PAYNET®

2017 Q2

Small Business Credit Outlook

Stuck In Low Gear

The data continues to signal more of the same that we've seen for the past 8 years. Subpar growth means expansion can continue for the foreseeable future. But implications from slow growth mean less lending activity for the next few quarters as this "Stuck in Low Gear" trend continues. On the positive side, slower growth means lower risk from below average defaults.

At the same time, regulations don't seem to be lessening explicitly through actual changes in laws & regulations such as Dodd Frank. The environment, then, is shaping up to be a familiar one – slow growth in C&I earning assets, low & continued pressure on loan pricing, and below average credit risk. This scenario is one commercial lenders have been living with for the past several years and will likely have to figure out how to deal with again in 2018.

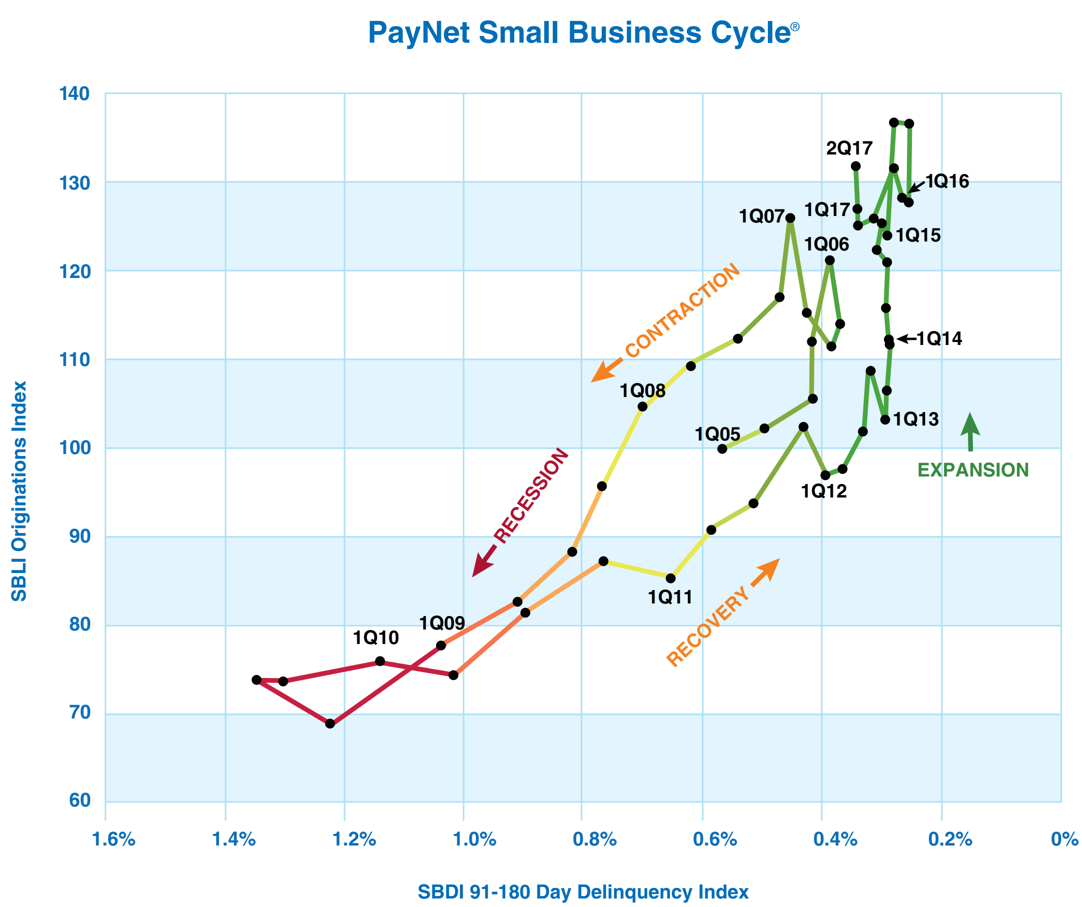
While these numbers offer good news and bad news, the acceleration of mergers and acquisitions is likely in this scenario as economics favoring scalable businesses takes its toll. A massive squeeze is underway in the U.S. economy that favors big companies over small companies because low growth and higher regulations make it tougher on small businesses that cannot amortize these costs over a larger base or cannot grow their way out of the higher costs.

The longer growth stalls and high costs persist, the more favorable business conditions become for larger companies, particularly as acquirers of smaller companies. It's big fish eating the small fish economy now with the exception of high tech businesses that can find growth and excess profits through innovation. The longer these conditions persist, the stronger this trend becomes.

Business Cycle

Low growth expansion is here to stay for at least the next quarter. While it is discouraging that higher growth has failed to materialize in private company investment, at least we can see in the data that a downturn was avoided. Q2 2017 saw small business borrowing and investment rise 3.9%. As we'll see in the sector section, private businesses remain stuck in a slow growth mode in the core sectors that have driven growth in the past. At least the downturn experienced in Q3 and Q4 2016 was moderate and has given way to modest expansion in the first half of 2017.

Another positive for the business cycle is continued strong financial health. When businesses contracted last year during the third and fourth quarters, they also exhibited higher financial stress. The good news is that financial health has stabilized in 2017 which positions private companies for further borrowing and investment if conditions improve.

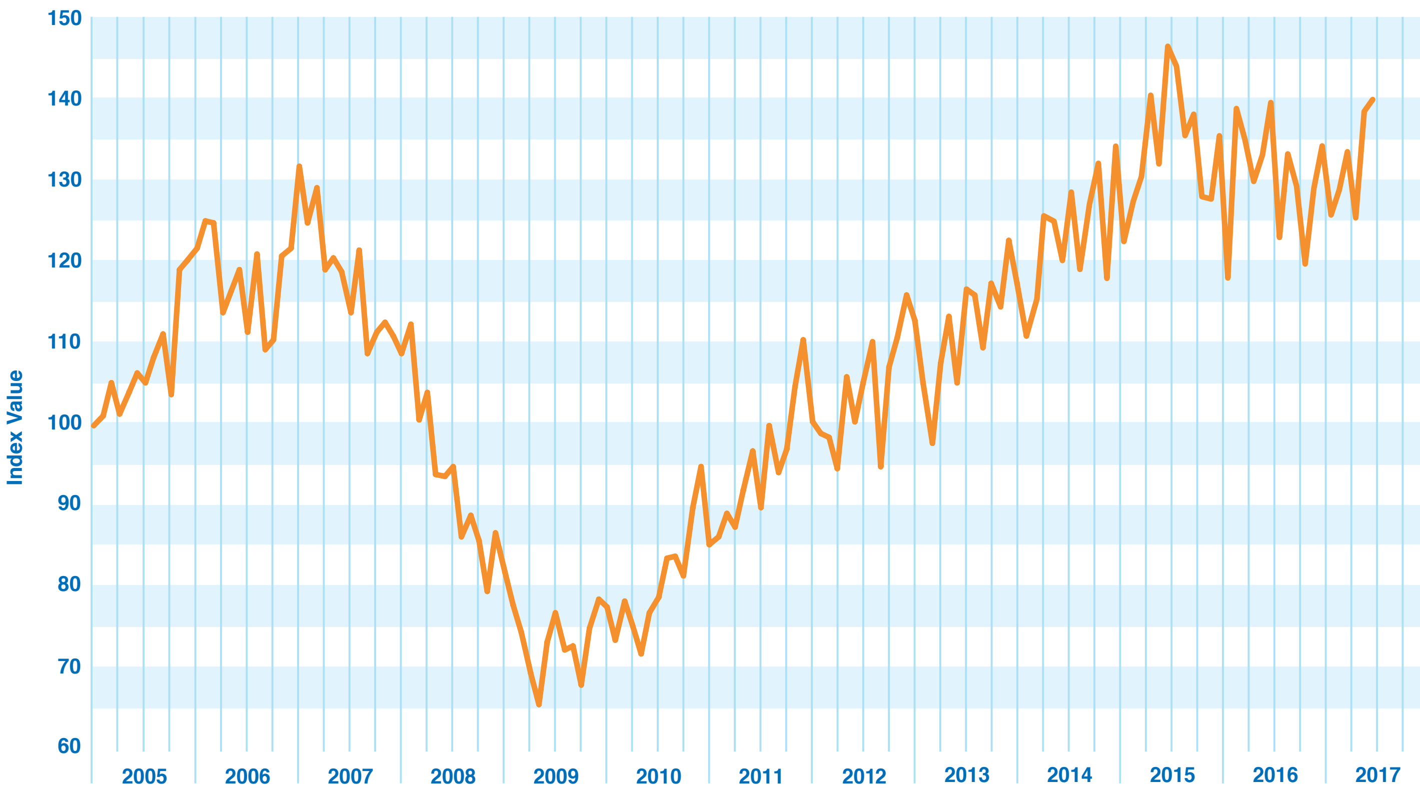


Recent Investment Activity

The chart below tells the story of stagnation over the past year. Borrowing and investment by the millions of private U.S. companies has failed to increase in any material way. And, the argument could be made that investment has actually decreased on an inflation-adjusted basis.

Private business investment remains at about the same level as it stood in 2015 with the Thomson Reuters/PayNet Small Business Lending Index (SBLI) at 139.9 in June, which is about where it stood in April 2015. Since then, the Index has expanded over the prior year 15 times, and it has contracted versus the prior year 12 times. It has waffled up and down, but has basically failed to move significantly in any way.

Thomson Reuters/PayNet Small Business Lending Index (SBLI)
(January 2005 - June 2017)



Credit Risk

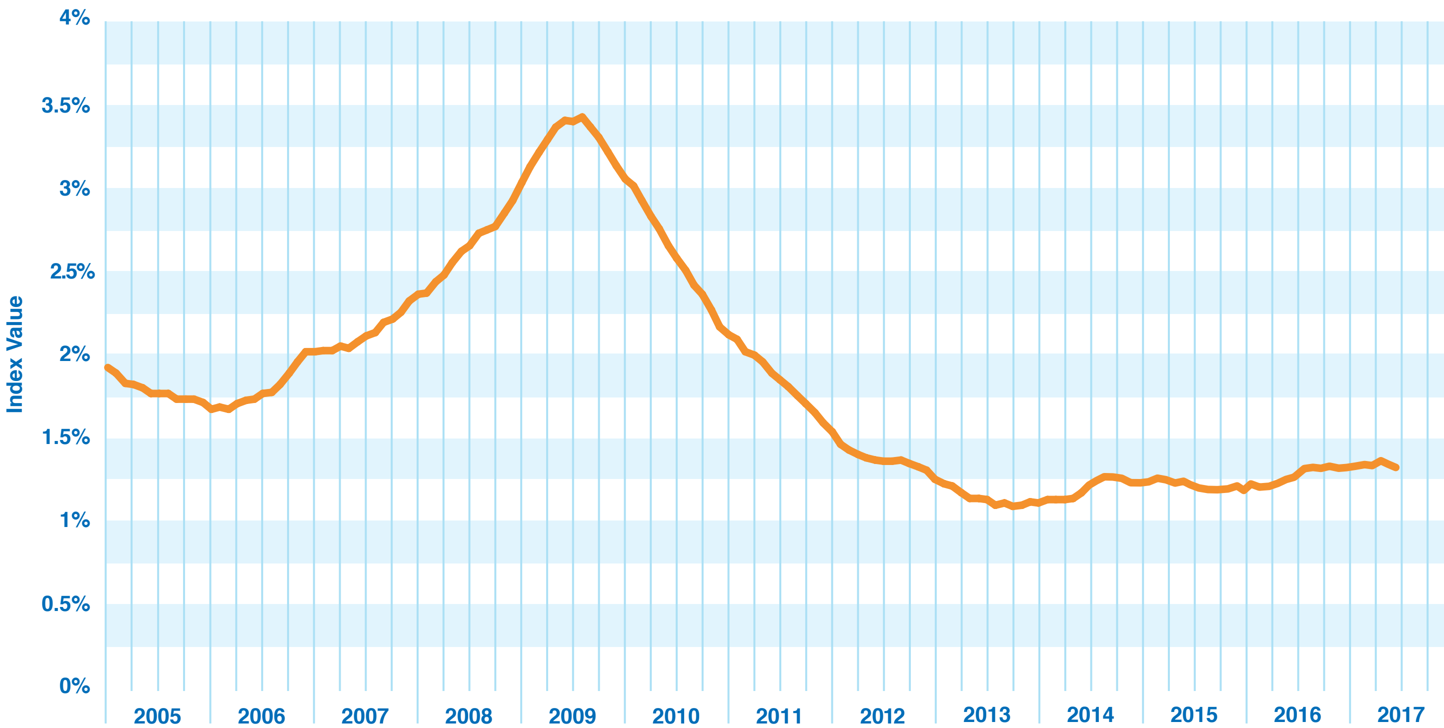
Credit risk has surprised on the upside by falling recently. While lower credit risk remains a positive for lenders providing capital to private companies, it coincides with flat growth.

The Thomson Reuters/PayNet Small Business Delinquency Index (SBDI) reflects anemic growth. After rising from all-time lows in 2013 to 1.36% in April 2017, we now see the level of delinquent loans falling back to 1.32% - another sign of low growth among private businesses.

Thomson Reuters/PayNet Small Business Delinquency Index (SBDI)

(31 - 90 Days Past Due)

(January 2005 - June 2017)



Industry Analysis

Industry sectors in growth mode reflect the stuck in low gear mode. Public Administration exhibits the only double-digit increase, 11.4% compared to one year ago, which is a comment on the anemic state of the economy when government services remain the largest driver. Arts, Entertainment & Recreation nearly breaks into double digits at 8.9%, partially reflecting the consumer's desire to find some solace from what you have to consider is increasingly divided and antagonistic politics. Accommodation & Food Services show organic growth of 5.5% which reflects the trend for dining out more often. Core sectors like Construction and Wholesale Trade are barely growing at 4.6% and 1.3%, respectively.

Big sectors which have traditionally been growth drivers are now in major contraction mode. Health Care, which rarely contracts, remains the worst performer at -11.9% reflecting policy uncertainty. Transportation at -10.9% translates into fewer goods shipping back and forth and partially reflects the aggressive investment in this sector in 2015-16. Professional Services -3.7%, Retail Trade -1.4%, and Manufacturing -0.3% are large sectors that remain in the dumps. If not for the diversions of "breads and circuses", we may be looking at an out and out contraction among private businesses in the U.S.

Regional Analysis

Every large state recorded a decrease in borrowing and investment by private companies in aggregate except North Carolina which barely squeaked out an increase at 1.7%. While the biggest states are not showing plummeting rates on investment by their private businesses, they are mostly negative.

Further demonstrating the waffling theme mentioned earlier, 6 of the 10 largest states are trending negative. Positives show in the near-term outlook for North Carolina, Ohio, Michigan and Texas. The growth drivers remain the same in those states as the national level – Public Administration, Entertainment, Administrative Services and Wholesale Trade.

Credit Risk Forecast

Consistent slow growth is not a bad thing because it can extend the longevity of the expansion phase and avoid boom to bust cycles. But a positive bump among private companies, like the one seen in public stocks, has failed to materialize. Weak growth equates to weak risk taking, and that translates into lower default rates for private companies.

PayNet's AbsolutePD® provides a read on future default rates by taking into account the drivers mentioned in this article and combining them with macroeconomic factors. We are forecasting default rates to remain at 1.8% for full year 2017 and to rise to 1.9% in 2018. While a projected increase in defaults, this is a moderate increase and a reversion back to more normal levels, albeit, still well below the long-term average for private company debt.

Historical and AbsolutePD® Forecast Default Rates

Industry Segment	Actual Historical Default Rates (1)		Forecast Default Rates (2)	
	2015	2016	2017*	2018
Mining	2.3%	4.9%	2.4%	1.9%
Transportation	2.6%	4.2%	4.3%	3.9%
Information	2.5%	2.2%	2.8%	2.7%
Professional Services	1.7%	2.1%	1.7%	1.7%
Agriculture	1.4%	2.1%	2.0%	1.6%
Construction	1.8%	2.1%	2.1%	2.2%
Accommodation and Food	1.6%	1.9%	2.3%	2.7%
Retail	1.8%	1.9%	1.7%	2.0%
Administrative Services	1.6%	1.8%	2.1%	2.0%
Manufacturing	1.5%	1.8%	1.8%	1.7%
Health Care	1.7%	1.8%	1.8%	2.1%
Other Services	1.2%	1.5%	1.5%	1.7%
Real Estate	1.0%	1.5%	1.4%	1.8%
Finance	1.2%	1.4%	1.5%	1.5%
Wholesale	1.3%	1.3%	1.4%	1.6%
Entertainment	0.9%	1.1%	1.2%	1.5%
Public Administration	0.6%	0.9%	0.9%	1.9%
Education	0.8%	0.9%	1.2%	1.6%
All Industries	**1.5%**	**1.8%**	**1.8%**	**1.9%**

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

$1.0mm or Less in Total Lease/Loan Exposure
*2017 Forecasts include 2 Quarters of actual defaults

Summary

Breads & circuses have replaced foundries, hospitals, grocery stores, and warehouse distributors as the key drivers of our economy now.

Evidence of a direct link between policy uncertainty and an industry sector in outright contraction can be found in the Health Care sector. More slow growth with strong financial health will result in moderate default rates for private company debt over the next quarter.

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 $1.5 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.

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