S&P Global
Market Intelligence

Small Businesses Dominate the World Scene - But Present Challenges When Analyzing Credit Risk

S&P Global RiskGauge Reports

Introduction

Small business is big business when looking at economic activity around the world. In 2017, small- and medium-sized enterprises (SMEs) accounted for approximately 90% of global businesses and more than 50% of worldwide employment.[1] SMEs played an even more significant role in the U.S. around this time, accounting for 99.7% of the 5.6 million employer firms in existence.[2]

The definition of an SME varies among countries and industries. In the U.S., it is typically a privately-held firm with fewer than 500 employees,[3] although this size varies by industry.[4] U.S. SMEs have been described as incubators for innovation and employment growth, and are major players on the international trade front. In 2015,[5] they comprised 97.6% of all identified exporters and 97.2 % of all identified importers, giving them a defining role in the supply chains of most economic activity.

While these millions of companies are the backbone of many economies, regions, and countries, significant challenges exist when evaluating their creditworthiness. They are a heterogeneous group, with idiosyncratic business models and risk profiles. They also tend to lack sufficient financial information to understand past performance and potential future cash flows. In addition, regardless of industry, they are often more affected by economic cycles than larger firms given their size. Being important cogs in the economic machine, detailed analysis is needed to understand their individual strengths and potential weaknesses as counterparties.

Unique Approaches to Assessing SME Credit Risk Can Help Avoid Unwanted Exposures

Credit risk analysis for an SME generally follows the same four-steps that are used to evaluate larger companies, as shown in Figure 1. However, a lack of available information on SMEs calls for the use of different methodologies and analytical tools to better understand the creditworthiness of these smaller-sized firms.

[1] "SMEs Finance", The World Bank, 2017, www.worldbank.org/en/topic/smefinance.

[2] "Annual Survey of Entrepreneurs", U.S. Census Bureau, 2016.

[3] "SME Definition," The balance small business, May 15, 2020, www.thebalancesmb.com/sme-small-to-medium-enterprise-definition-2947962; quoting U.S. Bureau of the Census 2016.

[4] The U.S. Small Business Association (SBA) provides a list of small business-size standards.

[5] "Frequently Asked Questions", June 2016, SBA Office of Advocacy.

Figure 1: A Four-Step Process for Assessing the Credit Risk of Counterparties

1: Identify and Validate an SME's Business → **2: Assess the Firm's Overall Risk** → **3: Set Credit Limits and Terms** → **4: Monitor Creditworthiness**

Take steps to better understand your customer:
- Their business model
- Location
- Contact details

Evaluate potential exposure:
- Credit risk
- Trade risk

Set exposure limits:
- Assess possible losses
- Protect on the downside

Track signs of credit deterioration:
- Identify early-warning signals
- Stay on top of developments

To help assess the potential risks of doing business with privately-held SMEs, we recently launched S&P Global RiskGauge Reports. Loaded with data and analytics, these comprehensive business credit reports synthesize information in an easy-to-use format to address the four-step process presented above for over 50 million companies across the globe.

1: Identify and Validate an SME's Business

As shown in Figure 2, S&P Global RiskGauge reports pull together essential information on an SME to better understand who they are and what they do. This includes:

- Date established
- Industry
- Address
- Number of employees
- Website and phone number
- Ultimate parent

Figure 2: Sample Firmographic Information

Modernistic, Inc. Date Created: Jun-18-2020

Address: 1987 Industrial Boulevard South, Stillwater, MN, 55082-6049, United States
Country/Region: United States of America
Industry: Office Services & Supplies

Website: www.modprint.com
Phone: 651-291-7650
Employees: 135
Status: Operating
Company Type: Private Corporate

Establish Date: 1938
SPCIQ Key: 4568110
MI Key: 7398021

Source: S&P Global Market Intelligence. For illustrative purposes only.

2: Assess the Firm's Overall Risk

A. Credit Risk

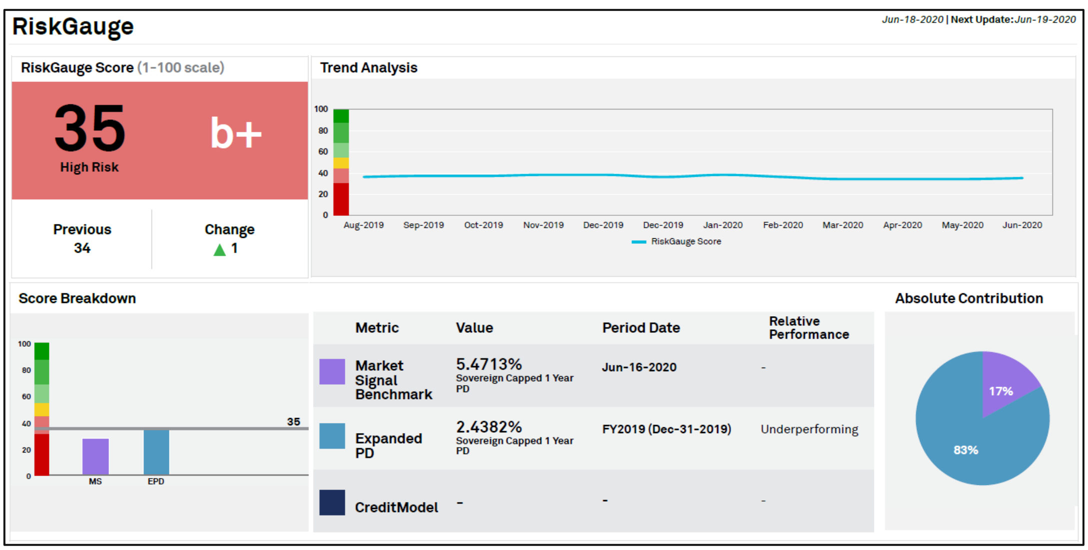
The credit risk portion of the reports draws upon our credit risk models that use advanced mathematical techniques to estimate creditworthiness in a quick, automated, and scalable manner. Each model is designed to meet a specific objective, so combining their results can help achieve a well-rounded view of credit risk. The models include:

- **CreditModel[TM] (CM),** a credit scoring model that leverages both financial data and the most relevant macroeconomic data to generate a quantitative credit score that is designed to broadly align with credit ratings issued by S&P Global Ratings.[6]
- **PD Model Fundamentals (PDFN)** that **i**ncorporates both financial risk and business risk to generate a probability of default (PD) value over a one- to more than 30-year horizon for public and private corporations of any size, and maps them to our credit scores.
- **PD Model Market Signals (PDMS),** a market-driven analysis of credit risk that links market movements to a company's PD. The model generates short-term PD values that are updated daily to reflect current market information, and are then mapped to a credit score.

One Unified Score

The S&P Global RiskGauge model combines these three credit risk assessments into a single RiskGauge Score to provide a simple, unified view of creditworthiness, with scores ranging from 1 to 100. As shown in Figure 3, the score breakdown shows the absolute contribution of each of the three models, and benchmarks indicate how an SME's credit risk level compares to its peers.

Figure 3: Sample Unified RiskGauge Score



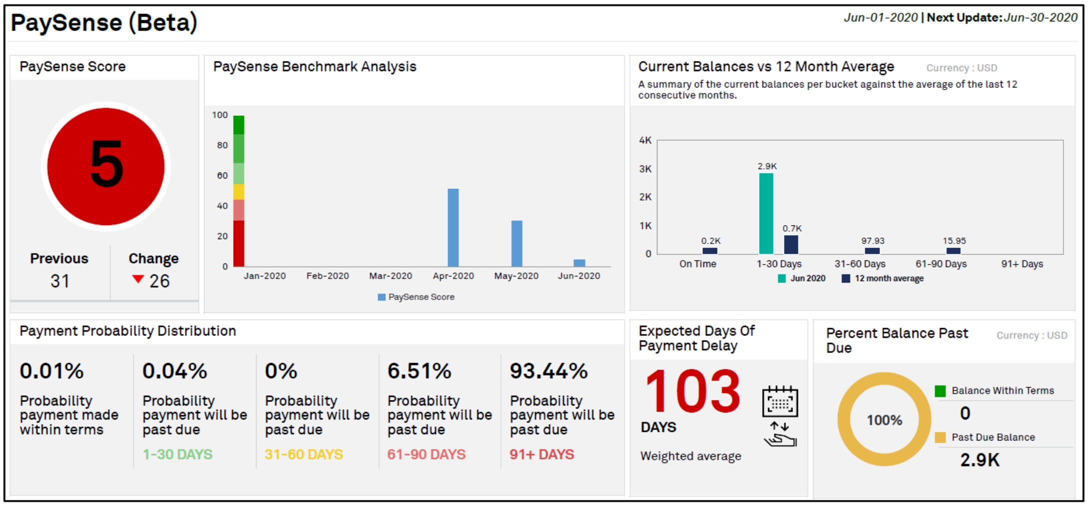
Source: S&P Global Market Intelligence. For illustrative purposes only.

B. Trade Risk

To assess the trade payment risk of SMEs, S&P Global's PaySense Model uses historical payment data and macroeconomic factors to estimate a company's potential delinquency (i.e., payment delay). This is captured in the PaySense (Beta) Score that also ranges from 1 to 100, as shown in Figure 4. The rich set of information contained in this section of the RiskGauge report shows the payment probability distribution, projections of expected payment delays, and more.

[6] S&P Global Ratings does not contribute to or participate in the creation of credit scores generated by S&P Global Market Intelligence. Lowercase nomenclature is used to differentiate S&P Global Market Intelligence credit model scores from the credit ratings issued by S&P Global Ratings.

Figure 4: Sample PaySense (Beta)

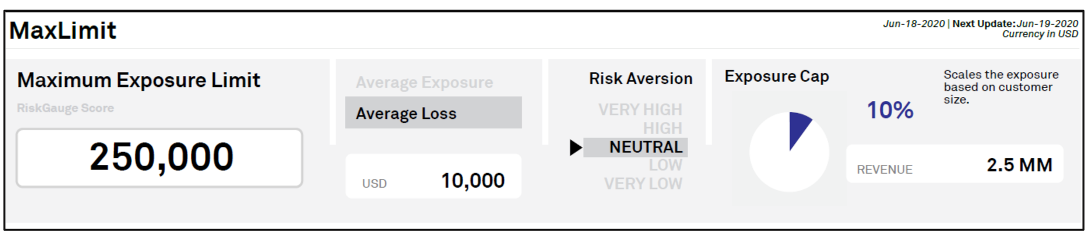


Source: S&P Global Market Intelligence. For illustrative purposes only.

3: Set Credit Limits and Terms

Defining the appropriate business credit limit for an SME plays an important role in helping a supplier maintain short-term liquidity, optimize growth opportunities, and manage the risk of non-payment. Our MaxLimit framework is a tool for managing existing exposures, or recommending maximum exposure limits based on multiple risk dimensions (i.e., it assesses the customer's financial and industry risks, while including the supplier's risk appetite). As shown in Figure 5, the MaxLimit scales the exposure based on the size of the SME.

Figure 5: Sample MaxLimit



Source: S&P Global Market Intelligence. For illustrative purposes only.

4: Monitor Creditworthiness

Assessing and monitoring the credit risk of counterparties and investments globally can be challenging and time consuming, especially for SMEs. S&P Global RiskGauge Reports are updated daily, providing fresh information to stay on top of developments that may impact a firm's creditworthiness.

Engage with SMEs with Confidence

SMEs dominate the world scene, but may appear risky to companies wanting to engage in business relationships with these firms, given the information gap that often exists. Unique approaches to assessing an SME's credit risk can reveal important insights to address these limitations. S&P Global RiskGauge was designed to streamline the credit risk analysis process and create more transparency by providing snapshots of essential information to support counterparty activities.

Please click here to request more information on S&P Global RiskGauge Reports available via Credit Analytics on the S&P Capital IQ platform.

About S&P Global Market Intelligence

At S&P Global Market Intelligence, we know that not all information is important—some of it is vital. Accurate, deep and insightful. We integrate financial and industry data, research, and news into tools that help track performance, generate alpha, identify investment ideas, understand competitive and industry dynamics, perform valuation, and assess credit risk. Investment professionals, government agencies, corporations, and universities globally can gain the intelligence essential to making business and financial decisions with conviction.

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