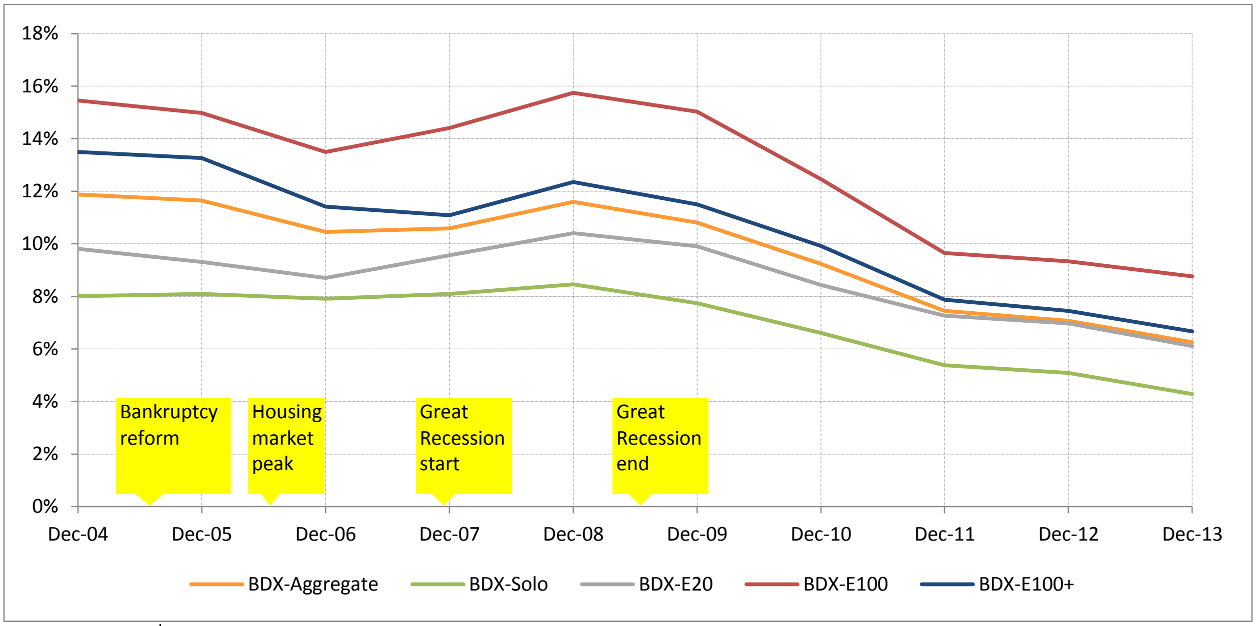
PUTTING DEFAULTS IN PLACE

In this Research Note we examine US business default rates from before the start of the Great Recession to the present. We use the same data set and methodology as the monthly Business Default Index (BDX) to study year-end default rates from 2004 till 2013. Additionally, we examine default rates for different segments of businesses based on employment size.

Figure 1: Business Default Rate



Aggregate	All businesses
Solos	Businesses without paid employees
E20	Businesses with 1 to 19 employees
E100	Businesses with 20 to 99 employees
E100+	Businesses with 100 or more employees

Key Observations

- ✓ From their lows of 2006, business defaults peaked in 2008 followed by a three-year period of considerable improvement. They have continued to improve since then and are now at their lowest levels in ten years broadly mirroring Federal Reserve statistics on commercial lending.
- ✓ The drop in default rates is most likely the result of a combination of factors.
  - Lenders have cleaned up their books so there are fewer defaults from “previous” exposures.
  - Lenders have tightened standards so new exposures are to stronger businesses that default at a lower rate.
  - General business conditions have improved and businesses are better positioned to meet their financial obligations.
  - Borrowers have dropped out of the “traditional” credit markets discouraged that the cumbersome application process would most likely result in a rejection.

Credit Quality Variations

There are surprising differences in credit quality between businesses of different size.

- ✓ Solos—sole proprietorships, self-employed and other businesses without employees have the lowest default rate. Ignored from most statistics because of their less than four percent share of total business receipts, they directly impact the lives of over 20 million people and generate nearly a trillion dollars in receipts.
- ✓ E100—businesses employing fewer than 100 and more than 20 have the highest default rate. They are a diverse group, squeezed in the middle, financially independent of the owner/operator, informationally opaque, and too small for special attention by the financial markets.
- ✓ E20’s are the credit quality gems. Employing fewer than 20, they are the true small businesses and largely underserved by the credit markets.
- ✓ E100+ businesses account for the bulk of business employment and receipts and garner the most attention. As a group, their default rate is similar to that of their smaller counterparts—E20’s.

These variations present opportunities for better serving the credit needs of businesses.

- ✓ E20 businesses represent an attractive segment for alternative lenders.
- ✓ Solos deserve another look. Lenders’ traditional approaches might be shutting out a potentially vibrant, growing and profitable segment of borrowers.

About the WAIN Street Business Default Index

The Business Default Index (BDX) is the first component of the WAIN Street Business Credit Health Index™ (BCH Index). Every month, the BCH Index aggregates multiple micro-level indicators concerning nearly 30 million businesses to reflect the holistic credit health of obligors nationwide.

Methodology

The BDX is based on the credit performance of a subset of nearly 18 million businesses that have been tracked by WAIN Street for over 12 months. A weighted aggregate, the BDX reflects the incidence and severity of defaults.

Defaults arise whenever there is non-performance of an obligation. The BDX incorporates the spectrum of defaults – delinquencies, charge-offs, and bankruptcies. Business-level defaults are pooled within demographic segments based on industry, geography and employee size. Default events within a segment are aggregated using weights designed to reflect default severity. Segments are assigned weights to reflect the *economic impact* of the businesses within the segment. Index values are obtained as the weighted harmonic mean across segments.

The BDX is seasonally adjusted and quoted as an annualized rate.

The index inception date is December 31, 2009.

Industry coverage

The BDX is designed to track "private, non-farm businesses" and excludes the following NAICS codes:

Description	NAICS Code
Agriculture, forestry, fishing and hunting	11
Rail transportation	482
Postal service	491
Financial vehicles	525
Religious, grantmaking, civic, professional, and similar organizations	813
Private households	814
Public administration	92

About WAIN Street

WAIN Street empowers credit markets to better serve middle-market and small business enterprises. By harnessing data on nearly 30 million US businesses, the WAIN Street Business Credit Health Index™ (BCH Index) provides an aggregate view of credit health trends with the ability to drill-down to granular demographic segments. The BCH Index is a platform that enables consistent measurement of middle-market and small business credit portfolio quality. This facilitates coherent industry-wide communication around portfolio credit risk and unlocks new opportunities.

Middle-market and small businesses account for over $1 trillion of aggregate credit exposure. The BCH Index and complementary WAIN Street services facilitate discovery, more effective management, and pricing of risks and opportunities that exist in this market. These capabilities create greater financing options for middle-market and small businesses, enhance liquidity for lenders, and promote financial innovation to stimulate entrepreneurship and new job creation in the US.

For more information:

Vidur Dhanda
Publisher
WAIN Street
vdhanda@WAINStreet.com
413-303-9765
www.WAINStreet.com

Copyright Notices and Legal Disclaimers