NATIONAL ASSOCIATION OF CREDIT MANAGEMENT

BUSINESS credit®

MAY 2010

THE PUBLICATION FOR CREDIT & FINANCE PROFESSIONALS $7.00

SELECTED TOPIC

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Gaining a Clearer Picture of Small Business Risk in an Uncertain Market

One of the most pressing questions credit managers and lenders face today is, "Are we seeing the light at the end of the proverbial economic tunnel, or is that really just another oncoming train?" For small businesses in particular, there are indications that delinquencies are slowing and credit risk is diminishing. In light of improving economic conditions, risk managers are seeing opportunities for growth. However, market uncertainty necessitates a cautious approach.

Other key findings from the report reveal that on a national average, commercial risk scores improved by .5% compared with six months ago.

Now more than ever, risk managers must ensure due diligence around credit. In addition to monitoring accounts, credit managers and lenders must exercise diligence on up-front credit evaluations in order to reduce the amount of risk entering portfolios. While the news today may be promising, what is ahead for small businesses remains unclear. This uncertainty means that credit managers and lenders must use all the tools available to them to more effectively determine risk when making decisions.

A Positive Outlook for Small Business

Recent trends indicate payment behavior for small businesses has stabilized or improved, suggesting a more positive outlook. According to Experian's recent Business Benchmark Report, payment delinquencies overall have dropped by 1% to 2% for businesses with fewer than 20 employees.

The national average percentage of delinquent dollars was 12.5% (remaining stable over the previous six months), and the percentage of dollars now 91-plus days delinquent is 5.3% (a 2% improvement from the previous period). These metrics indicate a continued increase in business activity, reflecting improved cash flow and a greater ability on the part of companies to meet their obligations in a more timely fashion.

Across the board, the number of days that businesses paid beyond the terms of their contracted amounts was 5.77. This represents a decrease of 2% over the previous six months, presenting further evidence that overall payment behavior may be improving. Other key findings from the report reveal that on a national average, commercial risk scores improved by .5% compared with six months ago. This improvement suggests the possibility of longer-term stability in expected payment behavior over the next 12 months.

This report closely matches positive indicators in the February 2010 Manufacturing Institute for Supply Management (ISM) *Report On Business.* The ISM report shows that manufacturing continued to grow, but the rate of growth decelerated as the Purchasing Managers' Index (PMI) registered 56.5%, a decrease of 1.9 percentage points compared with January's seasonally adjusted reading of 58.4%. Though down slightly, the PMI confirms a continued expansion of the overall economy—the tenth consecutive month it has grown. It also reveals an expansion in the manufacturing sector, the seventh consecutive month for this trend.

The ISM's New Orders Index shows a measure of 59.5% in February, 6.4 percentage points lower than the seasonally adjusted 65.9% registered in January. While this represents eight consecutive months of growth in new orders, it reinforces the need for managers to exercise heightened discipline in keeping bad risk out of portfolios.

Some Small Businesses Have Weathered the Storm

For some small businesses, recent economic conditions have been overwhelming, yet others have fared reasonably well. Studies have shown that businesses with no derogatory events (for example, incidence of a new lien, a judgment, a collection, a bankruptcy or severe payment delinquency) prior to the downturn performed significantly better than the overall small-business population. These so-called "clean" businesses have demonstrated a greater resilience to the challenging economic conditions and are more likely to be in a better position to thrive as conditions improve.

Using Payment Data to Better Manage Credit Policy

The relative success of "clean" businesses surviving in unprecedented, turbulent economic times is a clear indication of the importance of past payment behavior and other risk assessments as indicators of future health and creditworthiness. Additionally, commercial risk scores demonstrated a high level of predictiveness during these difficult times, proving their reliability in assessing which businesses will experience severely delinquent payment behavior.

Yet despite recent positive signs for the economy, risk managers have good reason to be cautious. Even though many small businesses appear to have survived the economic crisis, the health of their operations can be tenuous and difficult to assess. When it comes to evaluating small business creditworthiness, part of the problem is the fact that many owners of these businesses use both personal and commercial lines of credit to fund their operations. This leaves risk managers with the complex challenge of predicting where troubles will arise and trying to spot early indications of small business credit difficulties.

With so much uncertainty surrounding future economic conditions, credit managers and lenders should use all the tools available to them to make the most informed decisions possible. Because small business owners often leverage their personal assets to meet business obligations, it is prudent to review personal credit histories along with commercial credit information. Predictive business scores can help to determine the risk potential of small businesses, evaluating both the business's and its owner's credit performance. Recent studies have shown that this combined approach is more predictive than employing commercial or consumer risk models alone, and it can enable risk managers to more effectively manage credit policy.

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Enhanced Predictive Models Offer a More Complete Financial Snapshot

The latest market data shows payment behavior has stabilized or is improving for small businesses. Whether this trend is sustainable remains unclear. Recent improvements could be a sign of greater diligence in evaluating credit, as well as improved efforts in account management. These practices should lead to greater stability in payment performance.

Enhanced predictive models can forecast future delinquent payment behavior, providing risk managers with critical insights into the overall business condition of small business customers. Utilizing the power of commercial and consumer credit information offers a more complete financial snapshot of each customer.

Given the uncertainty of today's economic conditions, caution on the part of credit managers and lenders is certainly warranted. Fortunately, there are tools and practices available that will allow risk managers to accurately gauge small-business risk and better identify businesses that fit within their lending strategy. By fully understanding each customer, credit managers and lenders can manage portfolios more effectively and identify potential opportunities within existing small-business customer bases. ●

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