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Beyond the Trends

Understanding the Commercial Economy

Winter 2023

experian

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.

A small business New Year's resolution

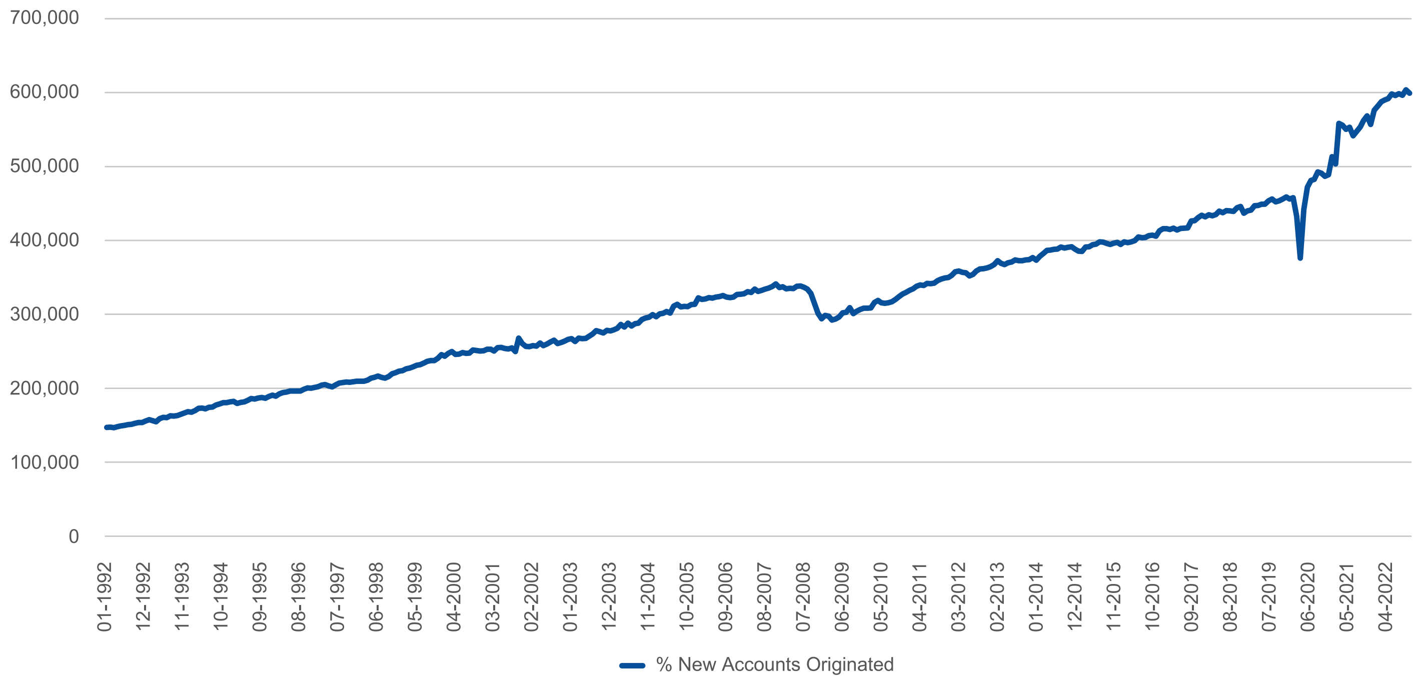
Small businesses' health and performance in 2022 was strong as consumers spent beyond their means, to prolong demand behaviors learned in an economy overflowing with stimulus, coming out of the pandemic where personal savings was running lean. In 2023 small businesses' resolution will be to prepare for higher costs and contend with consumers who are tightening their belts, as macroeconomic pressures squeeze their ability to spend. The pandemic-induced consumer savings buffer is exhausted for the lowest income segments, as consumers use savings to cover fixed expenses and discretionary spending activity that inflation-cramped wages cannot cover. As a result, small businesses will take stock of short-term funding and look at ways to survive a bumpy 2023.

The insights shared in this report 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.

A resolute small business lender will watch market factors such as labor, wages, increasing costs fueled by inflation, universe expantion, and delinquency trends as small businesses continue to invest as consumer spending remains strong. In addition, growth will be a target for small businesses as consumer cash flow continues to be stable.

The 2022 holiday shopping season saw holiday **spending increase by 7.6% YOY, according to Mastercard**, as consumers kept their discretionary spending for goods and services heightened.

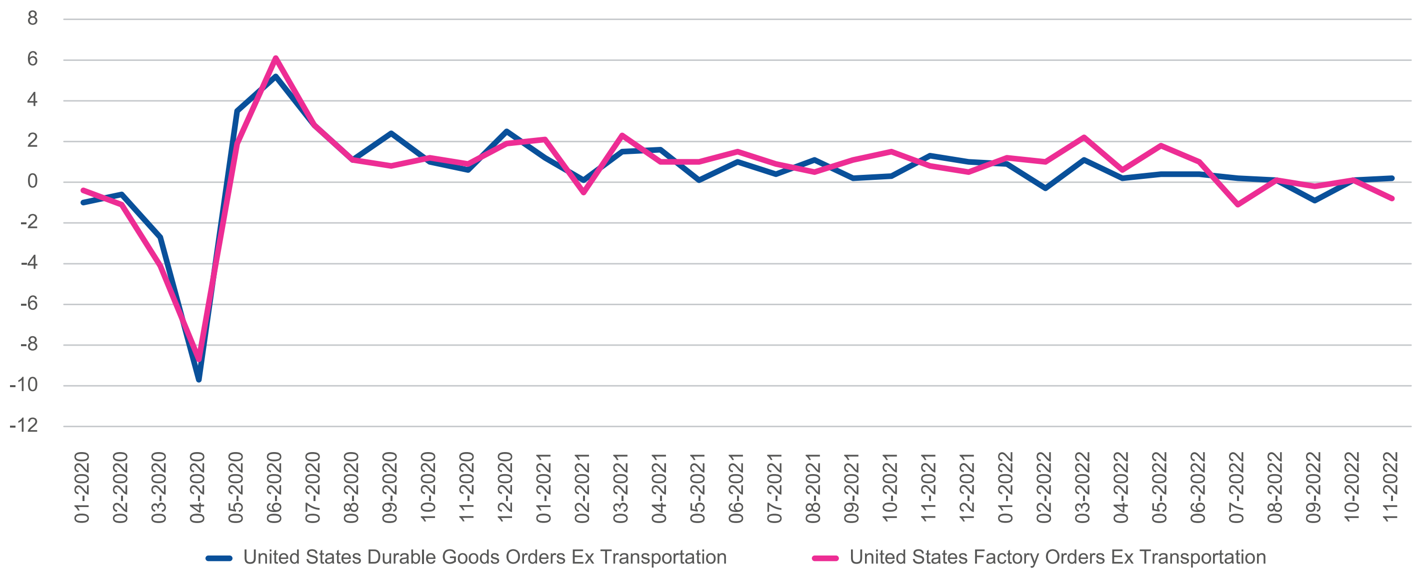
Change in Retail Sales Month over Month (Advance Retail Sales: Retail Trade, Millions of Dollars, Monthly, Seasonally Adjusted)



Source: https://fred.stlouisfed.org

This spending increase does not mean that consumers bought the same volume of goods. This trend is driven by fewer in cart items purchsed at a much higher price. Most industries had an ample supply of products and services online in preparation for this excess spending period. More sales were expected than were seen during the holidays as retailers held onto stock to take advantage of inflationary pricing and margin into 2023.

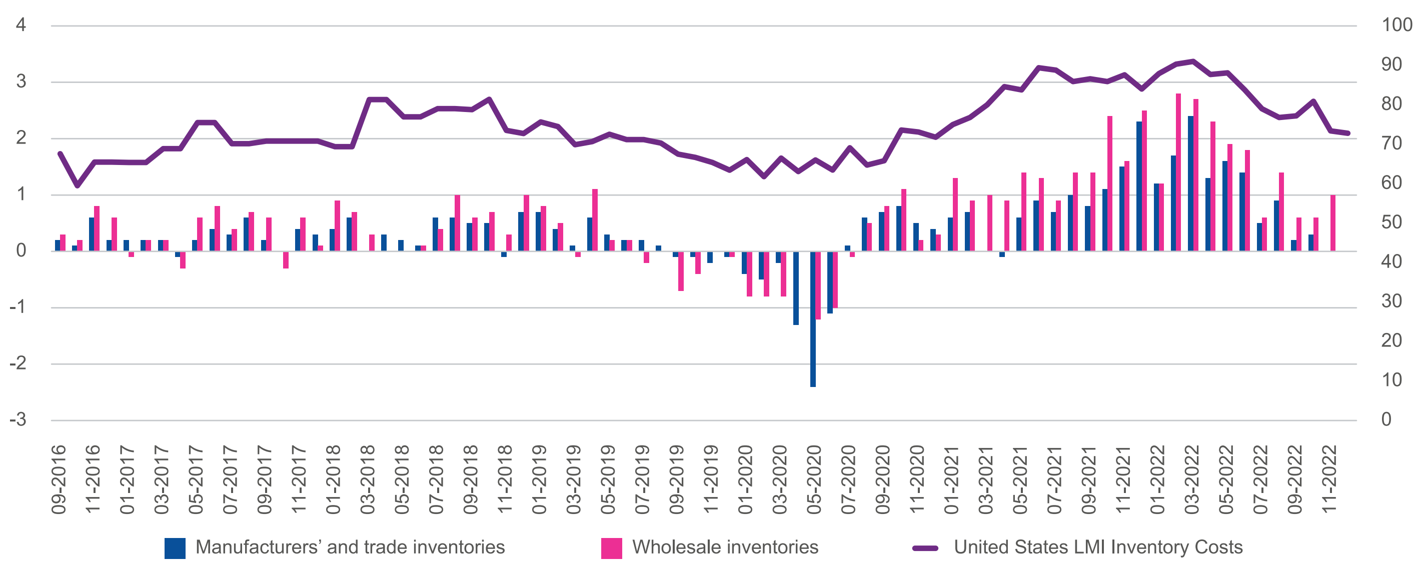
Orders and inventory demand weakening with softening consumer demand



Source: U.S. Census Bureau

Small businesses slowed orders due to softening demand for the volume of goods sold compared to prior years, which drove down logistic costs. This trend is expected as the Fed's activities begin to cool the demand side of the economic cycle.

Inventory costs follow consumer demand

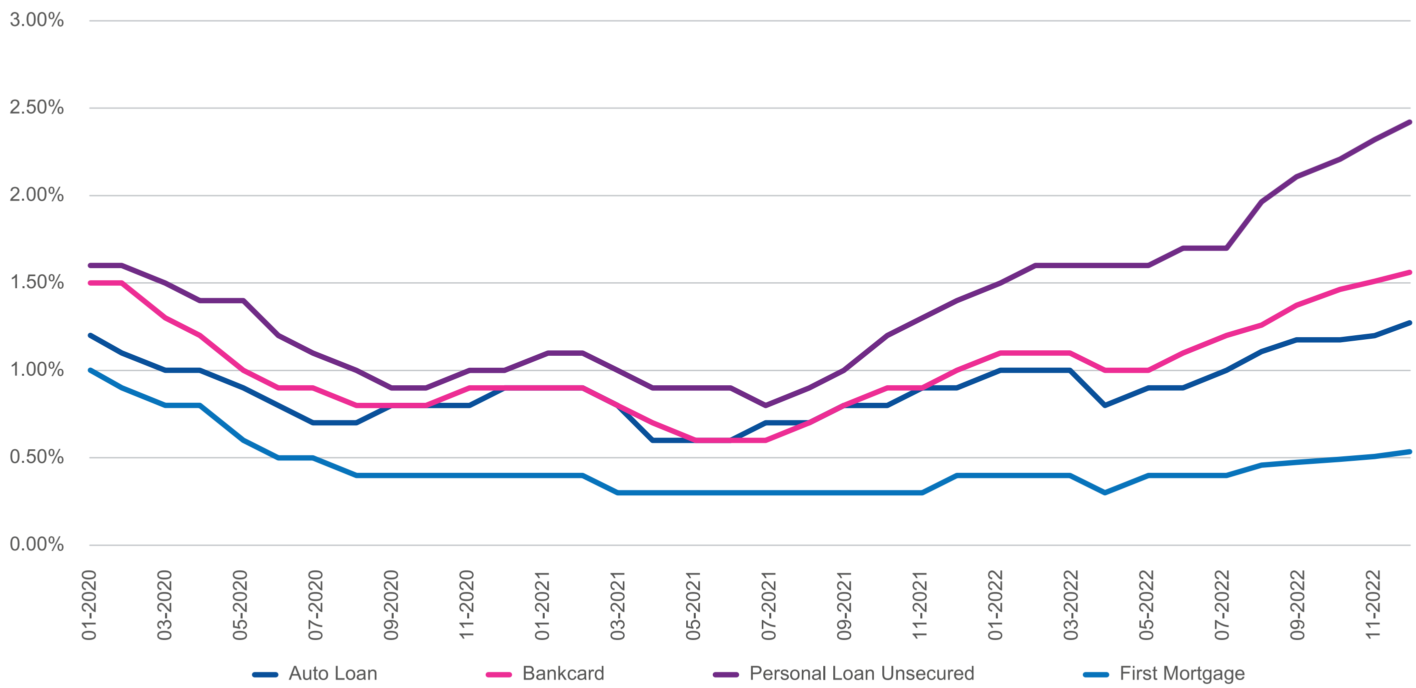


Source: Logistics Managers' Index

Shipping costs plumited 28.4% YOY (Logistic Managers Index) as fuel prices drops, factory orders fell .8% due to bloated 2022 pre-emptive inventories, and commercial warehouse space began to open as retailers utilized bloated inventories to fill shelves and held off on new orders as higher prices slowed the number of units moved. As retailers tighten their belts in expectation of economic instability in the short run, they will use 2022 pre-order inventory to support sales in 2023.

The U.S. economic environment for growth has been strong as pent-up spend, limited by access and supply chain disruptions, exaggerated consumer behaviors pushing spend in the direction of want versus need. Small businesses and consumer savings buffers shrank, created upward pressure on utilization. **Consumer credit overall decreased 16% month over month** in the fourth quarter as delinquencies climbed as mortgage markets continue to slow. New unsecured credit card debt rose 4% as thin consumer savings forced more debt to the consumers credit card. These trends are encouraging in the short term as unemployment rates remain low. However, other factors beyond employment impact the consumers' ability to repay debt, creating rising product delinquencies.

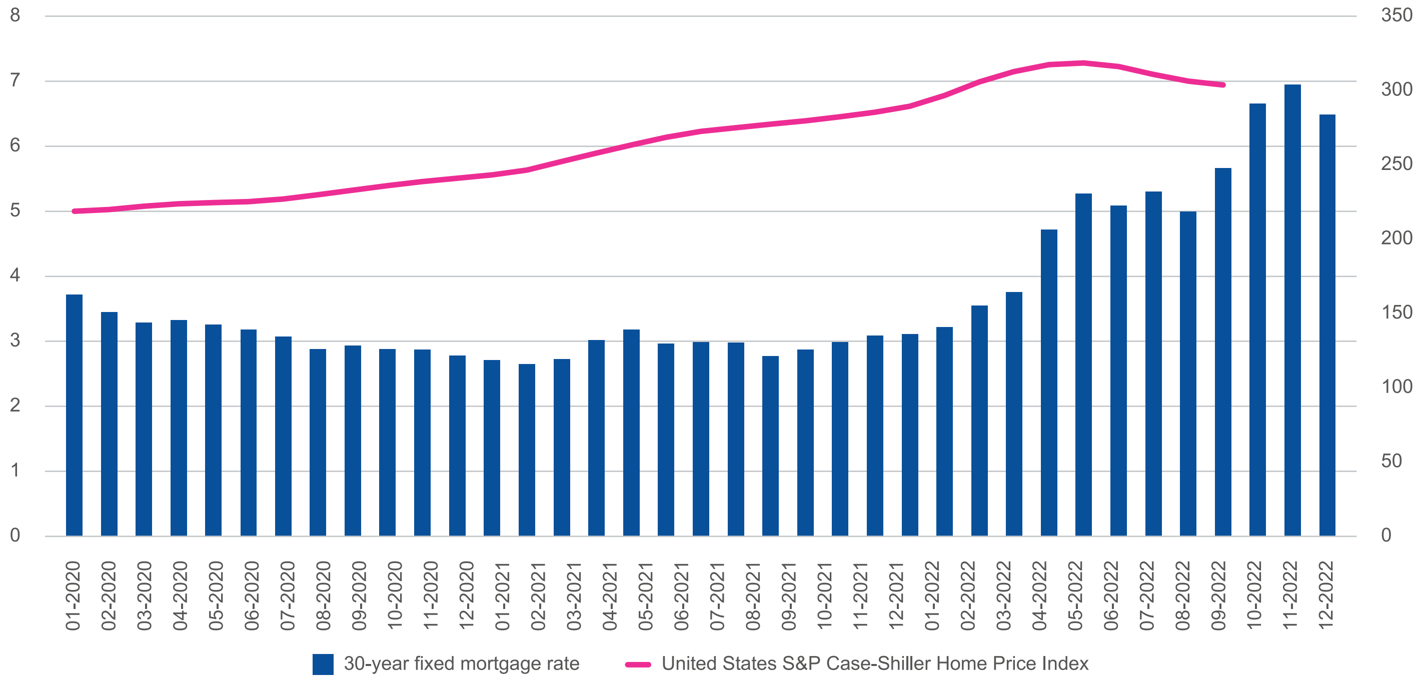
Consumer delinquency rates on the rise (U.S. % Balance 60+ delinquency rates on the rise)



Source: Experian State of Credit

Credit cards and installment-type loans are still readily available in the market. However, small businesses are utilizing these forms of credit as the use of available asset equity becomes less attractive in the coming months. For example, business owners will often use the equity built up in their personal homes or other assets to draw on when cash flow slows.

Home prices are falling, putting pressure on the amount available to cash out



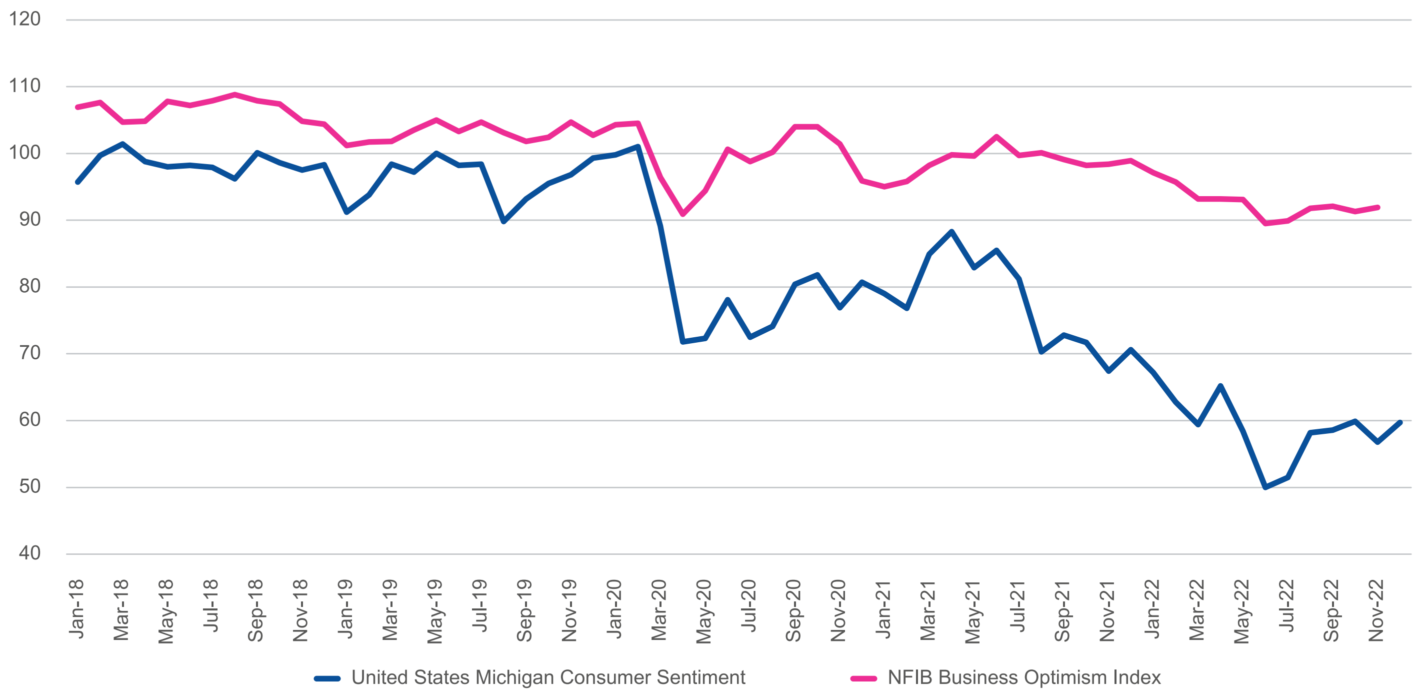
Source: Kay Schiller Index

As the market rate increases for these types of cash-out funding opportunities, small business owners will find this old behavior too expensive as an emergency cashflow option.

The Federal Reserve current dominant objective is to control inflation at all costs. They find the new year remains in a similar state to the position it was in several months prior, heightened inflation and a strong labor market. This state of the U.S. market will present the Fed with signals to pressure them to continue to pull interest rate levers and resolve to continue their lean into inflation. Consumers need to believe the Federal Reserve's actions will create change in the markets to maintain investor confidence and keep consumer spending to soften the slow down targeted by the agency.

Consumer vs Commercial Confidence

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



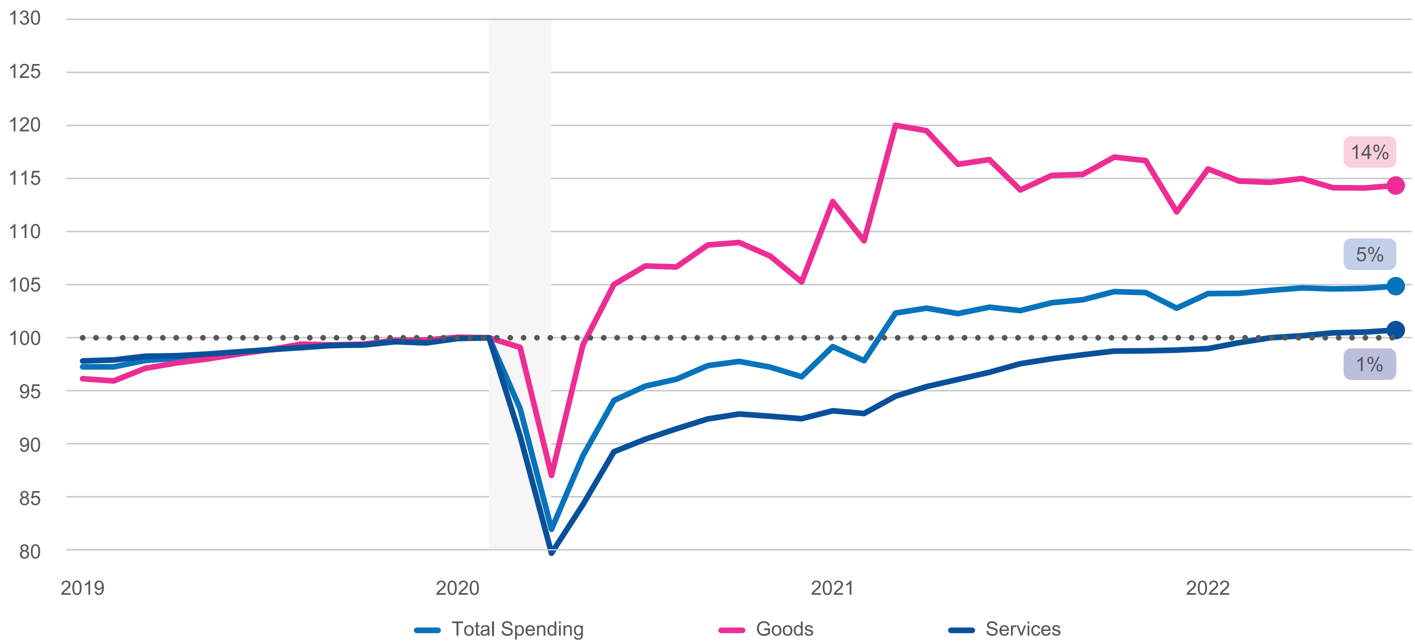
Source: University of Michigan, NFIB, U.S. Bureau of Labor Statistics

Consumer reliance on credit for core expenses has increased with inflationary pressure throughout the holidays. Consumers have seen recent relief in energy prices for gasoline and natural gas, but that relief was eroded by higher food, shelter, and reassumed debt obligations from the pandemic payment holidays. A segment of consumers with student loan debt on the verge of forgiveness may need to begin paying again on that debt if the program is withdrawn. The higher and in some cases unexpected consumer costs will put downward pressure on consumer confidence. Small business confidence follows close as businesses make future bets on inventory and growth based on consumer demand. Over the past few months, both consumer and commercial confidence have improved, but that improvement is slow as inflation persists and purchasing power weakens.

Reality check for consumers as holiday shopping bills arrive

Consumer will start receiving their credit card bills from the holiday binge and will look at the new year as a reason to reassess their credit behaviors and begin to tighten loose monetary behaviors picked up in a post pandemic revenge spending environment. The weakened consumer savings rate and affordability pressure felt by consumers on their favorite guilty pleasures will continue to add downward pressure on confidence. The weakening in confidence has historically been followed by a decline in spend behavior. For consumers, it meant changes in spending on premium products with discretionary dollars. We are seeing consumer spend plateauing in the final two quarters of 2022 signaling a change in behavior.

Consumers spend



Source: Bureau of Labor Statistics, Bureau of Economic Analysis and Author's Calculation

Small business resolution in 2023: Retailers will fight for consumer spending, but consumers will find their purchasing power limited as interest rates increase and assumption of unexpected debt payments. U.S. small businesses are already facing an extended period of higher costs and weakening demand. All eyes will continue to focus on the Federal Reserve's actions to slow U.S. economic growth, fueling small business development. The focus will be on cooling inflation in the next few years. **Lenders and creditors will need to assess how they will respond to struggling small businesses in 2023 as consumers tighten their belts**.

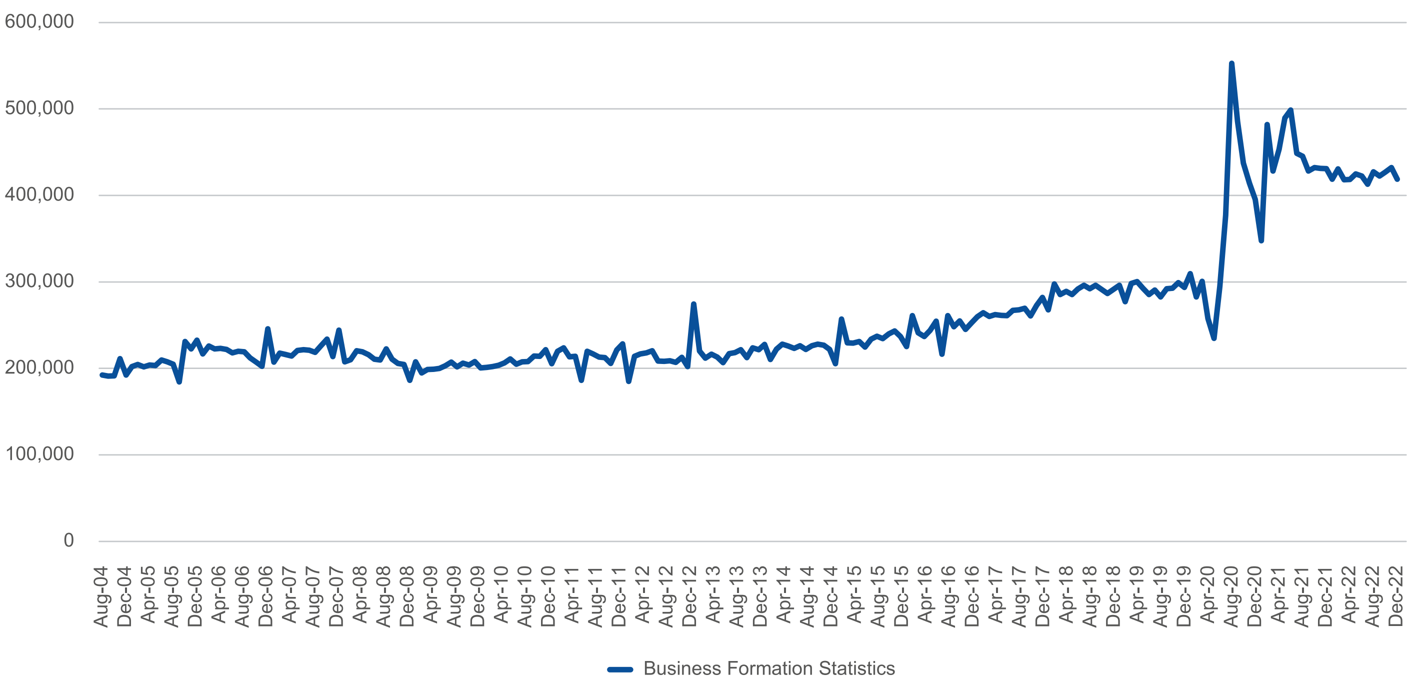
The mix is different, but the importance of small businesses will be evident in the new year?

Small businesses in the U.S. (31.7M 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 58 million people in the U.S. according to the Small Business Administration. They generate almost 1.5M new jobs annually, and a large portion of this job growth comes from companies with less than 20 employees. 67.6 percent of newly established businesses survive at least 2 years. Small business survivability improved during the pandemic due to an increase in SMB emergency stimulus available.

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, greatly influence the health and growth of the U.S. and the global economies they serve.

New small business creation remains elevated, but a prolonged high inflation environment has already begun to cool new entrants into the market. We will see elevated trends in new business applications as new year layoff activity, in preparation for a 2023 downturn, releases skilled labor into a market filled with recessionary safety net programs. These programs will create an environment primed for new business investment with heightened survivability.

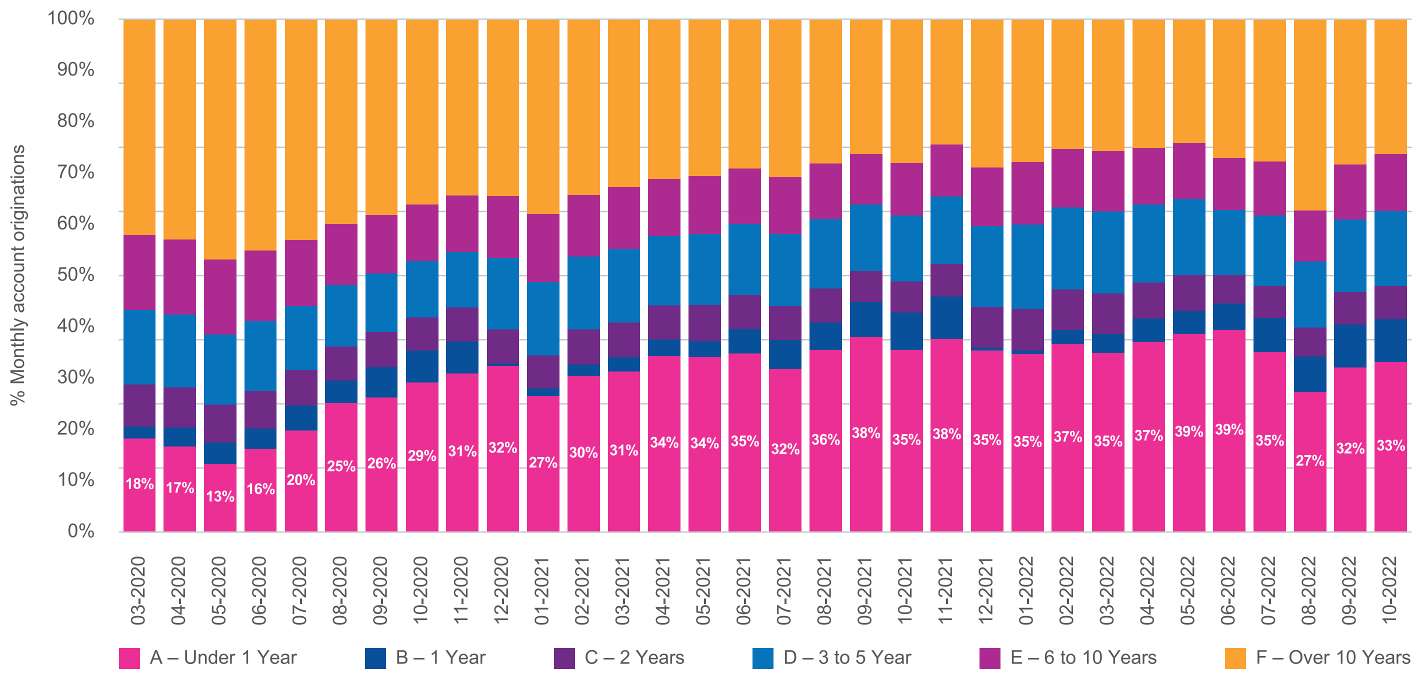
New business applications in the U.S.



Source: Census.gov

Retail continued to be the leader in the types of new businesses opening in the U.S. This industry had the most new business applications. Overall new business applications have slowed in the past few months but are still elevated significantly over pre-pandemic levels of opening. This explosion of new business starts during the pandemic has changed the landscape of commercial lending. Almost 33% of businesses in the market have been open for less than one year.

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. Expansion of SBA lending programs and pandemic protection stimulus programs provided initial protection to companies as they developed over the past two years.

Small business behaviors will begin to reset: 2023 will bring continued higher-than-target inflation and softer consumer goods and services spending. Privately sourced commercial credit will be harder to acquire as businesses struggle to keep consistent positive cash flow. Small businesses will need to be prepared to weather this leaner environment without the support of stimulus as consumers slow their discretionary spending behavior in preparation for market volatility that will impact employment and demand.

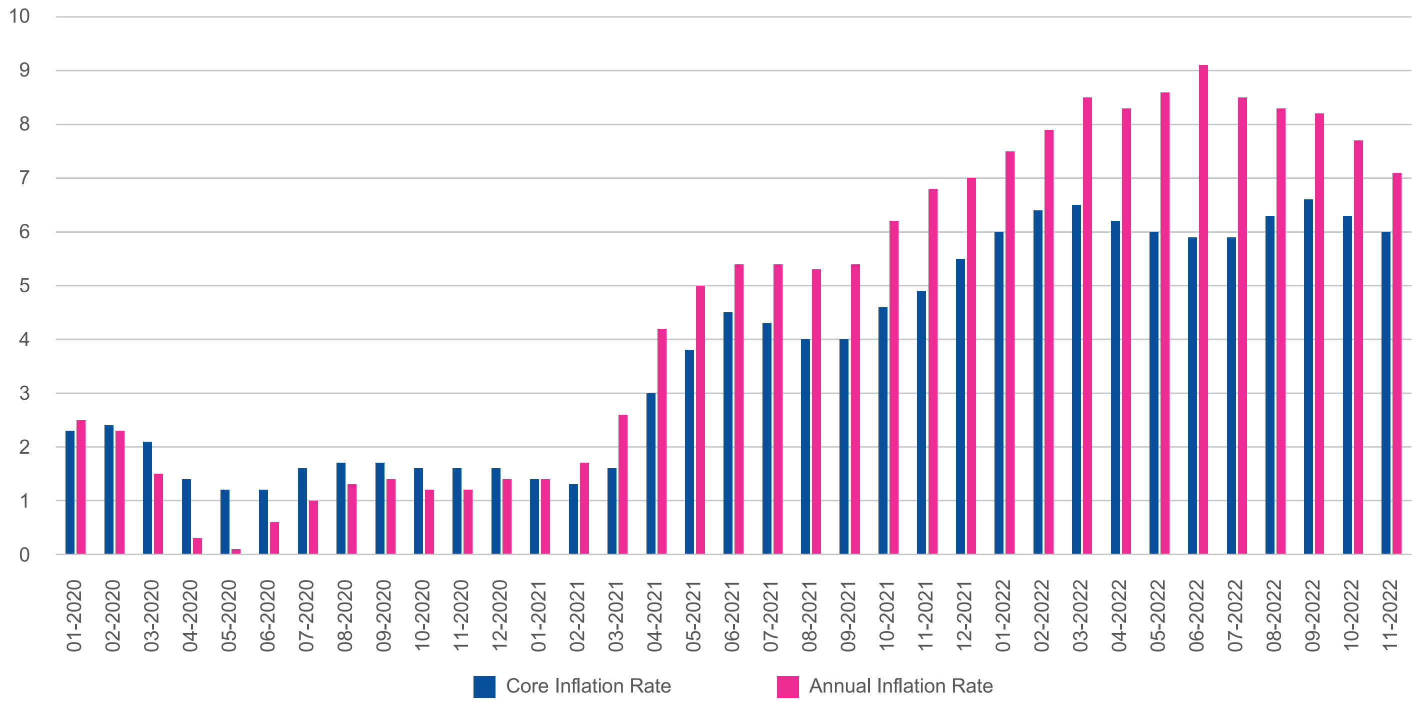
Wholesalers and retailers have been stockpiling inventory since early 2022 to prevent shortages and the risk of disenchanted customers, but disenchantment will be less of an issue than consumer spending power evaporating with prolonged inflation. The elevated level of preordered products is already hitting manufacturing as the orders slow due to bloated inventories and less need to preorder, even as the U.S. supply chain finds some late traction. The hold over and use of 2022 unsold inventory will soften new order demand. Manufacturers have been seeing the buy signals of customer slow amid the holidays. Those high-demand days are ending as the Fed works to slow consumer demand.

Lenders are preparing products and portfolios for volatile markets

Access to funding is critical for small business growth. Unfortunately, the price of funds is rising as the Federal Reserve continues to aggressively control inflation velocity in the U.S. Commercial lenders see the costs of funds rising and are beginning to pass that cost along to customers through increase APR on unsecured products and risk adjusted terms for longer term installment products.

The Federal Reserve will continue to raise rates if inflate on remains above target.

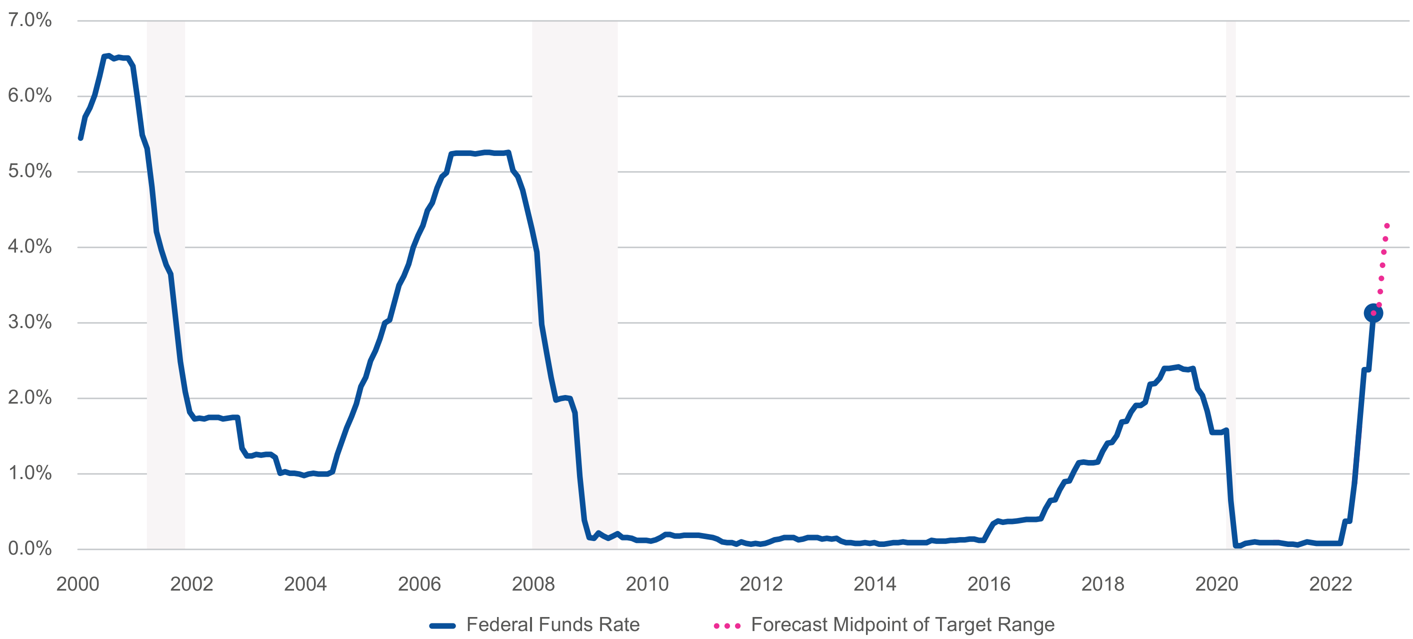
Inflation elevated (Core and Annual Inflation Rate)



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

Federal Reserve actions began in March 2022 to address accelerating U.S. inflation. As a result, rates began to rise at 50 basis point increments and continued to accelerate with additional 75 bases point hikes into the 4th quarter of 2022. The U.S. is beginning to see relief in inflationary pressure since the Fed began its activities, but the economy is not reacting as quickly to their efforts as hoped. The Federal Reserve will continue, in the new year, to be resolute in its directive to reduce inflationary pressure on the U.S.Economy. What does it mean for interest rates? They will continue to rise, but resent success will mean the Fed will have flexibility in the speed and extent to which rates rise before inflation returns to a more acceptable long term level.

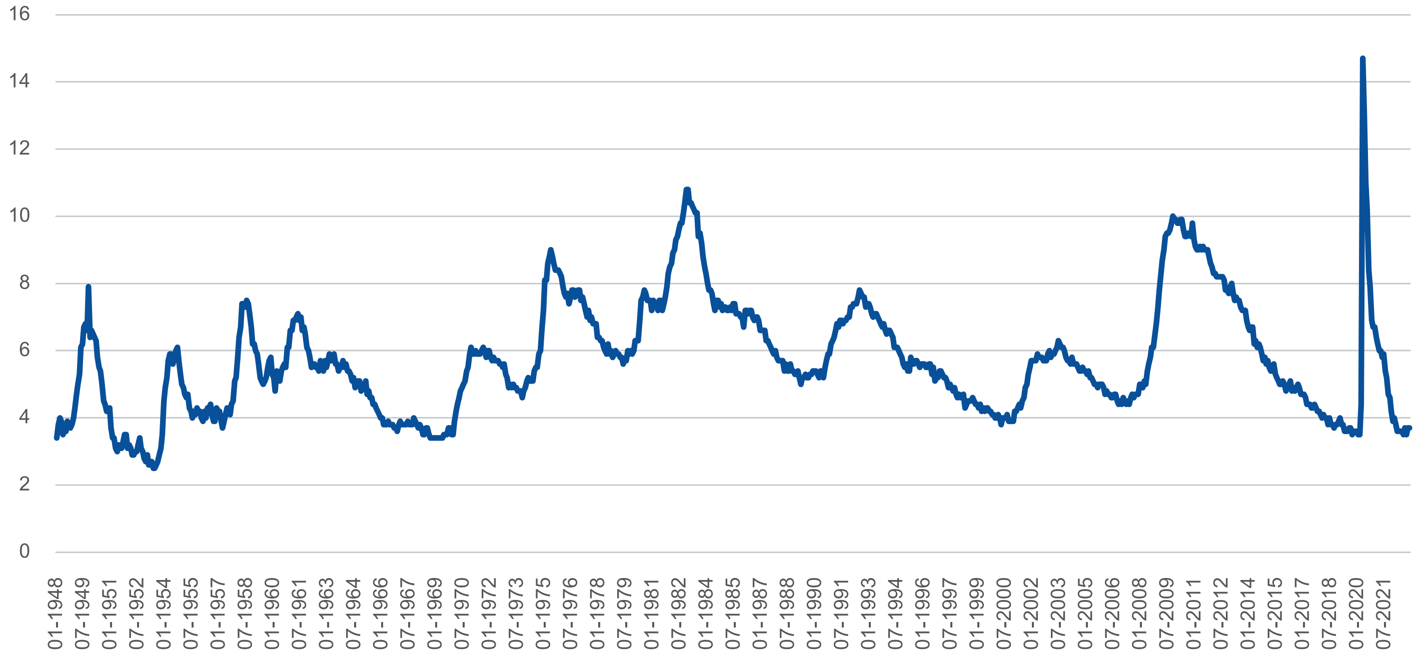
Federal Funds Rate and Forecast



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

This intervention activity is expected to continue into 2023, as the U.S. labor market continues to remain strong.

Unemployment rate



Source: U.S. Bureau of Labor Statistics

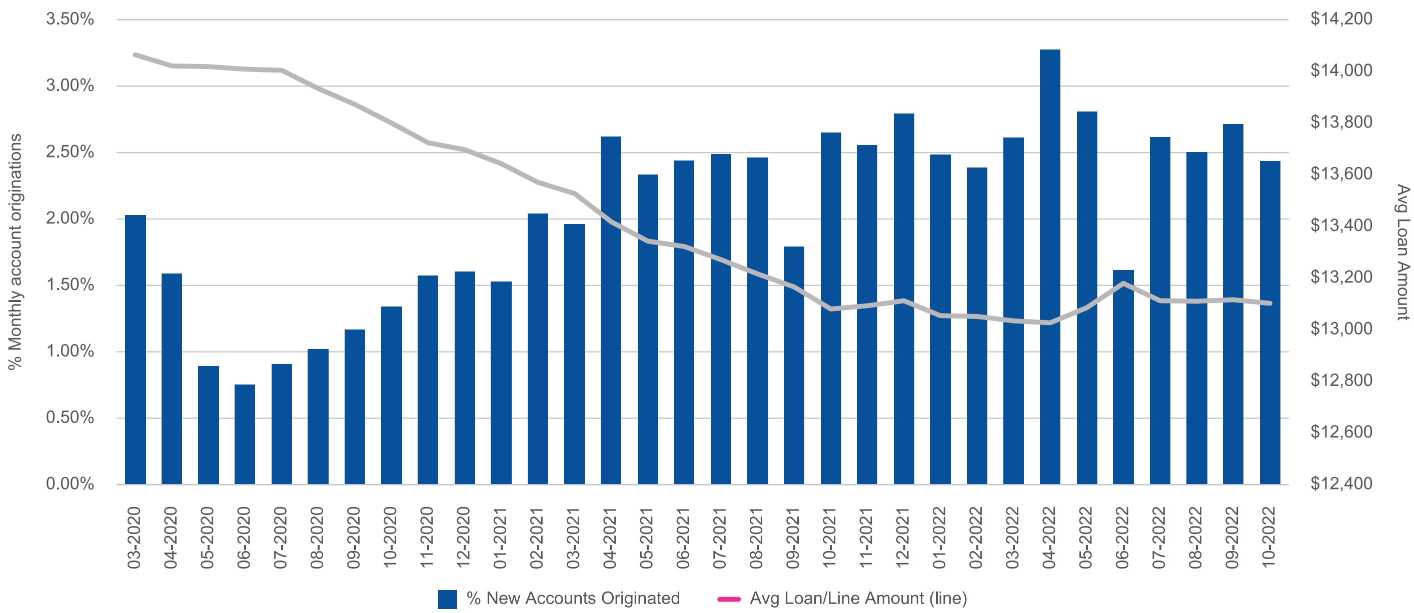
A softening labor market, in the first quarter, will provide feedback to the Fed that their activities are beginning to have impact on the market. They are focused on a target goal of between 2-3%. Market conditions and current signals point to improving global economic conditions spurred by milder winter scenario in Europe lowering energy costs in the region, Asian economies led by China's reopening getting back to business, global pandemic numbers low, will lessen the severity of global recession.

U.S. consumers will still be under the weight of elevated shelter, food, and energy costs that will not dissipate quickly in the new year. Even with the U.S. Federal Reserve actions, inflation is expected to be above the Fed's 2% target through 2025.

Small businesses reevaluate their safety net in the new year

Commercial lending has been accelerating through 2022 but has seen cooling in the 3rd quarter as small businesses access their short-term outlook. Unsecured debt product engagement trends are a good leading indicator to the health of small businesses.

Unsecured commercial credit softens



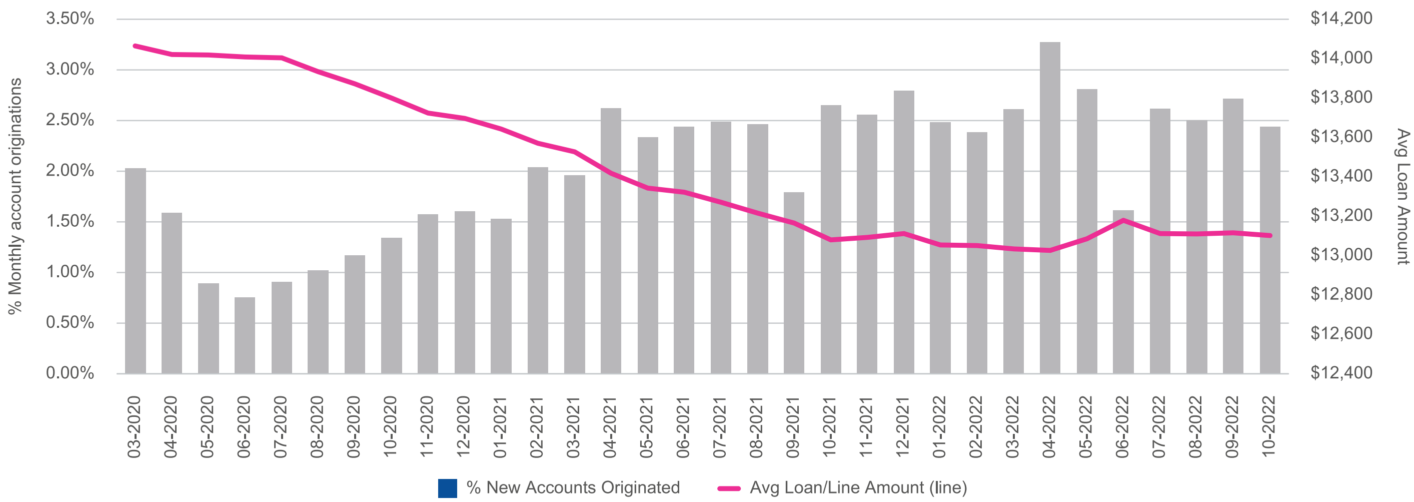
Source: Experian Commercial Benchmark

Originations have been accelerating through 2022, but in the last few months, are stalling as established small businesses rethink their growth strategies, as consumer demand weakens, and look to hold off on taking on new debt focused on investment and growth. New small and micro businesses will be a larger percentage of the credit seeking population in 2023, as the levers these emerging businesses have at their fingertips during lean time are more limited.

Commercial lenders will have a hand in the economy slowdown in 2023. As the Fed begins to cool the economy, many small businesses will not be able to absorb the increase in the cost of doing business. As small businesses run lean on cash flows, they will seek credit at a higher rate. Experian saw a **61% YOY increase in the percentage of high risk credit inquiries with emerging business seeking credit up 78.5% YOY with limited commercial credit history** in the 4th quarter leading to lower-than-normal average credit lines across the industry.

This means that higher-risk companies are feeling the pressure to seek credit before credit markets tighten. The decrease in the average credit line for unsecured debt is also driven by the high number of new small businesses in the market across the credit spectrum, presented with lower initial line amounts due to their available credit history.

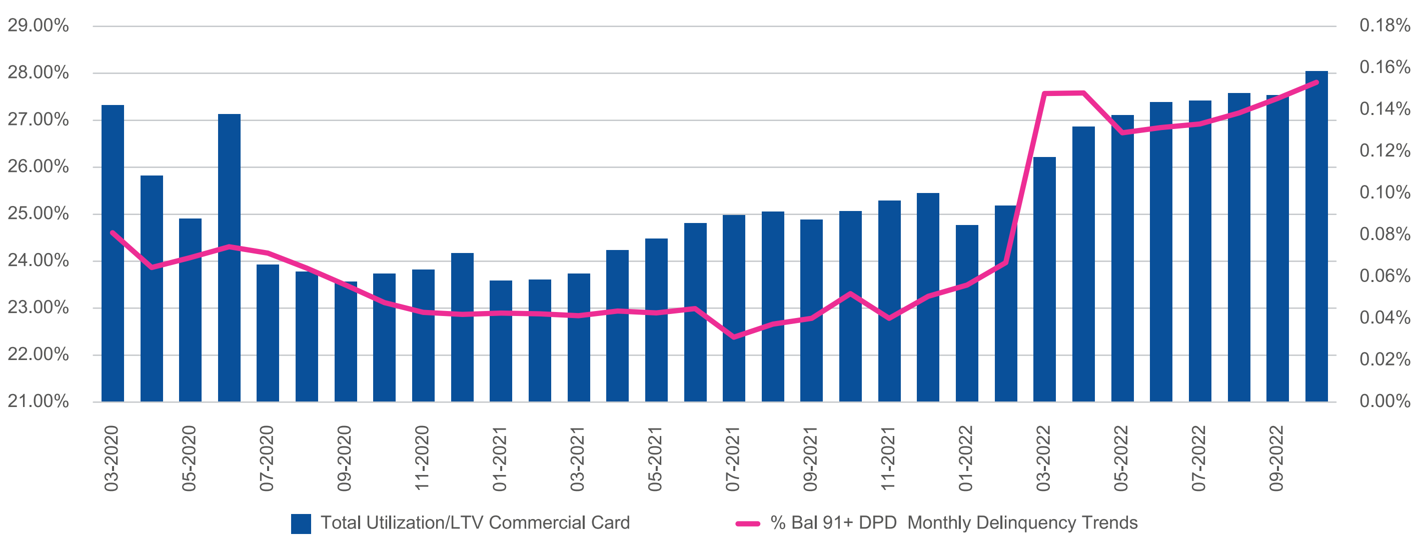
Unsecured commercial credit lines feel the pressure of new businesses



Source: Experian Commercial Benchmark

Lenders have been noticing utilization and delinquency increasing across products and industries.

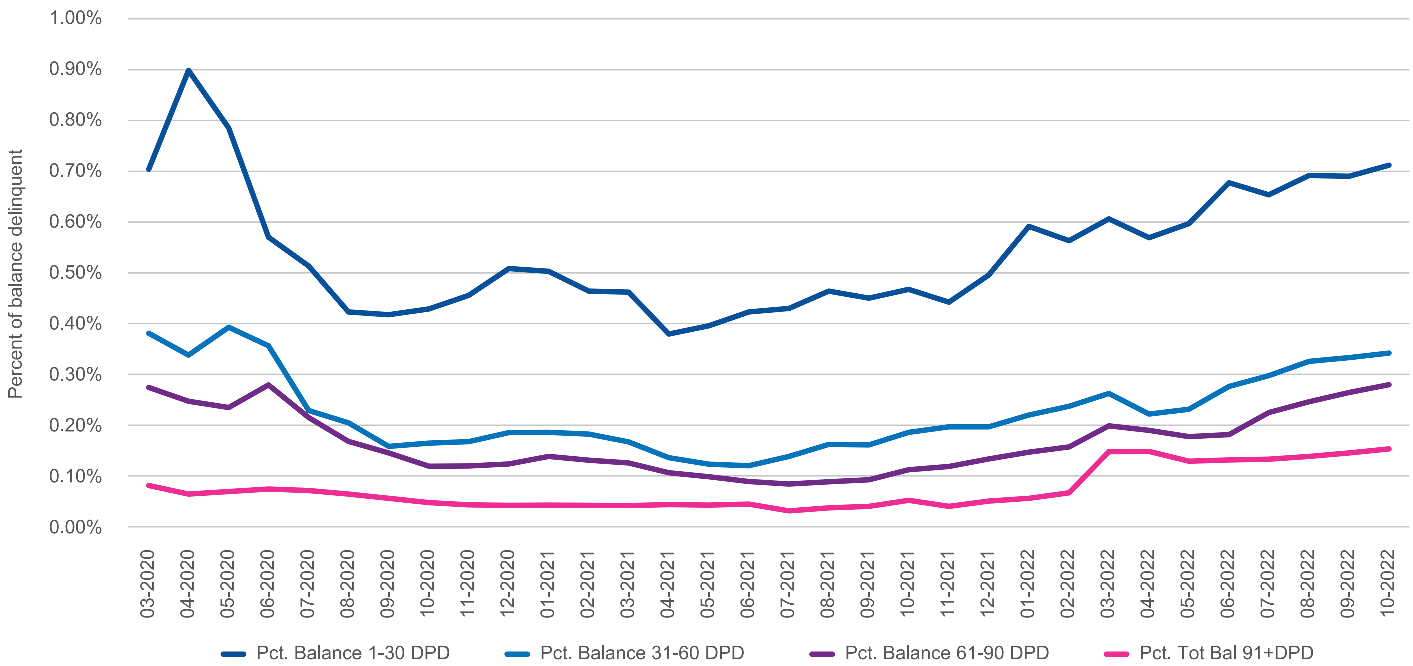
Relationship between utilization and 90+ delinquency



Source: Experian Commercial Benchmark

Even though commercial delinquencies and utilization are rising, in context, they are still seen as being historically low. As we enter 2023, the velocity of increase is moving beyond prepandemic levels. Good capitalization, aided by stimulus and short-term payment relief, kept higher delinquencies in check throughout the prior year. That behavior will change as utilization approaches 30%, and businesses struggle to find additional sources of funding to buffer cashflow losses. One day to sixty day delinquencies will rise, with more sever delinquency buckets, 90+, holding onto lower level as credit markets remain accessible.

Volatility in delinquency rates unsecured card (Rolling buckets)

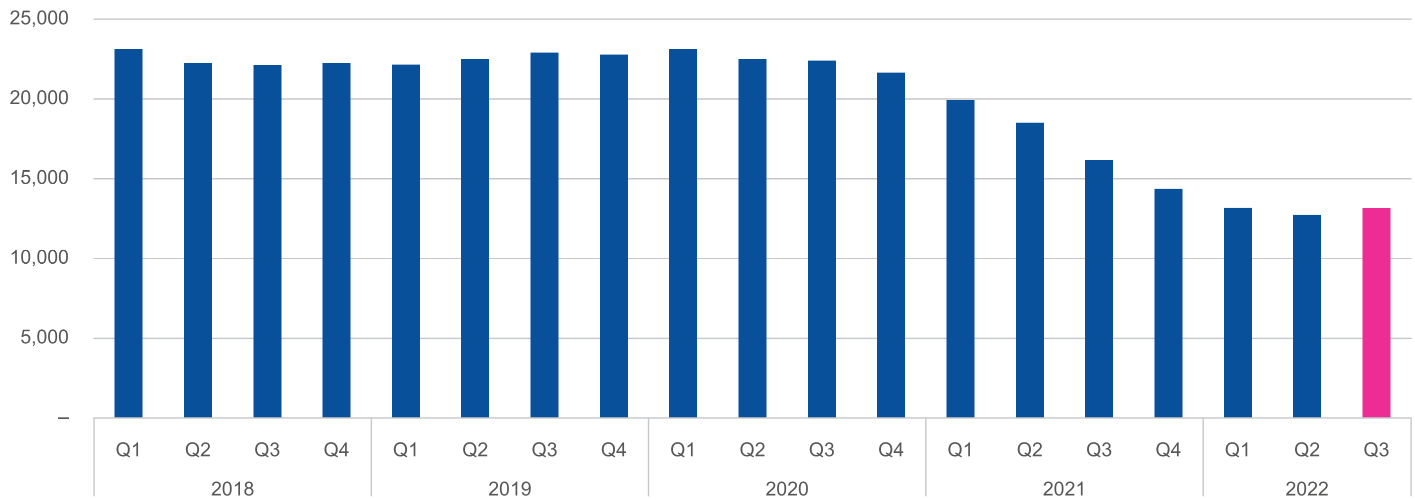


Source: Experian Commercial Benchmark

This view of delinquency behavior highlights business's ability to make strategic repayment decisions by delaying repayments but not allowing them to roll into later-stage delinquency buckets that activate collection and litigation by lenders. As a result, if the 90+ remains low, private commercial funding will remain open.

Those balances rolling into the later stages of delinquency and bankruptcy remain low and are not significantly impacting markets.

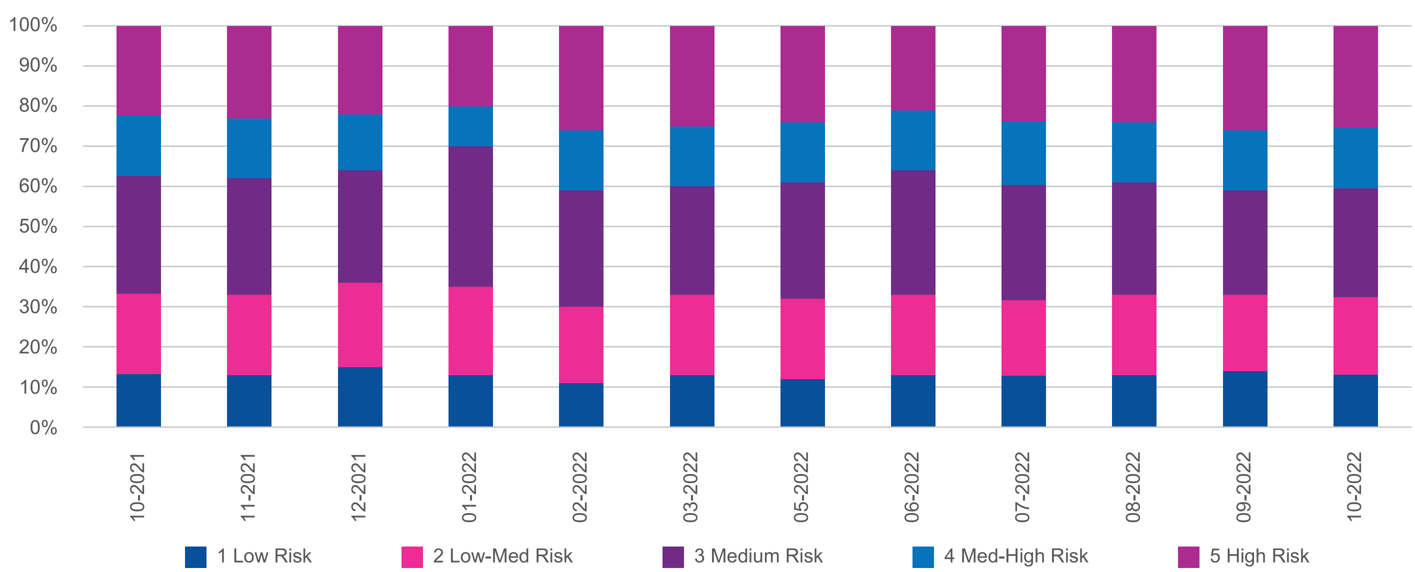
Small Business Bankruptcy rates remain low (Bankruptcies Trend – Chapter 11 & 17)



Source: Administrative Office of the U.S. Courts

Lenders surveyed in a recent SLOOS report more than 33.4% said they were already tightening credit criteria, as well as Experian client feedback, provide insight into the new year portfolio exposure reviews and preparation of recession underwriting adjustments for a tighter commercial credit environment.

Commercial credit tightening? Not yet



Source: Experian Commercial Benchmark

Small businesses and market investors will watch how lenders handle increasing delinquency pressure in their underwriting of new debt to continue growing as the U.S. and global economies slow.

Where do lenders adjust when small business cashflows weaken?

Small business lenders will focus on four critical areas in the coming months to ensure their businesses remain stable and continue to grow.

- Market expansion
- Deterring fraud
- Limiting portfolio exposure
- Developing loyalty among profitable customers

These key pillars are important as small business cashflows tighten and margins are squeezed. As a result, lenders will embrace these targets to create strong portfolios and stabilize the U.S. market.

Resolve to grow through market volatility

As the market places higher confidence on the Fed's ability to guide the U.S. to a soft landing, growth remains a firm focus for U.S. commercial lenders. Evaluating new market segments is a focus of any growing business, but this activity is even more critical as the market slows. Branching into a new customer segment can be tricky, as the goal is to expand your marketable population while maintaining or reducing the exposure. This can be accomplished through market data visualization called "Expansion benchmarking" to identify populations that look similar to you current customers and test into the profitability of these new market segment.

Lenders will need to update new year behavior to include regular review of underwriting policies. A review of underwriting rules and in-house policies can be a wake-up call to lost opportunities. Experian has seen an uptick in reviews as lenders find that they have hundreds and sometimes thousands of rules that can be well-purposed but contradictory. This web of legacy underwriting policy is often the best way to identify those new segments of profitable customers left on the floor by outdated policies. In addition, this form of analysis and revamp can improve turn-time SLAs and customer acceptance of offers.

Resolve to strengthen and defend your house

Commercial fraud increases as fraudsters focus turns from government support programs back to the private lending industry, third-party fraud. Business owners, themselves, will feel pressure to purposely default on newly acquired debt as cashflows slow and delinquencies rise, creating an environment for elevated first-party fraud behavior.

Metrics on Fraud

$56B
ID Fraud Losses
$13B Traditional Identity Fraud
$43B Identity Fraud Scams

+58%
YoY Growth in Account Takeover Fraud Losses

55%
of consumers have higher expectations of their digital experience since pandemic began

Source: Global Fraud Report

Interrogating new commercial credit applications for fraud signals and frequent reviews of a lender's portfolio will be necessary to identify fresh and lingering exposure to the portfolio. As macro-economic pressures increase, these exposure-busting activities will become critical to mitigating risk deeper in the credit lifecycle.

Resolve to have healthy commercial portfolio behavior

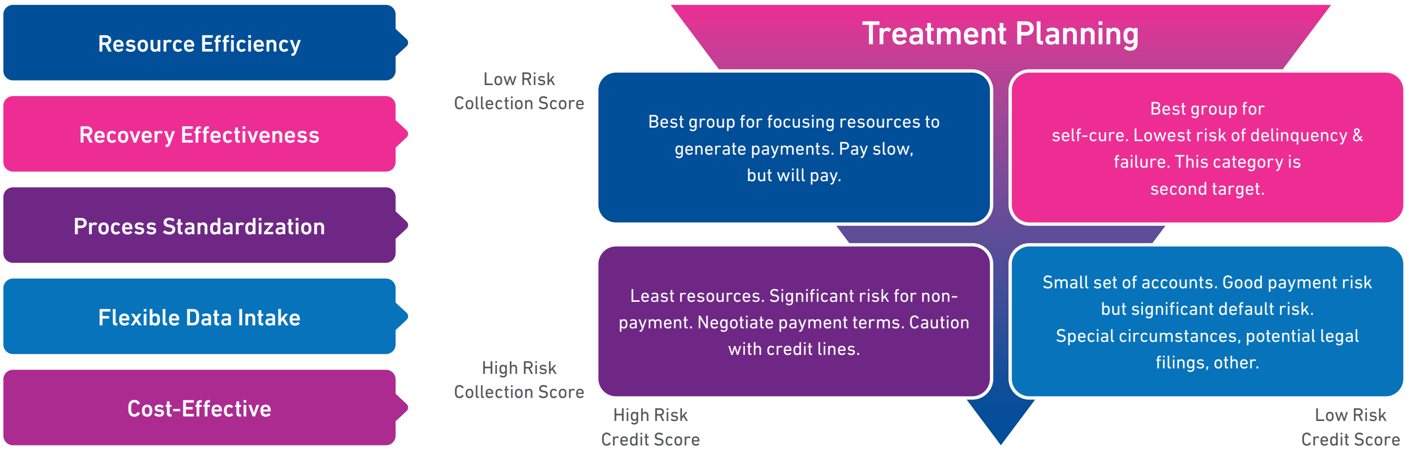
Commercial and consumer credit markets have been open and running hot over the past year. Exposure risk from unused lines or new exposure from highly utilized customers will create additional risk to portfolios. Credit line decrease is an activity that can help a lender to reduce exposure for high risk clients. Using a generic line decrease strategy across segments can negatively impact a small business utilization ratios and ultimately scores more significantly than consumer credit, because small businesses hold on average 1-2 cards in their wallet compared to a consumer who will 3+ cards.

These exposure mitigation activities are expected to increase in 2023 to limit exposure.

Modeling the attrition behavior of clients is becoming more popular as market savvy customers will look to an open credit market as an alternative to repayment. The willingness and ability of a customer to repay will change the lender's offer strategy to maintain the most profitable and loyal customers.

Pretreatment strategies will be critical to maintaining the portfolio's most loyal and profitable customers. Therefore, frequent portfolio review activity will highlight those customers at the highest risk and focus recovery activity on those accounts with the greatest recovery potential and lifetime value.

A high level example of the types of actions a lender might take might look like the below.



Source: Experian Business Information Solutions

Focusing recovery on those accounts most likely to cure, and reducing recovery spend on those where the customer is trending to a non-repayment scenario. This is the time to turn on monitoring of portfolios to identify areas of risk within the portfolio and develop strategies to either create accommodations of profitable customers or look for opportunities to engage less stable customers with pretreatment strategies. 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.

Resolve to focus on a future state portfolio participant

Customer loyalty through a troubled period in the economy can create great opportunities for future growth and success in periods of heightened market strength.

Statista conducted a survey of consumer loyalty that found 50 percent of consumers were willing to switch to less expressive brands, in a 2022 survey while 40 percent will keep purchasing brands they currently consume but will purchase less often. (Source: Statista Survey_Statista.com) The White House Office of Consumer Affairs reported that these loyal customers are worth up to ten times as much as their first purchase and six to seven times more expensive to acquire a new customer than it is to keep a current one.

Levers are available to lenders as markets change. Lenders will use modified term programs, payment holidays, forbearance programs, or consolidation offerings to help customers through a challenging cash flow event. Experian has seen these events stretch 12 -24 months in duration and not be limited to macroeconomic factors, including but not limited to climate, pandemic/health, global trade, and global market availability. Great success has been seen in these activities, most recently in the post-hurricane recovery within Florida and Texas, where creditors allowed brief periods of payment holidays and loan modification programs that allowed businesses to recover to near pre-event performance in months vs years.

These activities create an environment for greater success and profitability more quickly after an event and benefit the lender, small business, and ultimately the consumer.

Lenders can also point to the expanded support from the Small Business Administration. The SBA has been expanding and revamping program offering to create a broader safety net to small U.S. businesses, young and old. Evidence of the success of these programs can be seen at an elemental level as survivability has improved for emerging businesses to 67.6% This means small businesses can open and have funding available as cash flow develops or fluctuates around their industry.

Have a plan after the consumer holiday spending high wears off

Post-holiday remorse will begin to set in for consumers in January as holiday credit card bills are a reminder of overspending decisions made in 2022. These reminders will direct consumers to look at how they will change behaviors to limit unnecessary expenditures and adjust spending behaviors in the new year. Consumer costs will continue to rise in 2023 as inflationary pressure persists. If the Federal Reserve is successful unemployment will see some increase which will place downward pressure on consumer spend behavior as consumers prepare for a more volatile cashflow environment.

Impacts to businesses will be delayed as consumers adjust to a new year and settle into new fiscal behaviors. The expectation is for business cashflows to begin to be impacted late in the 1st quarter and gradually increase into the latter half of 2023. Small business owners are developing survival plans for their businesses understanding that those industries focused on discretionary products and services will feel the brunt of the impact early in the slowdown. Smaller businesses will need to make more drastic decisions as the potential of an elongated slowdown period is rising.

Commercial lenders should have made their 2023 resolutions in the 4th quarter of 2022 by developing strategies and putting in place triggers to engage portfolio exposure limiting activities when the market warrants a behavioral shift. For now, the most likely focal areas for lenders will be:

- Market expansion
- Deterring fraud
- Limiting portfolio exposure
- Developing loyalty among profitable customers

Delinquencies are rising for small businesses across regions and products. These delinquencies are most significant in the early-stage delinquency buckets. Late-stage delinquencies, although growing, have remained historically low. Businesses are making decisions about how they replay debt, being careful not to roll into late-stage delinquency, something that would impact credit score and hinder access to capital down the line.

Global economic pressures, U.S. government activities focused on inflation/labor, and extended availability of open U.S. credit markets will accelerate or delay the U.S. market reset. The economy will slow in 2023. Consumers and small business credit health and spending behavior will adjust to the new reality and resolve to be more future state driven when making fiscal decisions in 2023.

Are you acting on your new year resolution?

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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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