2016 Q2

Small Business Credit Outlook

It's not as bad as it looks, but the early signs of business cycle change are appearing like the dark clouds that precede a storm. The U.S. economy is vast and complex, and the cause of every contraction, in retrospect, is obvious. We cannot tell what exactly is causing the private sector of the economy to curtail investment so sharply, but we can see the result of reduced borrowings and investments in 4 of the last 7 months.

"Thing" is the worst word in the English language because it is non-descript, so I regret using it here, but "something" is happening among these private small businesses that is causing them to pull back. The importance of this observation is that private companies continue to make up a larger share of the U.S. economy, so a small change by this enormous private company economy can have a big impact on GDP.

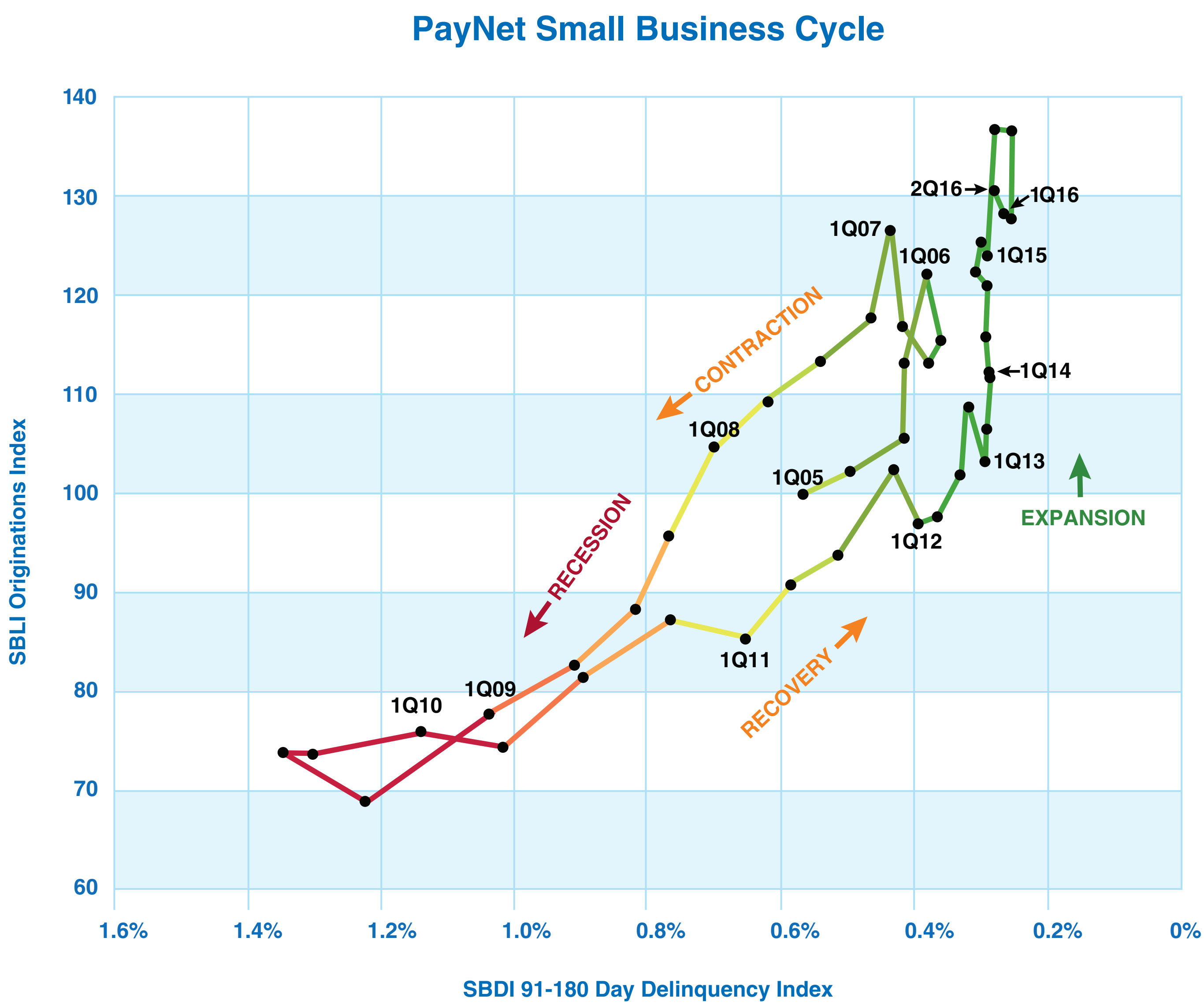
We held off publishing this Quarterly Outlook until July to give you a better read on the economy and on private company credit quality. We don't want to be predicting the next non-recession, but after 7 years of business expansion, now appears a good time to be cautious with lending activity. Credit quality of small private companies will most likely fall over the coming quarters, so preparing now for this change appears prudent.

Business Cycle

The business cycle remains in an expansionary/low-credit-risk phase, but it is wavering at the moment. Small business investment continued its decline in the 3 months ending July compared to the prior 3-month period and compared to the same 3-month period a year ago.

Even taking into account a seasonal adjustment versus prior year, the decline in small business investment provides further evidence that the economy is not as strong as the stock market would indicate, nor as many hope.

Another sign of a changing business cycle is the amount of loans past due. Loans severely past due edged up 4 basis points since December, but the definitive jump in loans moderately past due last month (see Credit Risk below) can flow through to severe past dues over the next quarter.

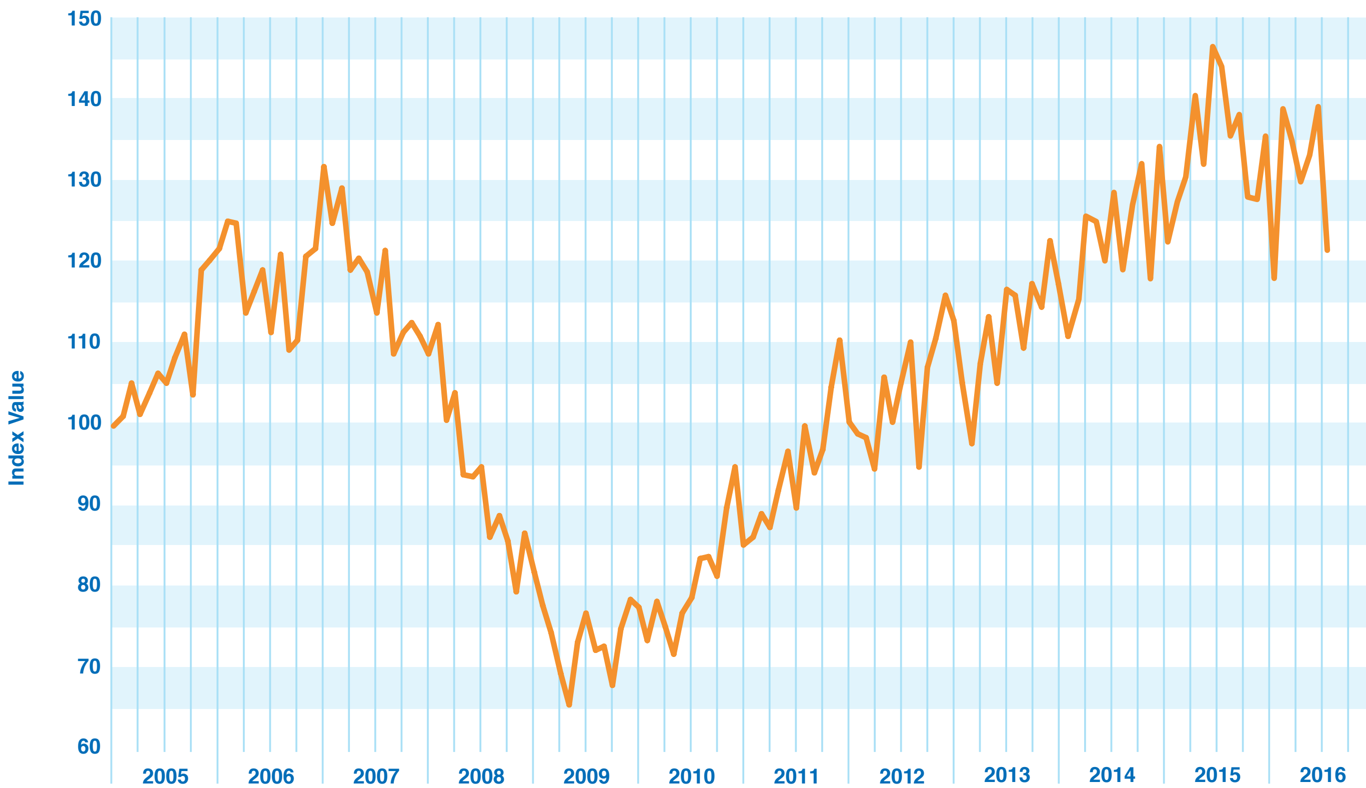


Recent Investment Activity

The Thomson Reuters/PayNet Small Business Lending Index (SBLI) seasonally adjusted originations decreased 13% from 139.2 in June 2016 to 121.5 in July 2016. That is the second time the Index has dropped by 13% in the last seven months. Compared to the same month one year ago, the Index is down 16%, the largest decrease since October 2009.

The rolling three-month index is down 2% from June 2016 and down 7% from July 2015. The rolling three-month index has decreased year-over-year for three consecutive months after registering no year-over-year decrease for six years. All indications point to the probability of small business investment falling at an increasing rate.

Thomson Reuters/PayNet Small Business Lending Index (SBLI)
(January 2005 - July 2016)



Credit Risk

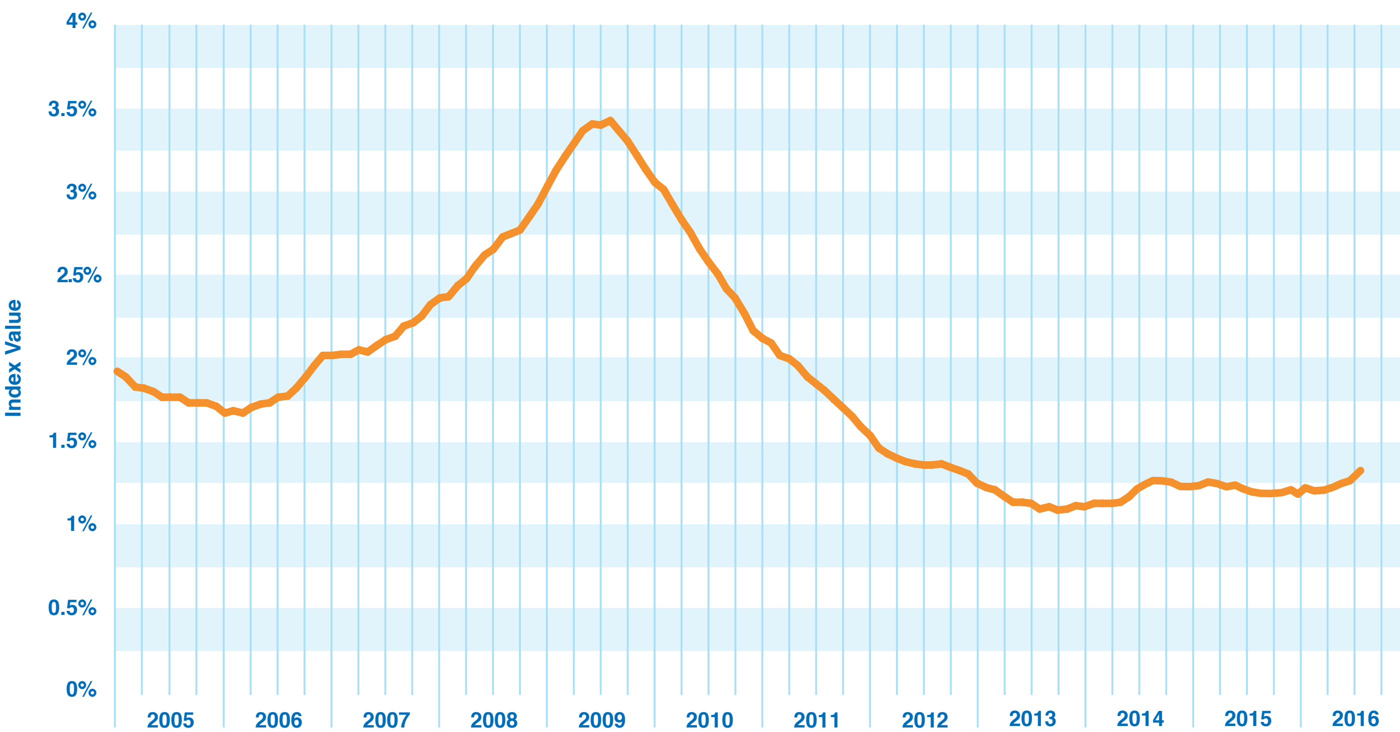
Further erosion in the business cycle is shown through higher loan delinquencies. The Thomson Reuters/ PayNet Small Business Delinquency Index (SBDI) 31-90 days past due increased 6 bps from 1.27% in June 2016 to 1.33% in July 2016; that is its highest level since December 2012. As compared to one year ago, delinquency increased by 13 bps which is the largest year-over-year increase since December 2009.

Transportation delinquency increased 14 bps to 1.81% - its 17th consecutive month of increase and its highest level since September 2011. Every other segment increased by at least 3 bps from June 2016.

Severe credit risk currently remains benign as delinquencies of 31-90 days past due have not yet flowed through to 91 days past due. The Thomson Reuters/PayNet SBDI 91-180 days past due increased 1 bp from 0.29% in June 2016 to 0.30% in July 2016; that is its highest level since November 2014. The Index previously experienced 11 months without a decrease in delinquency. The Index is up 4 bps from one year ago which is the largest year-over-year increase since February 2010.

Transportation delinquency increased 2 bps to 0.54% - its 11th consecutive month of increase and its highest level since September 2011. Agriculture delinquency was flat, but every other segment increased at least 1 bp.

Thomson Reuters/PayNet Small Business Delinquency Index (SBDI)
(31 - 90 Days Past Due)
(January 2005 - July 2016)



Regional Credit Risk

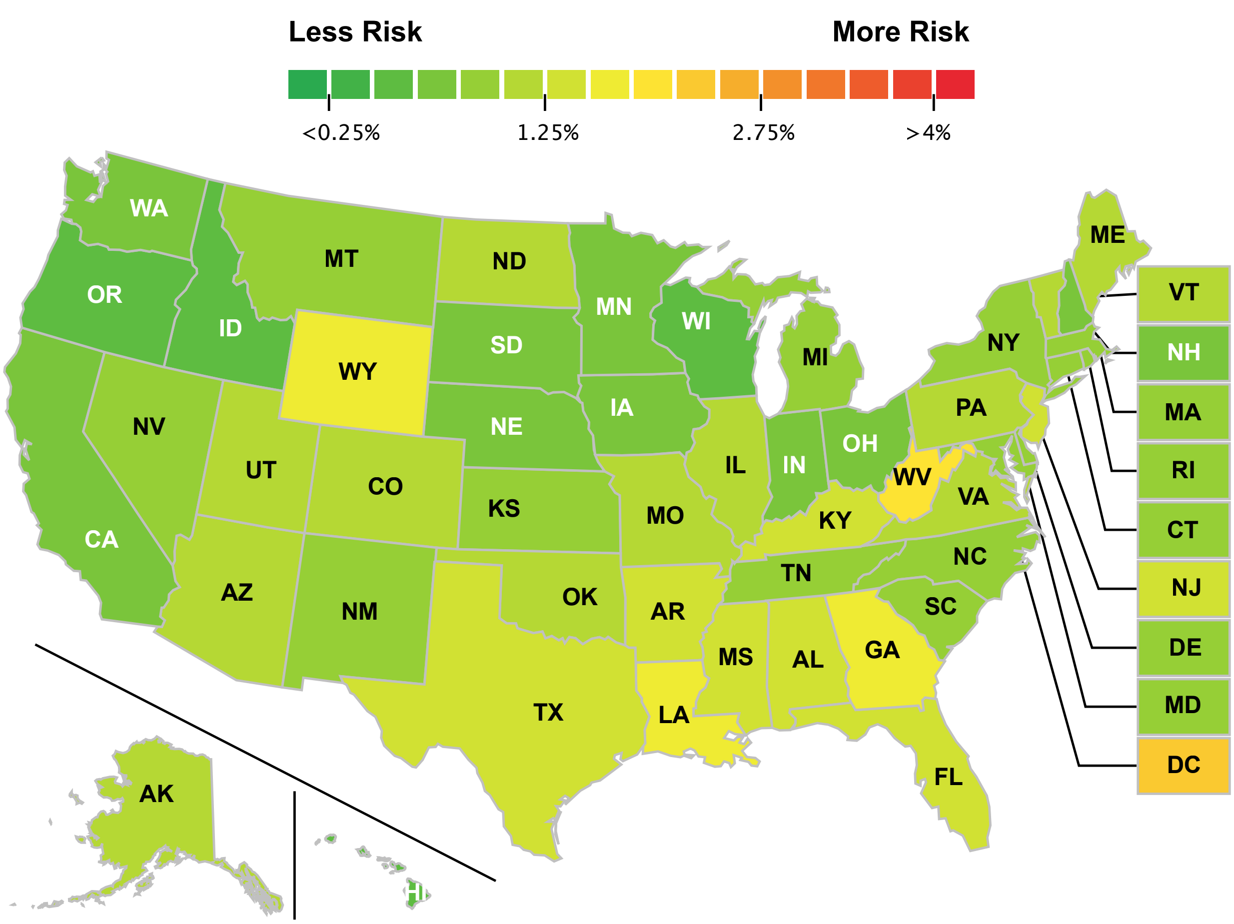
Small business borrowing and investment in most of the largest states reflect the national conditions – weak year over year increases and a slowing trend. The national trend exhibits slowdown with a 0.5% decrease in lending and investment over the past 6 months. Illinois shows the largest year-over-year decrease in lending and investment at -7.9% and a -0.7% slowdown over the past six months. Large states showing small business year-over-year increases in borrowing and investment can be found in Michigan (+0.9%), New York (+2.0%), and Georgia (+4.2%). The majority of the largest states where small business is borrowing and investing more are now treading water with almost no growth.

The only exceptions among large states where the trend is towards more borrowing and investment is North Carolina, up 7.0% over the prior year and trending up 1.7% over the past six months, and Florida which shows the strongest year over year increase at +7.7%; however its recent trend is barely positive at 0.7%.

The loans past due at the state level reflect the broader trend towards less investment and rising financial stress at the national level. Only two large states, New York and California, show decreased loans past due of 0.14% and 0.03%, respectively. North Carolina and Florida, where small businesses are still expanding, show no material rise in loans past due among their small businesses.

The states showing the largest decrease in investment also show the largest increase in loans past due. Ohio and Pennsylvania show moderate year over year increases of 0.10% and 0.17% respectively. Illinois (+0.30%), Texas (+0.32%), and Georgia (+0.33%) reflect the greatest rise in financial stress among local small businesses. These rises still pale in comparison to the highs reached during the height of the Great Recession.

Small Business Delinquency Index as of Jul-2016



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Credit Risk Forecast

Given the sluggish economy, rising loans past due, and the general malaise, credit risk will likely rise in 2016-17. Business defaults reached the lowest levels during this business cycle at 1.5% in 2014 and 2015. While we expected higher defaults in 2015, the conditions now favor higher defaults. With lower borrowing and investment, we'd expect lower loans past due.

However, the opposite appears underway. Even with falling borrowings, we are seeing higher loan delinquencies now as mentioned above. Another factor in favor of rising defaults is that the business cycle lows appear to have been reached. The general economic malaise also supports lower defaults, but financial stress is rising after 10 years of sub-par GDP growth. AbsolutePD® forecasts a slight rise in defaults in 2016-2017 to 1.8% and 1.9% respectively.

Historical And AbsolutePD® Forecast Default Rates

Industry Segment	Actual Historical Default Rates (1)										Forecast Default Rates (2)	
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016*	2017
Transportation	4.3%	6.5%	10.3%	12.8%	7.8%	4.2%	2.7%	2.7%	2.4%	2.6%	4.1%	3.2%
Information	3.9%	4.8%	5.4%	7.7%	3.9%	3.5%	3.0%	2.9%	2.6%	2.5%	2.0%	2.0%
Mining	1.3%	2.8%	3.6%	7.5%	5.1%	2.0%	2.1%	1.1%	1.3%	2.3%	4.2%	2.4%
Retail	2.6%	3.3%	4.6%	6.4%	4.4%	2.5%	2.0%	1.7%	1.7%	1.8%	1.8%	1.9%
Construction	3.0%	4.4%	7.0%	10.4%	7.5%	3.8%	2.2%	1.6%	1.7%	1.8%	2.3%	2.4%
Professional Services	2.7%	3.6%	4.3%	5.3%	3.5%	2.4%	2.0%	1.7%	1.6%	1.7%	1.9%	1.7%
Health Care	2.8%	3.2%	3.8%	4.3%	3.5%	2.2%	2.1%	1.9%	1.8%	1.7%	1.7%	1.8%
Administrative Services	2.7%	3.3%	4.6%	6.5%	4.6%	2.8%	2.2%	1.8%	1.9%	1.6%	1.9%	1.9%
Accommodation and Food	4.0%	5.2%	6.7%	7.4%	5.4%	3.1%	1.7%	2.1%	1.6%	1.6%	1.8%	2.4%
Manufacturing	2.2%	2.5%	3.5%	6.0%	4.1%	2.3%	1.7%	1.3%	1.5%	1.5%	1.7%	1.6%
Agriculture	2.1%	1.9%	1.9%	2.8%	2.3%	1.4%	0.9%	0.8%	0.9%	1.4%	2.1%	1.8%
Wholesale	2.1%	2.1%	3.1%	4.2%	3.0%	1.8%	1.2%	1.1%	1.3%	1.3%	1.4%	1.7%
Finance	3.4%	6.9%	6.8%	5.7%	3.4%	1.9%	2.0%	1.3%	1.2%	1.2%	1.5%	1.5%
Other Services	2.5%	2.9%	3.9%	4.7%	3.0%	2.1%	1.6%	1.3%	1.2%	1.2%	1.5%	1.7%
Real Estate	2.3%	3.6%	5.2%	6.9%	4.3%	2.3%	1.5%	1.4%	1.4%	1.0%	1.6%	1.7%
Entertainment	3.2%	3.9%	4.4%	4.3%	2.6%	2.3%	1.6%	1.2%	1.0%	0.9%	1.3%	1.9%
Education	2.6%	2.7%	2.9%	3.1%	2.1%	1.5%	1.4%	0.9%	1.1%	0.8%	1.1%	1.8%
Public Administration	2.3%	2.9%	2.4%	2.7%	1.4%	1.6%	2.2%	1.0%	0.5%	0.6%	1.2%	1.8%
ALL INDUSTRIES	**2.7%**	**3.7%**	**4.9%**	**6.3%**	**4.3%**	**2.5%**	**1.9%**	**1.6%**	**1.5%**	**1.5%**	**1.8%**	**1.9%**

Source:
(1) PayNet Small Business Default Index
(2) PayNet AbsolutePD®

$1.0mm or Less in Total Lease/Loan Exposure
*2016 Forecasts Include 2 Quarter of Actual Defaults

Summary

While July trends are not as concerning as they appear at first glance, the cumulative effect is that we are beginning to believe investor sentiment has changed. The 16% decline in July from the prior year is actually a less severe 4.4% decrease due to the effects of leap year and extra business days in 2015.

But the fact that investment on a per day basis decreased 4.4% means that all is not well with the economy. After factoring in the rise in loans past due, indications are that a change in the business cycle can be sooner rather than later.

At this stage it is far too early to determine the reasons for less investing and higher past dues. It could be a host of factors, but this all means greater risk for the underlying credits and, most likely, rising defaults of private companies over the next 12 months which our default forecast projects at 1.90%.

About PayNet, Inc.

PayNet is the leading provider of credit ratings on small businesses enabling lenders to achieve optimal risk management, growth, and operational efficiencies. PayNet maintains the largest proprietary database of small business loans, leases, and lines of credit encompassing over 23 Million contracts worth more than $1.4 Trillion.

Using state-of-the-art analytics, PayNet converts raw data into real-time marketing intelligence and predictive information that subscribing lenders use to make informed small business financial decisions and improve their business strategy.

PayNet's small business capabilities range from historic credit-reporting and automated credit-scoring to detailed strategic business reviews that include portfolio risk measurement, default forecasting, peer benchmarking, and critical industry trend analysis.

PayNet Contact Information

PayNet, Inc.
5750 Old Orchard Rd., Suite 300
Skokie, IL 60077
866-825-3400

William Phelan
President
866-825-3400
bphelan@paynet.com

WEB
www.paynet.com

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