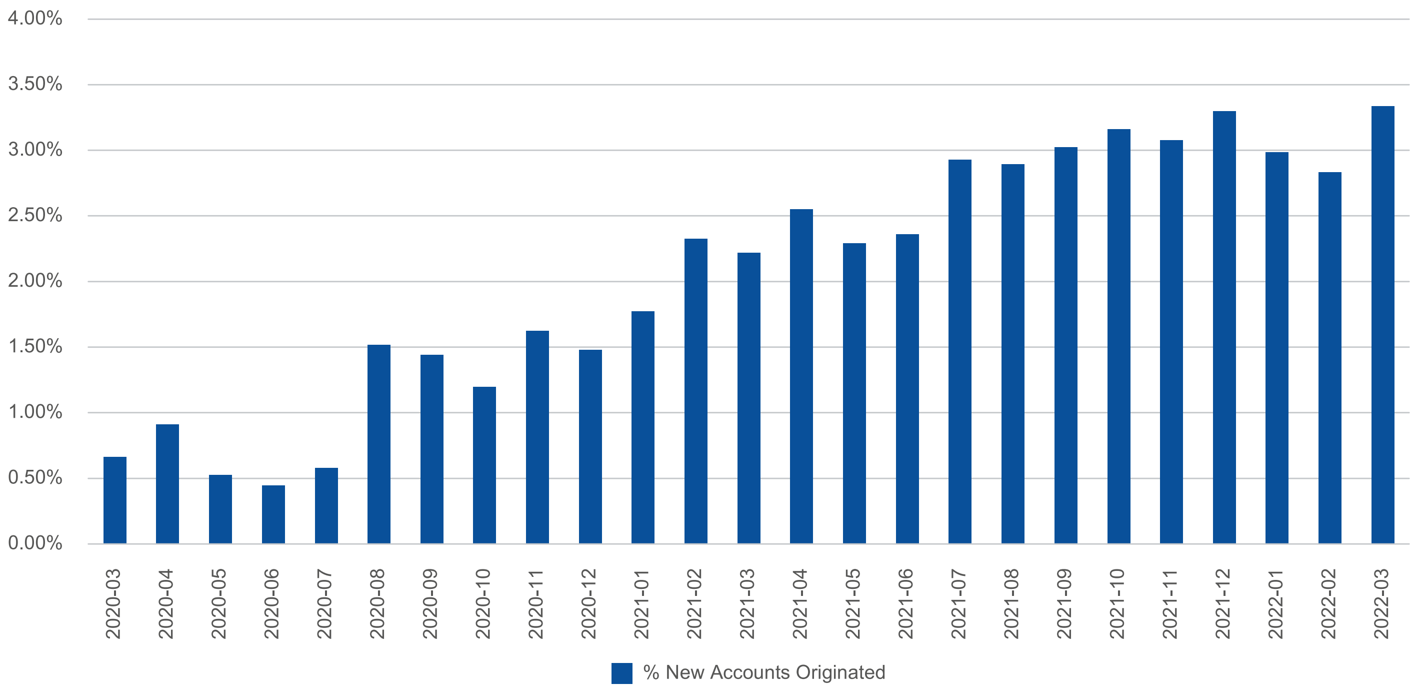
Small businesses in the U.S. (A corporation, limited liability company, or proprietorship with 500 employees or less) make up 99.9% of all businesses in the U.S. employing more than 61 million people in the U.S. according to the Small Business Administration. They generate almost 65.1% of new jobs as they expand every year, and a large portion of this job growth comes from companies with less than 20 employees. **67.6% of newly established businesses survive at least 2 years**.

These small businesses provide essential goods and services across industries. These businesses are very inclusive of all gender and minority segments which broadens socioeconomic success, independence, and innovation. Small businesses, and the entrepreneurial spirit they present to the U.S. market, have great influence on the health and growth of the U.S. and the global economies they serve.

Strong performance for small business growth in Q1 2022

Lenders and creditors monitor commercial portfolio performance as inflation, and other headwinds change how consumers and businesses spend and invest in the next 12 months. In addition, businesses seek more private credit as capital reserves from stimulus dwindle, and additional stimulus is unlikely as the Federal Reserve moves more aggressively to slow U.S. economic growth.

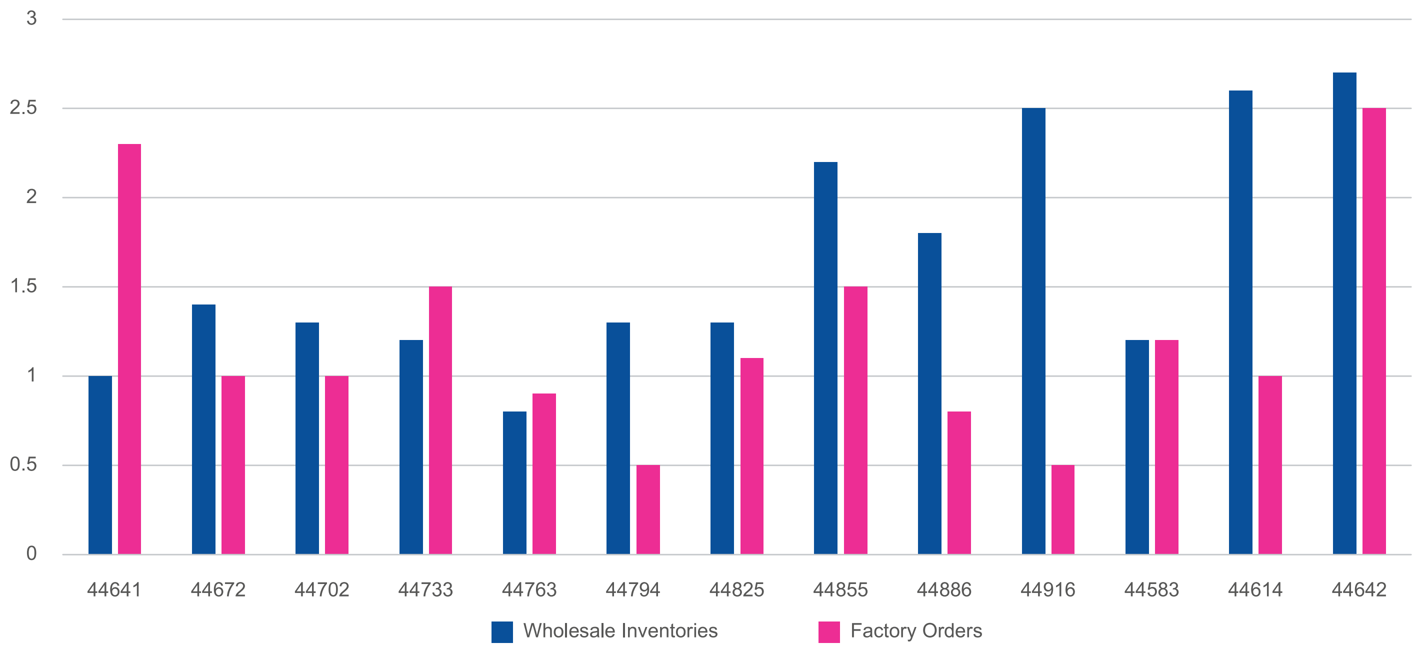
Unsecured commercial credit increases in Q1 2022



Source: Experian Commercial Benchmark

Manufacturers are working hard to cash in on higher prices and borrowing to deliver in a high-demand market. Wholesalers and retailers are stockpiling inventory to prevent shortages and the risk of disenchanted customers. Year over year delinquencies in these supply chain-focused businesses have doubled as they struggle to keep up.

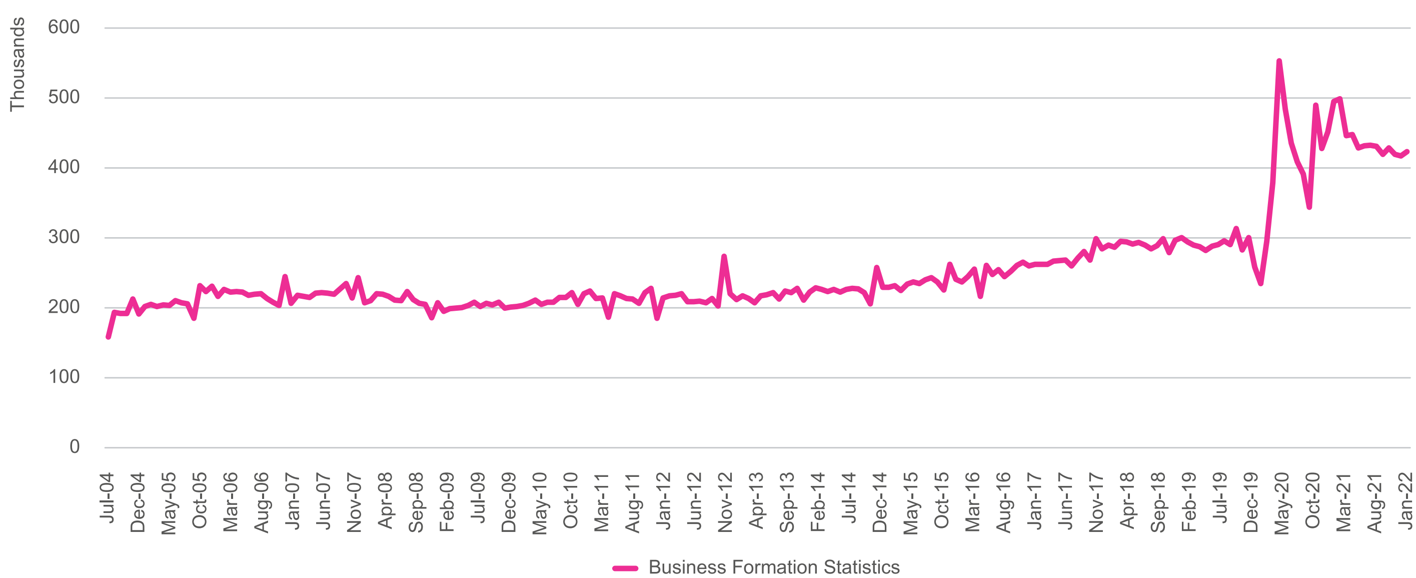
Orders and inventory demand up



Source: Census.gov

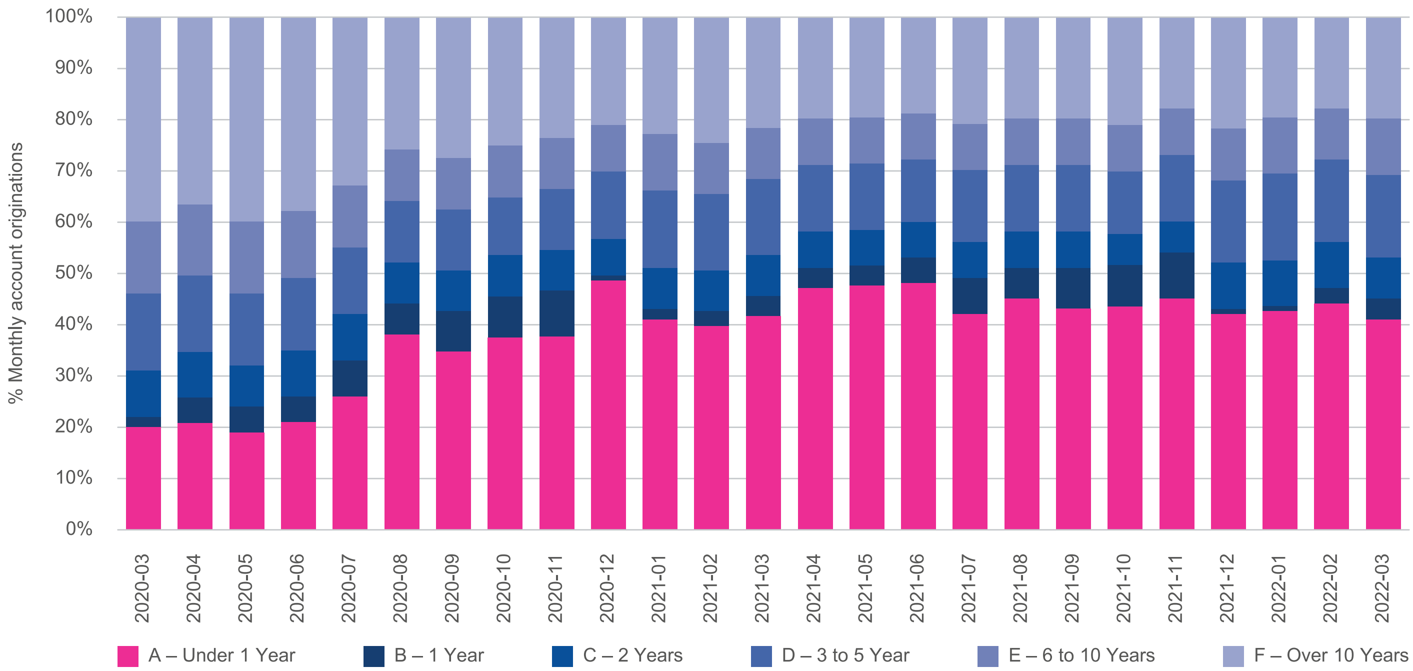
New small business creation remains elevated in the U.S. as a strong economic environment, and elevated consumer spending creates space for emerging ventures to gain a foothold and sprint to become a stable viable business.

U.S. new business applications remain elevated through the first quarter



Source: Census.gov

Businesses less than a year old continue to be a large portion of the U.S. marketplace

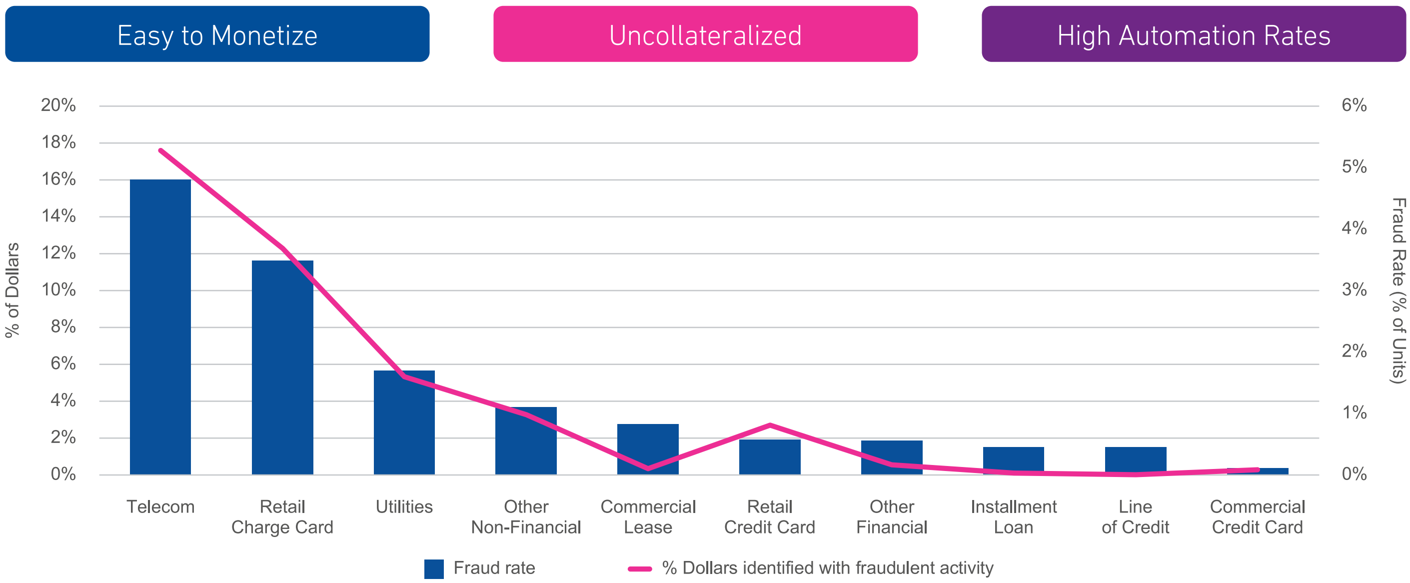


Source: Experian Commercial Benchmark

These small businesses are in a race to become stable, viable businesses. As they emerge in their first years in the market, these businesses are more susceptible to market events. Pandemic stimulus programs provided initial protection to businesses as they developed over the past two years.

The stumble: While the current market tailwinds are pushing these young businesses forward, they will run into strong headwinds, which will significantly impact their current pace. Lenders and creditors will see heightened fraud activity as these new businesses are more vulnerable than established businesses. The number of new business applications provides cover for bad actors to attempt to create fictitious businesses with no intent to repay. Weaker economic conditions in the second half of 2022 will mean the heightened fraud activity of 1QTR22 will continue through the year.

Fraud activity will increase portfolio costs more heavily in specific industries

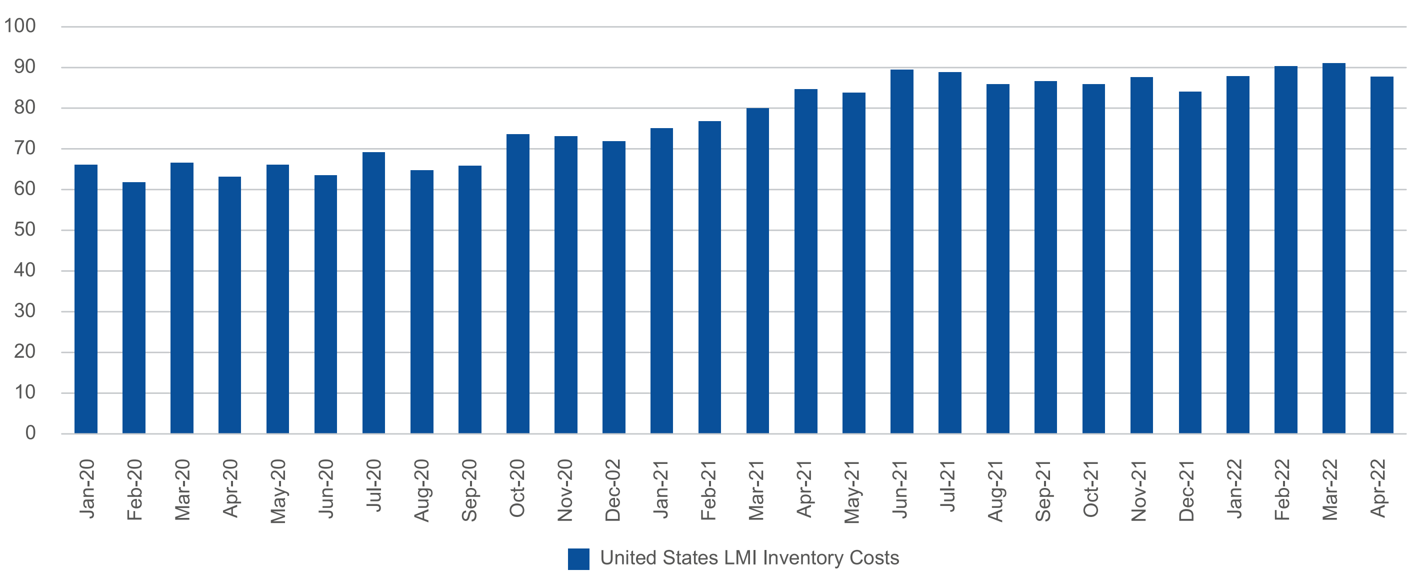


Source: Experian

Not allowing these fraudulent accounts to be established will reduce lender portfolio management and treatment costs when accounts are experiencing distress. In addition, the time gained from suitable fraud protocols will allow lenders and creditors to focus on small businesses as they stumble to get them back in the race and perform more quickly.

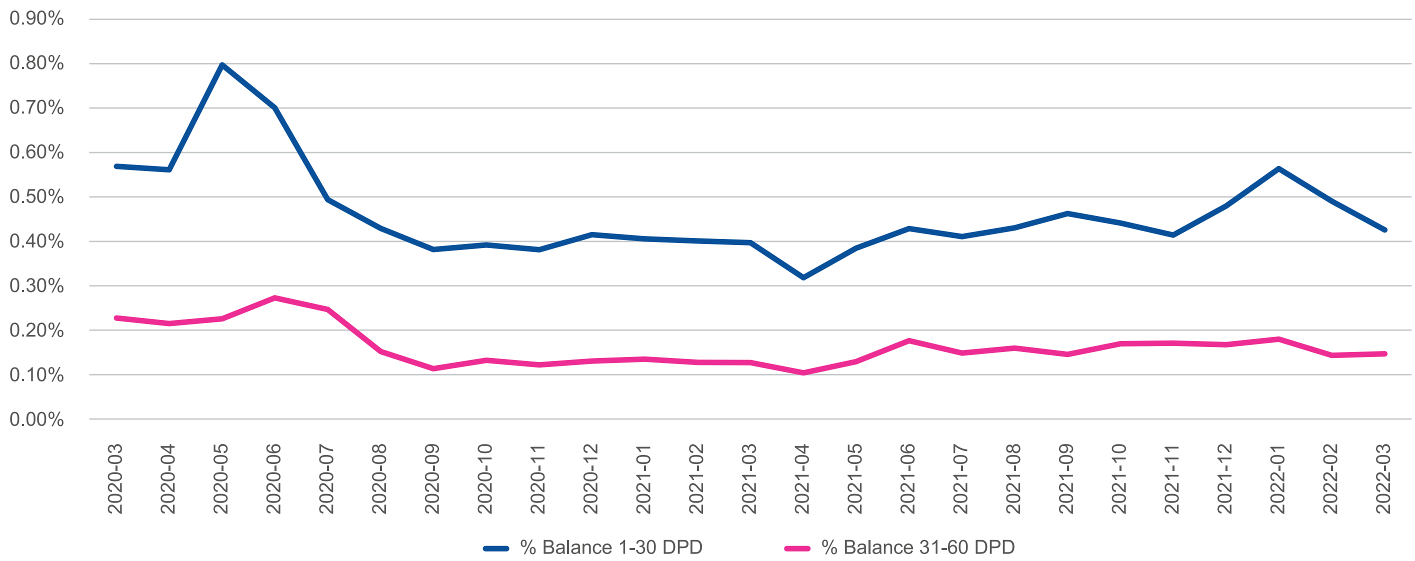
Legitimate new businesses will be hampered fundamentally by supply chain gaps, lack of scale, and developing infrastructure. In the first quarter, delinquency rates became more volatile as small businesses dealt with rising costs.

The pinch of higher costs of doing business



Source: Logistics Managers' Index

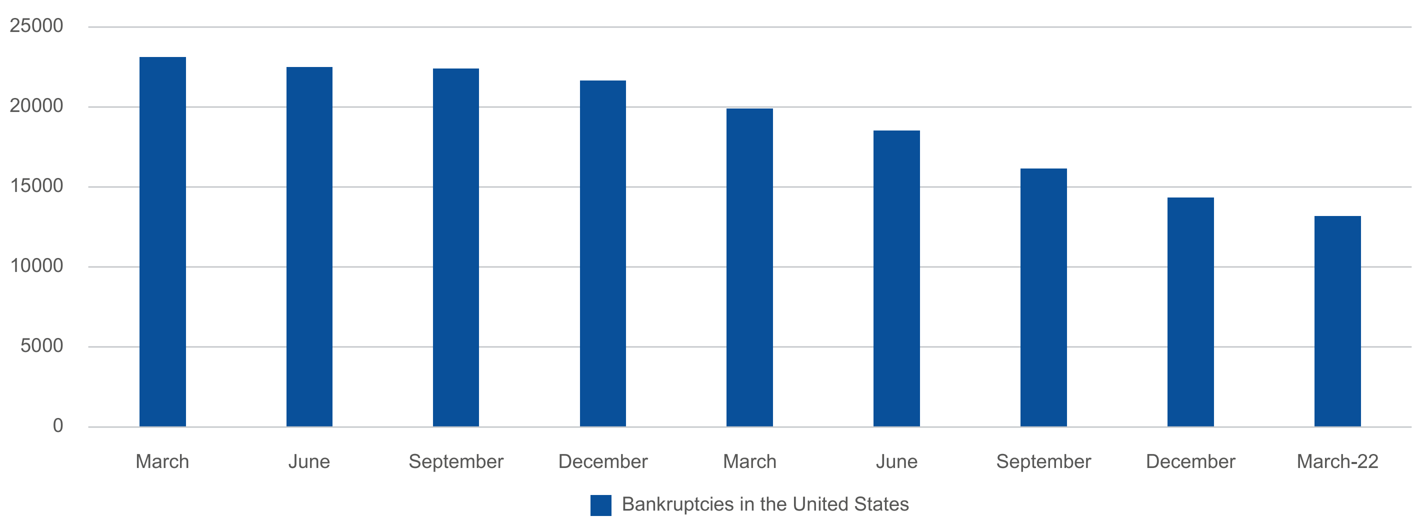
Volatility in delinquency rates



Source: Experian Commercial Benchmark

While delinquency is generally increasing in the early stages, the later stage delinquency and bankruptcy rates have remained low.

Bankruptcy rates remain low



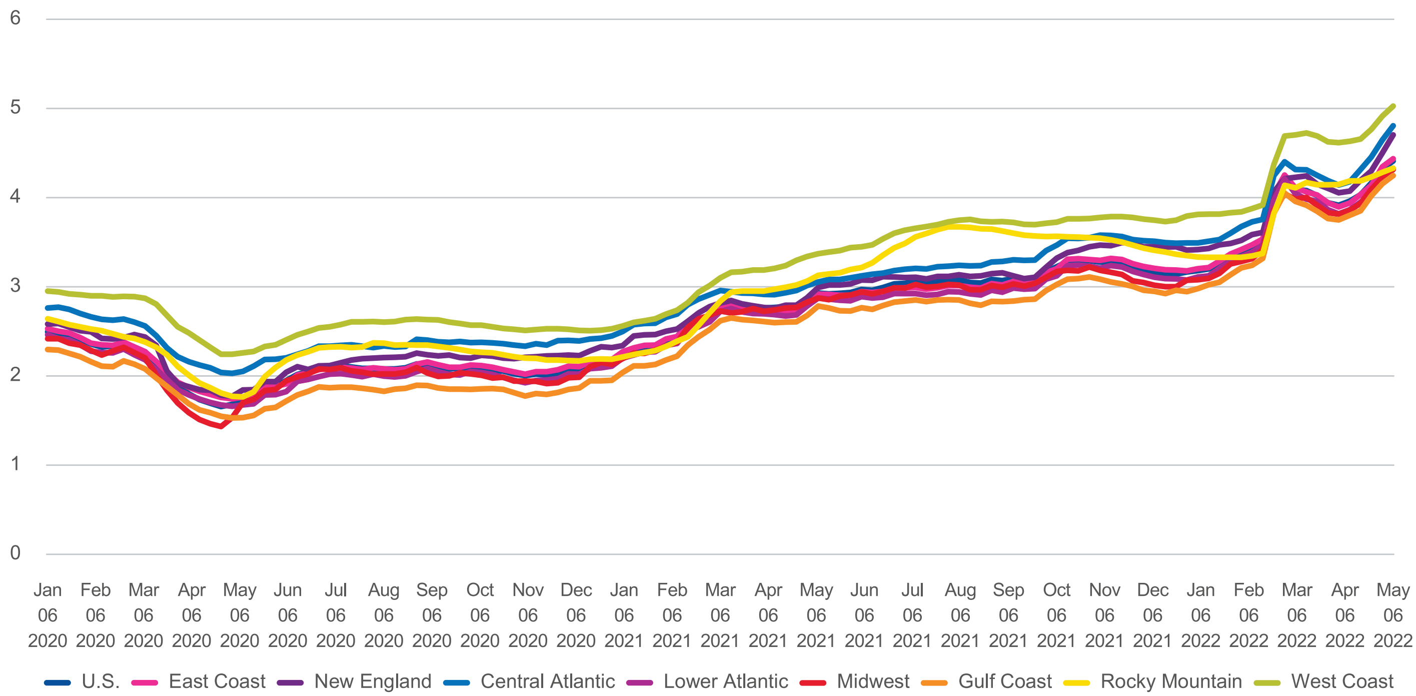
Source: Administrative Office of the U.S. Courts

Choices are being made in the order of repayment of debt.

What will likely cause small businesses to run out of steam?

Weakening consumer demand as pressures like fuel prices smashing through the 4 dollar a gallon high water marks, driving consumers to cut into discretionary spending to cover core costs.

Weekly U.S. Regular All Formulations Retail Gasoline Prices (Dollars per Gallon)

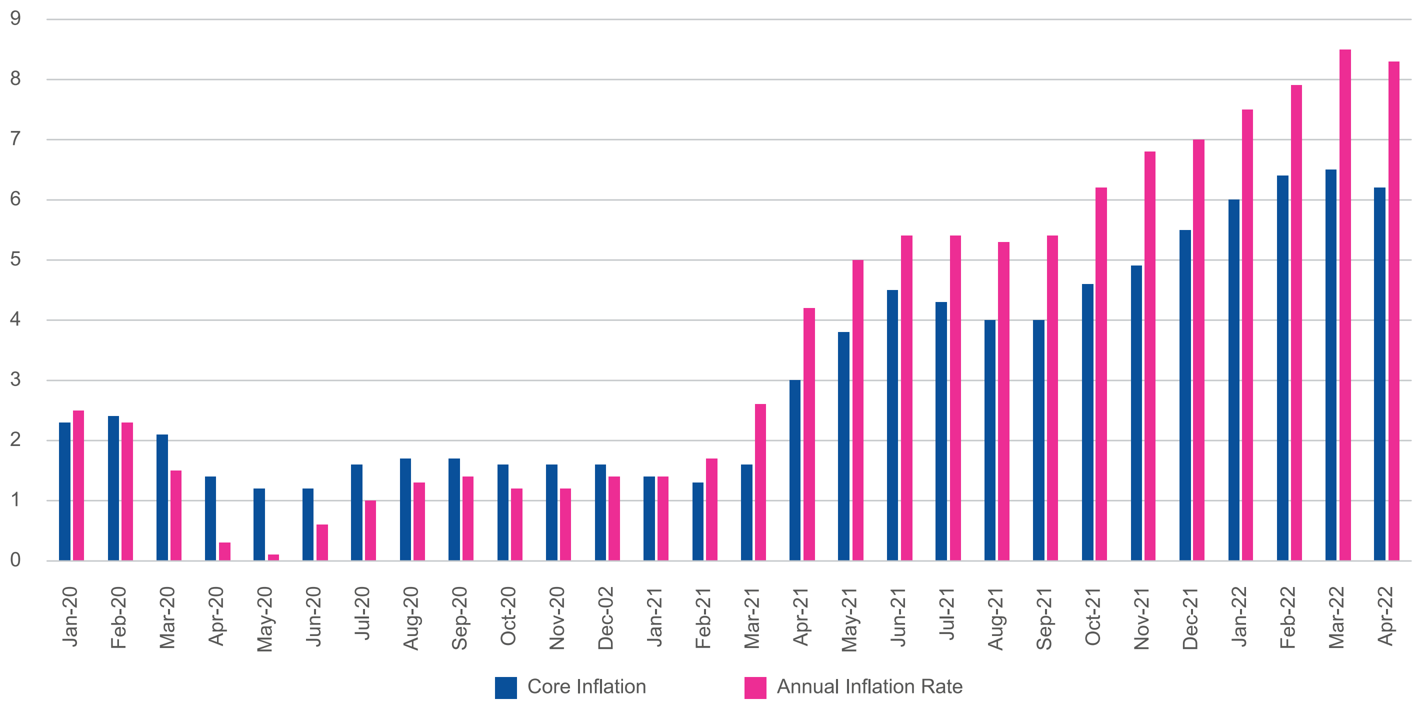


Source: https://www.eia.gov/petroleum/gasdiesel/

The pressure will continue for consumers through 2022 as the global energy trade is disrupted by reactive policy changes and sanctions leveraged toward Russia, a top producer and distributor of energy around the globe. Sanctions leveraged on developers and producers of Russian supplied oil and the banks that fund them will create supply shortages in the U.S. and other regions. Fuel impacts more than the transportation of goods. This elevated cost will impact farmers and food-producing industries as the production cost will rise.

Although continuing its rise, consumer wage growth is being eaten away by inflation in the U.S. Employers continue to offer special incentives for candidates, but the number of open positions significantly outpaces the number of job seekers. People are reentering the U.S. job market, which will continue to push the unemployment rate towards ~4% in 2022. High inflation combined with reduced benefits/stimulus will place millions of people in a tighter fiscal position, reducing their ability to spend. These are near-term risks that will impact consumers' discretionary spending willingness and capacity. This will change the labor dynamics of the U.S. and will create pockets of full employment while other regions struggle to find workers. This means wages continue to rise as employers fight to attract and maintain a labor force for the worker.

Inflation elevated

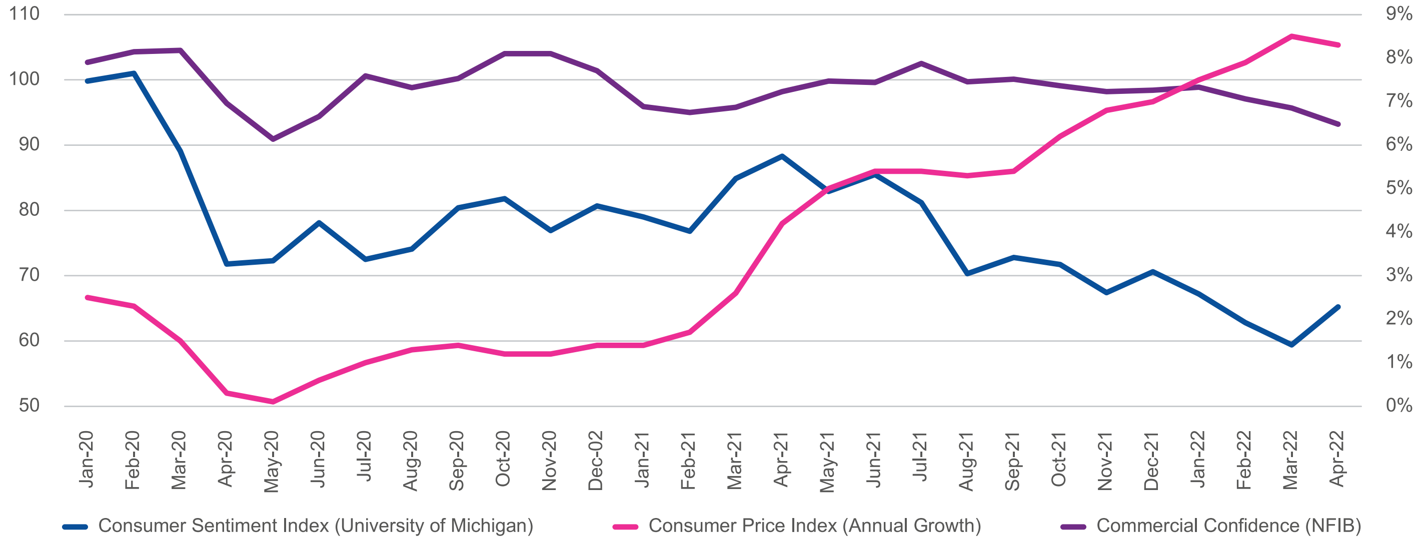


Source: https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.html

Consumers feel the tangible economic strain of rising food and energy costs, increasing at rates not felt since the early 90s. These strains are not felt evenly across income segments in the U.S. Low-income families will feel the brunt of the impact. According to a recent Gallup poll, twenty-eight percent of low-income families, making less than $40k, will suffer severe hardship as an impact of inflation versus 2% for those families making greater than $100k. In addition, low-income families will be spent 40% more on these core expenses as a percentage of core spending as discretionary funds dry up.

Small business confidence is beginning to follow consumer confidence on a downward trajectory. The decline is slow and more in line with market expectations and pressures than consumers, which is unusually low compared to the strength of consumer balance sheets and spending.

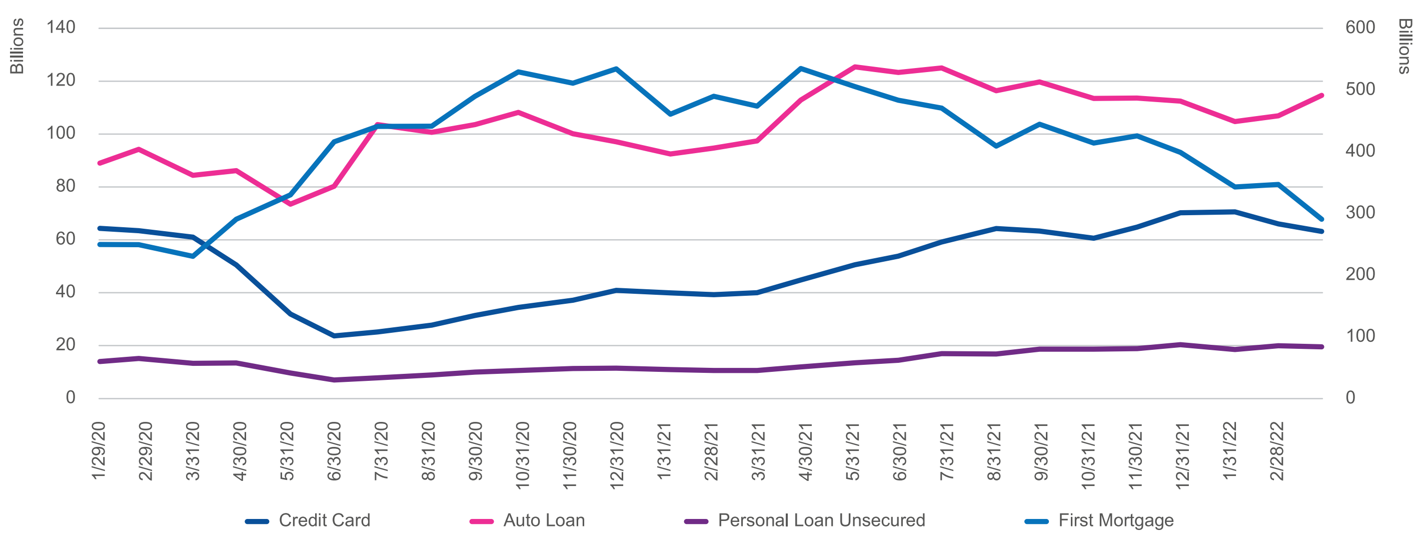
U.S. Consumer confidence at a 20 year low and small business confidence is following



Source: University of Michigan, NFIB, U.S. Bureau of Labor Statistics

Consumer reliance on credit for core expenses will increase with inflationary pressure, and this will create upward pressure on forbearance and modification programs as consumer cash flow tightens. The U.S. market will feel the pressure of supply gaps for inventory creation in the auto industry, keeping demand high but supply very low. The consumer mortgage market will be impacted by higher borrowing rates as the Federal Reserve slows U.S. growth, affordability (At originations and within portfolios), and low inventory. Unsecured lending will see growth as consumers look to credit products to fill cashflow gaps.

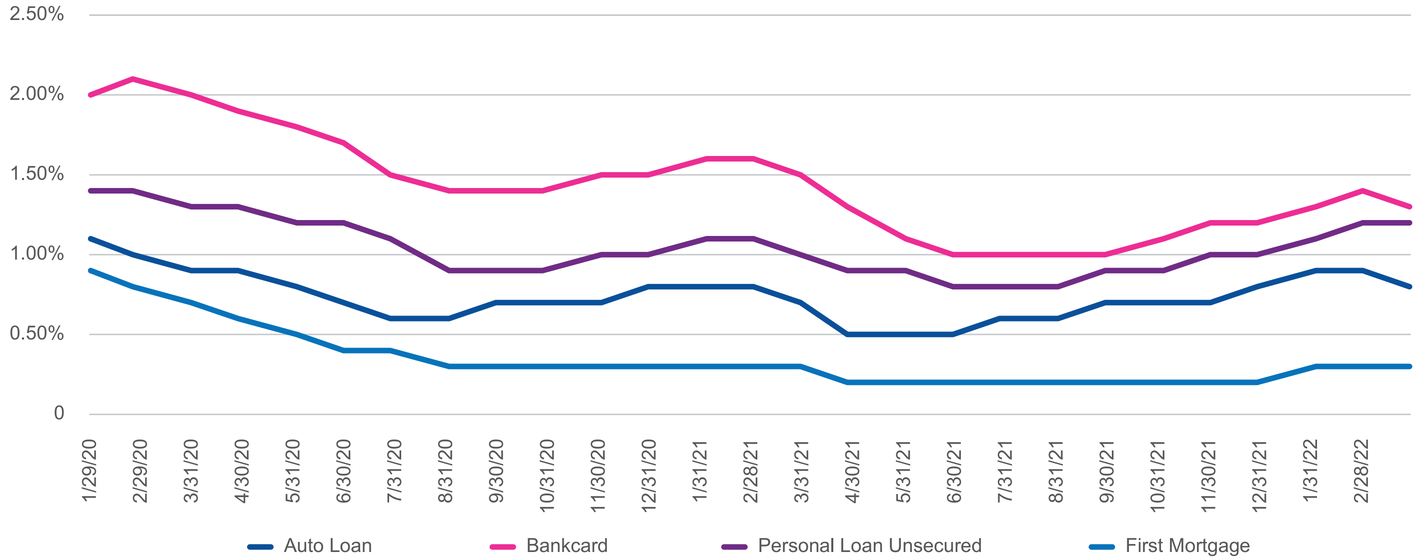
U.S. Consumer lending



Source: Experian

Delinquency rates are rising but remain historically low below pre-pandemic levels.

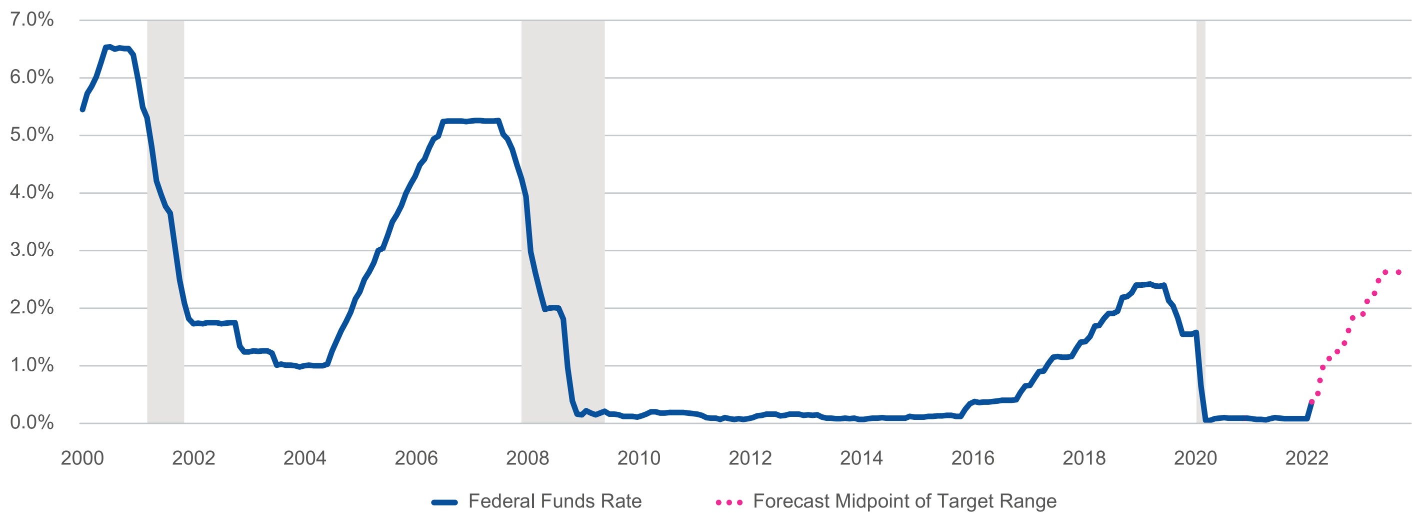
U.S. Consumer % Balance 60+ delinquency rates on the rise



Source: Experian

Federal Reserve actions began in March 2022 to address accelerating U.S. inflation. Rates began to rise at a 50 basis point increments, likely 4-5 times, in 2022. Inflation is expected to be above the Fed 2% target through 2025.

Federal Funds Rate and Forecast

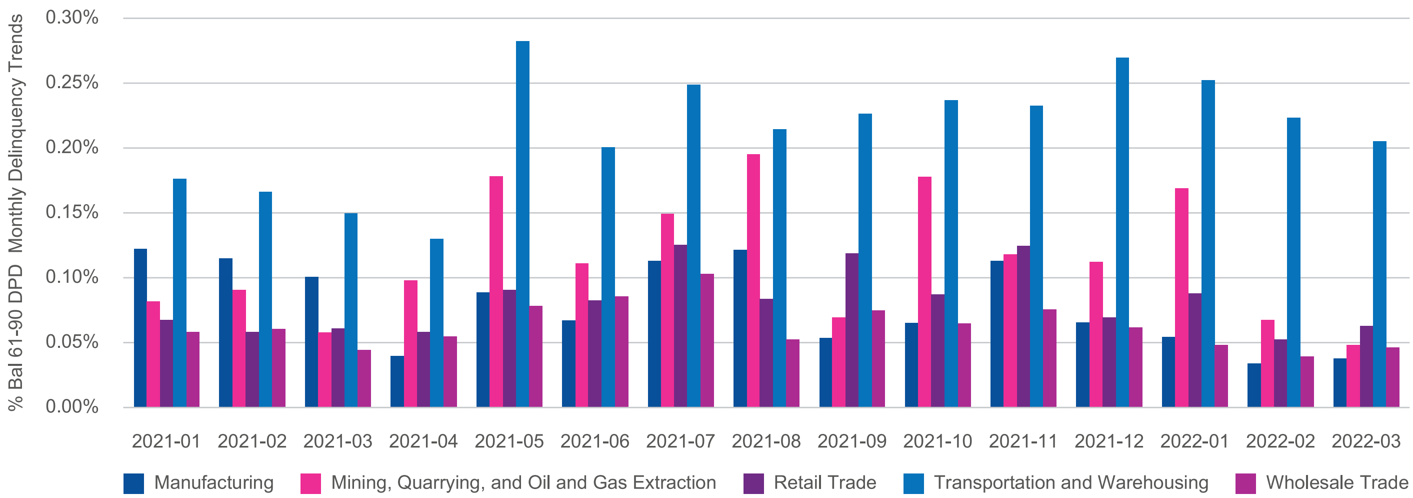


Source: Bureau of Economic Analysis and Federal Reserve Open Market Committee

Consumers need to believe the Federal Reserve's actions will create change in the markets to maintain investor confidence and keep consumer spending. Consumers are very pessimistic about the markets and don't like the inflation pressure. The higher consumer costs are putting downward pressure on consumer confidence. Small business confidence follows close as businesses make future bets on inventory and growth based on consumer demand.

The volatile domestic and global supply chain will continue beyond the first quarter to create cost and availability of product issues for small businesses in the supply chain. From the mining of critical resources to the delivery of final inventory, businesses will feel the squeeze of global conflicts, sanctions, and global U.S. trade policies. Volatility in these industries will persist through 2023.

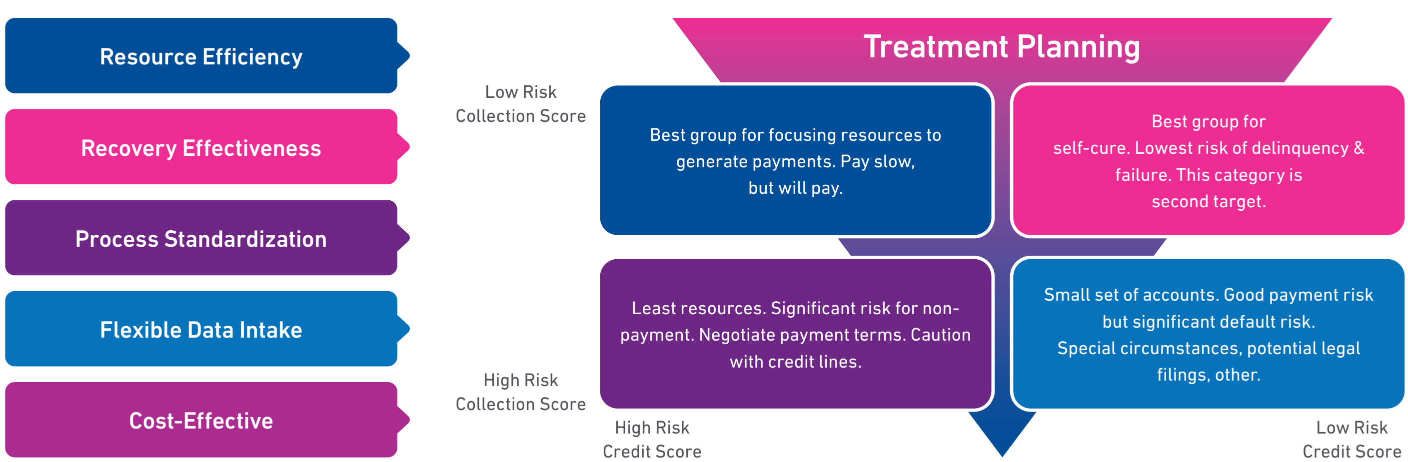
Supply Chain Industry Segment Origination Trends



Source: Experian Benchmarking

Have a plan for a grueling road ahead

Small businesses will need support and guidance as the environment around them becomes more challenging. As costs rise and consumer demand weakens, businesses will begin to make decisions on whom to repay first. Lenders and creditors will be monitoring customer performance and plan pre-treatment and potentially collection strategies for accounts with balances in the arear. Accessing these strategies before the economy begins to slow and small business cashflows are affected is key to customer support and service. Simple strategies using collection scores and commercial credit scores can segment a portfolio into risk and repayment groups where more targeted contact and engagement strategies will improve success and customer experience.



What is around the corner for the pack?

Small business performance was strong in the first quarter as delinquencies remained low. Private lending slowed to small businesses in the first quarter as the 2021 stimulus continues to provide a cushion for cash flow. Risk and costs are being built into 2022 small business strategies as cost pass-through, and products and service price increases are not receiving significant market pushback as consumer spending remains unexpectantly elevated.

Changes are on the horizon. Elevated consumer costs will take a more significant proportion of discretionary spending, which has begun to change consumer engagement with premium products in the 2QTR22. Consumer and small business delinquencies are expected to increase through 2022 driven by supply chain bottlenecks and inflation. Domestic sources will run lean as global shortages will drive U.S. producers to export at a higher rate. Small businesses will experience disruption in their reinvestment strategies in 2022 as commodity shortages, contracting market conditions, and a decline in consumer spend will test investor confidence.

A weak recession in the U.S. is likely as activities by the Federal Reserve focus on slowing a hot economy and cooling inflation velocity. The action viewed as a reset to more normal growth targets for the U.S. and not a reversal of growth, just a slowing and already high-velocity economic environment.

The U.S. remains a beacon of innovation and a bastion for entrepreneurs.

New business applications are trending at almost 425k a month, and nearly 40% of businesses operating in the U.S. are less than 1 year old. To address new small businesses entering the financial market, lenders and creditors will be looking at broader ways to engage these new entities and differentiate risk earlier in the life of a business. They are recalibrating scores and looking at trends to spotlight nuanced signals. 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., and traditional credit data to differentiate the resiliency risk of a small business. Non-traditional data overlays will become critical in assessing and pricing risk in 2022.

2022 will be a reset and growth year for the U.S. market filled with risks and big opportunities.

Help to clear the course for the marathon!

About the author

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Brodie leads a team of statistical consultants, scientist, modelers, and engineers with diverse skills to provide clients with leading edge analytic-driven information solutions, services, and visualization of actionable insights. His is an industry expert, who speaks on behalf of Experian at industry conferences.

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