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selected topic

Dan Meder

Benchmarking and Blending

Keeping Watch on Both Details and the Big Picture

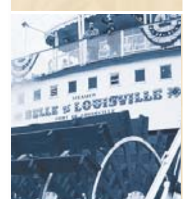
Keeping a sharp focus on a small-business credit portfolio can be challenging. Equally tough is pulling back the lens to see how a portfolio fits within the big picture. Benchmarking is a useful way to illustrate a portfolio's strengths and weaknesses, define business trends, identify areas of opportunity and uncover useful data to shape strategic planning.

Credit scoring, once prohibitively costly for small businesses, is an increasingly popular tool. But not all scores are alike. For optimum accuracy, the data shows that it's best to use a sophisticated blend of information on the business owner and the business itself.

At the heart of benchmarking are massive amounts of industry-wide data and the ability to make sense of it all—the ability to identify trends over time and discern how a particular portfolio compares with its peers. By measuring a portfolio against the overall economy and current industry standards, credit professionals can implement a plan based on market conditions and adjust that plan as benchmarks are updated.

Performance benchmarks can track numerous trends, including critical ones such as risk profiles, regional bankruptcy statistics, credit line utilization and rate of delinquency and derogatory public record trends.

NACM's 112th Credit Congress Exposition



Dan will be presenting:

16081. The Art and Science of Understanding Owners Behind Small Businesses: Who They Are, What Makes Them Tick and How They Manage Their Business

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A look at high-level business benchmarks shows some revealing statistics. First, business in America means small businesses. This poses special challenges to credit professionals that we'll discuss later. For now, let's note that 89% of all U.S. businesses have less than $1 million in annual sales. Millions of businesses have fewer than five employees, including 67% of service businesses and 60% of all retail.

The majority of businesses are relatively static in terms of growth, according to the Oxford LifeCycle metric. Growth businesses—defined as growing 25% faster than normal—account for 27% of all U.S. businesses. Declining or static businesses—growing 25% slower than normal—account for 18%. In the middle 55% are maturing businesses that could, with changes, join the growth businesses or laggards.

Investigate growing businesses and you'll find a reflection of strong consumer spending. Retail accounts for 21% of all businesses, but these businesses comprise 31% of growth businesses. In other words, retail growth is outpacing its percentage of the overall business market. On the other hand, services represent 44% of all businesses but only 37% of businesses classified as growing. These sorts of numbers are by no means set in stone. In a dynamic economy, they will shift. That makes it important to regularly update benchmarks to keep them relevant to the marketplace.

Looking at the country from a regional basis gives a rough idea of business activity. The Northeast, stretching from Ohio to Maine, accounts for 20% of the nation's businesses. California alone is home to 13% of businesses. The Southeast, Southwest, Mid-Atlantic and Midwest regions each account for 11% to 16%. The number of businesses is fewest in the West and Northwest, an area from Kansas to the state of Washington. The territory covers 11 states and a vast amount of land but only 11% of the nation's businesses.

Credit scoring was cited recently by the Small Business Administration (SBA) as an important factor in changing the landscape of small-business lending.

Bankruptcy trends add to the regional picture. Overall, there was a 50% decline in bankruptcies in 2006 compared with the prior year. That number was skewed by a 2005 change in law, but it will remain a valuable metric of business conditions going forward. Regional bankruptcy differences are telling. Two regions accounted for 44% of the nation's bankruptcies in 2006: the Northeast and the Southwest. Meanwhile, despite its large number of active businesses, the Mid-Atlantic states made up only 4% of bankruptcies in 2006.

Those are just broad-brush benchmarks. Another way to evaluate a market is by examining its risk profile and credit trends within a region or industry. Experian® examined commercial credit scores nationwide over a 12-month period, based on an analysis of approximately 9 million records in its proprietary BizSource℠ database. This particular snapshot ended in March 2007, but it's the kind of benchmark measure that could be tailored to a specific market and regularly updated.

The study found a significant (10%) increase in the percentage of businesses deemed low- to medium-risk. At the same time, businesses with a medium- to high-risk classification fell by 15%. The number of businesses rated at the highest and lowest levels of risk remained steady. Over the same period, the study shows that businesses grew more cautious in using available credit, dropping from using nearly 80% of available credit to less than 60% by the end of the 12 months.

Interestingly, while credit utilization declined, the percentage of accounts that were 60 days or more delinquent remained roughly constant. This likely indicates that people were buying on need while stretching out their suppliers. They were conserving cash. The bottom line: businesses during the year managed their credit more conservatively, perhaps because they sensed a downturn ahead.

From the perspective of a credit professional, there's good news in that. Rather than taking risks regardless of market conditions, businesses are monitoring events carefully and limiting their exposure appropriately. Viewed regionally, the Mid-Atlantic region looks like a great place to do business. The bankruptcy rate is low, the credit utilization rate is relatively high, and its past due beyond 30 days is low. Businesses are buying. They tend to be less likely to be delinquent. They tend not to file bankruptcies. The Southwest during this period emerged with a caution flag to credit professionals. As a region, it registered above the norm on credit utilization, high on the past due beyond 30 days and with a relatively high rate of bankruptcies.

Now let's return to the particular challenge posed by small businesses. First, it's important to note their importance to the U.S. economy:

- Small businesses contribute about 50% of the U.S. gross domestic product
- Two-thirds of new jobs are created by small businesses
- Financial industry spending on the small-business market segment is expected to grow at a 12.8% annual rate through 2009, according to the Tower Group

It's an incredibly robust sector of the economy. But small businesses also are volatile, and their creditworthiness can be relatively hard to assess. That's why an early indication of trouble can help determine that it is time to reduce risk by imposing more stringent conditions on credit. However, it's often hard to predict where the first indication of small-business credit difficulties will surface: within a commercial or a personal file.

Credit scoring was cited recently by the Small Business Administration (SBA) as an important factor in changing the landscape of small-business lending. But when scoring a small business, it's important to apply best practices for best results. Many credit issuers consider one limited measure: the owners' personal consumer credit information. Other small-business creditors watch for signs of trouble by scoring and monitoring commercial credit information on the business itself.

We find neither approach ideal. For risk managers, a score that blends both personal and commercial information brings optimal results, meaning more "good" approval rates, fewer "bad" accounts and the confidence to increase the size of credit lines and loans.

In a recent study, Experian analyzed credit reports and other information on roughly 50,000 small businesses. Using Experian's Business Owner Link database, the study analyzed the owners of those same businesses. The goal was to find the best tool for predicting small-business failure.

Very rarely — in only a fraction of 1% of the studied cases — did problems come to light on both commercial and personal credit fronts in the same quarter, the study found. That's one reason a blend of both commercial and personal data provides the best early warning system for small-business credit problems.

Advocates of relying solely on consumer data might point out that small-business owners often look and act like consumers. Nearly half — 46% — of small businesses use personal payment cards. Many small businesses fail to separate business and personal expenses, according to research conducted by MasterCard.

Indeed, an internal analysis of Experian's databases shows a strong correlation between the creditworthiness of the business and the business owner.

Many banks currently use consumer data exclusively when evaluating creditworthiness of small businesses, according to an SBA study published last year. (The study, *A Survey-Based Assessment of Financial Institution Use of Credit Scoring for Small Business Lending,* may be found at www.sba.gov/advo/research/rs283tot.pdf.) The SBA found that larger, more urban banks with greater technological sophistication were more likely to use credit scores. By more than a 4-to-1 ratio, banks that use credit scores to help evaluate small-business loans use the credit score of the owner as the key credit metric, not business credit scores.

A score based on a business owner alone, or the business on its own, is better than no score. But relying on one or the other may leave risk managers with a blind spot. The weakness of relying on consumer data alone was shown in the Experian study. The study revealed that when trouble hit the business, blended scores each dropped an average of 30% over the four quarters leading up to the "bad" event. Meanwhile, business owner consumer scores showed no statistically significant decline over the same period. Those creditors relying on a consumer score alone would remain unaware that anything was amiss with that small business in their portfolio.

The key reason is that, unlike consumer scores, blended scores are designed to predict business performance. The consumer score utilizes personal information to predict consumer performance. On the other hand, the blended score evaluates the personal information on the owner as it relates to business performance. However, solely tracking business credit is no panacea. The study found that of businesses that experienced significant credit problems, about 53% revealed their first signs of credit problems through their business credit report. However, nearly half the time — 46% — problems showed up first on an owner's personal credit report.

> The blended score helps credit managers maximize the bad accounts that are rejected while not increasing the rejection rate of accounts that actually would be good.

As stated above, problems almost never come to light on both commercial and personal credit fronts during the same quarter. When blended scores are validated, they typically outperform commercial-only or consumer-only scores by 10% to 20%. That allows a risk manager to do one of two good things: increase approvals without increasing losses or keep approval rates the same and reduce losses. The blended score helps credit managers maximize the bad accounts that are rejected while not increasing the rejection rate of accounts that actually would be good. In addition, it can help manage riskier accounts by appropriately adjusting credit limits or repricing credit to reflect risk.

Blended scores give creditors the best view of an individual business. Benchmarking puts the big picture into focus. Using both blended scores and benchmarking, you can optimize your portfolios for better results. ●

Dan Meder is vice president of marketing and development for Experian Business Solutions. He can be reached at dan.meder@experian.com or 714-830-5578.