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Reaching Out to Small Businesses

By Dan Meder

Illustration: Getty Images

AMERICA'S SMALL BUSINESSES – some 26 million strong – form the heart of our nation's economy, creating two out of every three new jobs and making up more than 99.7% of businesses in the United States, according to the Small Business Administration.

Of these businesses, all of which employ fewer than 500 individuals, less than 1% generate more than $10 million in annual sales. Yet, as a whole, small businesses contribute an estimated 50% of the country's gross domestic product.

This means financial institutions frequently lend to small businesses – and this can be a sizable risk category for defaults. Still, the potential in the market has led lenders to build targeted marketing plans and dedicate budgets to growing business in this group.

The shift in spending on small-business cards will grow at a 12.8% annual rate through 2009, reaching an estimated 71% of the $429 billion market by then, according to TowerGroup, a financial research company. The growth is expected to come from more spending rather than a shift from consumer card use for business expenses.

Despite the importance of the small-business market, many lenders are not using the best tools to tap its potential. For years, lenders relied on either straight consumer or commercial credit scores to determine whether to extend credit to small businesses.

While each score contains valuable information and insight, relying on just one provides only a partial picture of whether a business is creditworthy and is not as effective as looking at a blended score.

With considerable stock market volatility and talk of

recession, it is not surprising that Discover Small Business Watch found that only 24% of small-business owners felt the economy was improving in April, down from the 45% who felt that way in April 2007.

Small businesses are highly susceptible to economic changes. With fewer resources to draw from, one or two consecutive difficult selling seasons can seriously squeeze cash flow for small businesses and put their survival at risk. With many analysts predicting continued economic turbulence, it will be important for lenders to have the most complete and accurate data about the small businesses in their portfolio and on their prospect lists.

Commercial vs. Consumer

Understanding how the commercial and consumer worlds differ in their views of credit is critical. Given that there is one commercial business for every 10 consumers in the United States, lenders on the commercial side deal with much less volume than their consumer counterparts.

Commercial credit scoring is much less regulated than consumer credit scoring. The commercial environment is multidimensional.

There are single individuals in the consumer world versus multiple business structures; industry differences that are not found in the consumer world; and major differences between small and big businesses. The broad-based nature of the commercial world means it inherently comes with more exposure than the consumer side.

Furthermore, business credit information relies on diverse sources of data beyond pure financial aspects such as a loan or business credit card.

A crucial part of business credit information comes from the network of business-to-business suppliers. For example, an auto repair shop does not pay cash every time a headlight is delivered. Rather, it might pay on a term basis, typically 30 or 45 days. This web of suppliers report on their relationships, but the process is not as well-established as is the consumer process.

In contrast, in the consumer world, the use of scoring has been around since the 1970s, driven by the need to evaluate thousands of credit card applications quickly and consistently. Consumer credit information comes from credit cards, mortgages, home equity loans and other sources that report regularly. The data is easily retrieved.

Single Score Drawbacks

Many issuers still size up the potential performance and risk of small businesses with one limited measure – the owners' consumer credit information. Other small-business creditors track credit reports on the actual business to watch for signs of trouble.

Advocates of relying solely on consumer data to determine small-business creditworthiness often point out that these owners tend to act like consumers and fail to separate business and personal expenses.

While the percentage is dwindling, the TowerGroup study indicated that more than 30% of small-business purchases are made with personal credit cards. This means that business transactions could be locked within a small-business owner's consumer performance information. For example, the same van a florist uses to take his or her kids to soccer practice also may be the van used to deliver flowers. Given this factor, are the owner's van payments a business or personal expense?

Relying solely on commercial information for small-business credit scoring presents different challenges and complexities that provide only a partial picture of creditworthiness.

Business reports can be inconsistent and incomplete. Making smart decisions in the commercial world requires a different paradigm. A more reliable system looks at a complete credit profile, which takes into account both the owner's individual credit history and the business's commercial credit score.

There is considerable research to support this newer, holistic view. A study by Experian looked at a sampling of 50,000 small businesses and their owners over four years to determine which method of evaluation, business or consumer credit, was a better indicator of default risk.

The study analyzed hypothetical and real business data to validate the performance of blended scoring models using the Kolmogorov-Smirnov (KS) measure, the powerful test of a model's accuracy. (The KS statistic measures the separation between companies that are a good credit risk and those that are bad. The better the model, the greater the separation – and the higher the KS.)

The study demonstrated that when trouble hits the business, blended scores dropped an average of 30% over the four quarters leading up to the financial difficulties. Meanwhile, business owner consumer scores showed no statistically significant decline over the same period. Therefore, creditors relying on the consumer score alone would miss the cautionary red-flag warnings provided by the blended score.

That being said, tracking business credit alone is not much better, particularly in the micro-business

segment – those with fewer than five employees. The study found that of businesses that experienced significant credit problems, about 53% revealed their first signs of difficulty through their business credit report. However, nearly half of the time (46%), problems showed first on an owner's personal credit report.

For microbusinesses, it appears that personal and business credit activities are far more intertwined than for companies with more employees.

Data indicated these owners' credit was a leading indicator of trouble 70% of the time. But when looking at small businesses with more than five employees, the first signs of trouble consistently are shown through their business credit.

A CASE STUDY

Another strong argument can be made for a blended approach by diving deeper into one company – a large small-business card issuer. The company analyzed its portfolios of more than 100,000 credit records and found that the blended score was able to match 99.1% of the accounts in its portfolio and produce a KS in the mid-30s, a strong showing in predicting commercial performance. In contrast, when compared to different commercial-only scoring methodologies, the performance of the blended model more than doubled against the commercial-only scores.

When one examines the scores of a portfolio of businesses over a 12-month period and checks to see how each of these businesses actually performed, the benefits of the blended score are clear. Across portfolios, blended scores outperform consumer-only scores by 10% to 20%.

The key reason for the success is that, unlike consumer scores, blended scores are designed to predict business performance. The consumer score utilizes personal data to predict consumer financial behavior. Conversely, the blended score evaluates the personal information on the owner as it relates to business performance.

For more information about the Experian study, detecting signs of credit trouble among small businesses and the advantages of using blended scores, watch for part two of this column in the July issue of *Collections & Credit Risk*. **CCR**

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