

Credit Conditions: Steady Improvement, But Causes for Concern

January 2012

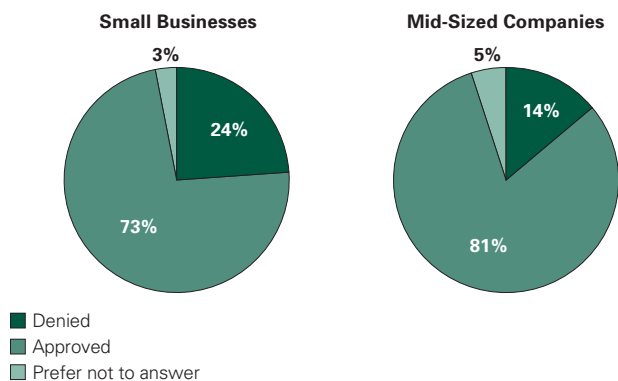
The results of an October Greenwich Associates Market Pulse of 464 small and mid-sized U.S. companies reveal steady improvement through most of 2011 in credit demand and credit approval rates among businesses. But in what could be a sign of increased caution, businesses that borrowed reported that it was harder to obtain credit.

“Banks in need of revenues and profits are under increasing pressure to pick up the pace of lending activity,” says Greenwich Associates consultant Duncan Banfield. “In the middle-market segment, banks are competing aggressively for lending business by lowering rates and fees and loosening terms and conditions. This is working to the strong benefit of creditworthy mid-sized U.S. companies.”

The Greenwich Market Pulse results reveal strong gains in both credit demand and supply. Overall credit application activity has nearly doubled each quarter over the past nine months among small businesses and mid-sized companies. However, the fact that only about one-third of these companies expect to apply for credit in the coming three quarters suggests that companies are moderating their outlook amid concerns that pressures on the economy could continue in the year ahead.

Bank credit approval rates in the fourth quarter of 2011 hit the highest levels observed in Greenwich’s post-crisis research. Approximately three out of four small businesses that applied for credit over the prior 12 months and approximately four out of five mid-sized applicants were approved by their financial institutions. Credit approval rates were strong for companies in the transport, mining and services sectors. Denial rates were highest for companies in the retail and construction sectors.

Credit Approval Rates



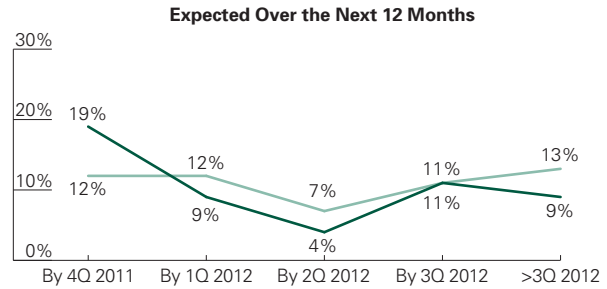
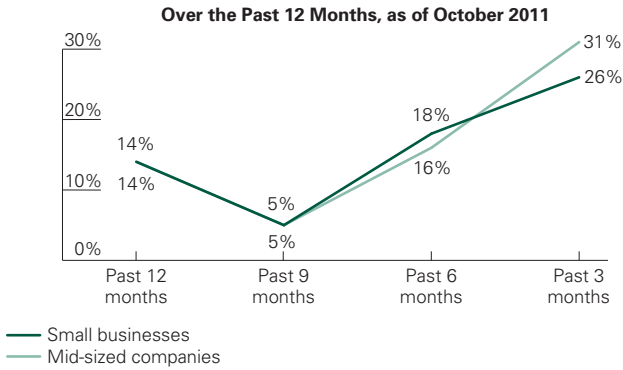
Note: Based on responses from 126 small businesses and 170 mid-sized companies in 2011. Source: Greenwich Market Pulse v43

Recommendations for Small Businesses and Mid-Sized Companies

Based on the results of the most recent Greenwich Associates Market Pulse study of U.S. businesses and extensive conversations with clients in the banking industry, Greenwich Associates presents the following recommendations for small and mid-sized companies:

- 1. Take advantage of favorable credit conditions.** Credit approval rates and overall borrowing rates increased steadily in 2011 for both small businesses and mid-sized companies. However, feedback from recent corporate borrowers suggests that bank lending policies could be tightening. Even if questions about the strength of the economy have companies on the fence about business strategy for 2012, it might make sense to lock in funding at a time when banks hungry for loan business are offering relatively favorable rates and terms.
- 2. Focus relentlessly on working capital.** In challenging economic times, companies that squeeze every possible efficiency out of their working capital management are at a significant advantage. In 4Q 2011, approximately 60% of small businesses and 70% of mid-sized companies said they were planning to fund general capital needs with cash or retained earnings — both up considerably from the prior year. Corrective action is required by companies incapable of meeting general capital needs through generated cash.
- 3. Act now to upgrade equipment.** Even companies pessimistic about the 2012 business environment should take advantage of relatively favorable credit conditions to repair or replace existing equipment, if required. Many companies have deferred such actions for several years as part of cost-management efforts. Employing affordable credit to fund equipment upgrades should be part of basic preparations for 2012 and beyond — even for companies without any plans for expansion.
- 4. Don’t bank on continued improvement in credit conditions.** Although measures of banks’ “willingness to lend” to small businesses and mid-sized companies improved during 2011, they may have hit their peak in the summer of last year and have slipped slightly in the fourth quarter. As we enter 2012, a host of negative factors including market volatility, slow job creation, and the European crisis are hanging over the economy and the banking sector. There is no doubt that credit conditions for small and mid-sized companies are quite favorable at the moment relative to conditions just 12 months ago. But companies should be working now to prepare themselves for continued challenges by keeping costs low, maximizing working capital and securing funding for operations and necessary capital expenses.
- 5. Lean on your banks for assistance.** Healthy mid-sized companies and even some small businesses that qualify for bank loans are in a relatively strong position to demand favorable terms and additional support from their banks. In addition to negotiating for the best rates and terms on loans, companies should press their banks to provide advice and assistance in key operational areas such as cash management. If a company’s relationship manager has not initiated a conversation about ways the bank might be able to help improve working capital management, company officials should request one — or find another bank willing to provide this type of support.

Demand for Credit



Note: Based on responses from 205 small businesses and 259 mid-sized companies in 2011. Source: Greenwich Market Pulse v43

Thanks to these improvements, concerns about the ability to access the credit required to operate their businesses have declined among mid-sized companies and small businesses. Among mid-sized companies, the share saying they are “very concerned” about their ability to access required amounts of credit in the year ahead has fallen to just 11% in 4Q 2011 from 24% in 3Q 2009, while the share saying they are “not at all concerned” about securing credit climbed to 48% from 31%. Among small businesses, the share of companies saying they are “very concerned” about their ability to access required amounts of credit has fallen to 23% in 4Q 2011 from 35% in 3Q 2009, while the share saying they are “not at all concerned” about securing credit climbed to 32% from 17%. Retail companies expressed the greatest concern about their access to credit in 2012, followed closely by firms in the construction sector.

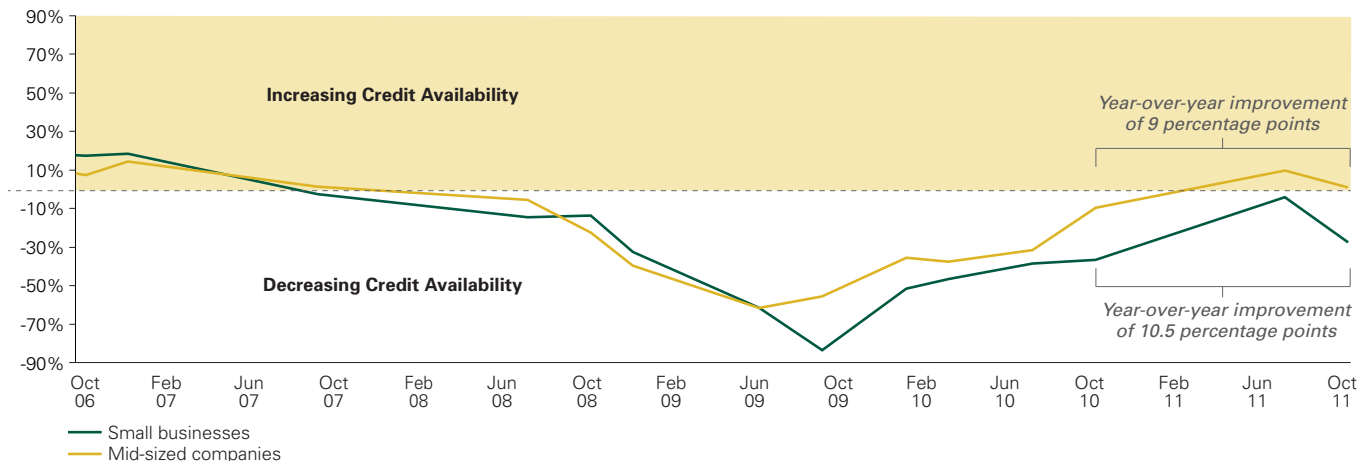
Tempered Optimism

It is important to note, however, that about two-thirds of small businesses and half of mid-sized businesses still express at least some degree of wariness about their ability to access sufficient amounts of credit in the coming year.

In fact, after two years of gradual but steady improvement, businesses’ perceptions of credit conditions took a sudden downward turn in 4Q 2011, according to the Greenwich Credit Availability Index. The Index score for small businesses had been moving in the direction of positive territory since October 2009. When the score is in the negative range, small businesses that obtained loans believe they were more difficult to obtain than in the prior year. Over the past three months, the positive trend reversed and the small business Index score dropped back further into the negative range.

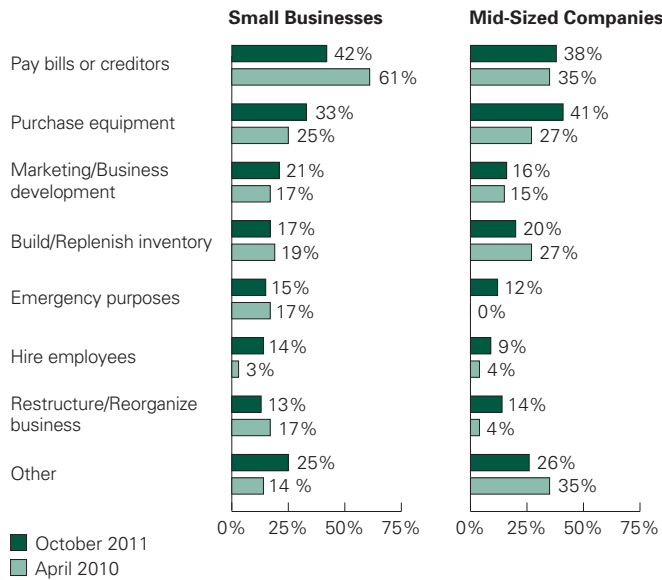
A similar reversal in outlook among mid-sized companies brought the Greenwich Credit Availability Index for this segment back to the brink of negative territory. The Index for mid-sized companies had been improving since June 2009 and finally broke through into the positive range in the summer of 2011, demonstrating that the number of mid-sized borrowers reporting greater ease in obtaining credit exceeded the number reporting more difficulty in borrowing. Nonetheless, the net year-over-year view of availability was positive for both small and mid-sized companies.

Greenwich Credit Availability Index



Note: Based on companies that have borrowed in the past 3 months. The Greenwich Credit Availability Index is the net score of companies that feel that credit is easier vs. harder to find. Based on responses from 205 small businesses and 259 mid-sized companies in 2011. Source: Greenwich Market Pulse v43

Use of Credit



Note: Based on responses from 205 small businesses and 259 mid-sized companies in 2011. Source: Greenwich Market Pulse v43

Uses of Credit

Small businesses and mid-sized companies that obtain credit are deploying this capital to two primary uses: purchasing equipment and paying bills or creditors. After two years of challenging financial and economic conditions, it comes as no surprise that paying off existing debts is the primary use of new capital among small businesses and the number-two use among mid-sized firms. Likewise, the heavy use of credit to fund equipment purchases can be tied to the difficult environment in which companies have been operating. “Many companies have been deferring equipment maintenance and replacement for years,” says Greenwich Associates consultant Don Raftery. “Access to credit gives companies the ability to finally take these critical steps.”

In what can be seen as a possibly positive signal for the U.S. economy, the share of small businesses and mid-sized companies planning to use credit to hire new employees has more than doubled since April 2011. But it must be noted that hiring plans remain far below other priorities in both segments: 14% of small businesses in October 2011 say they plan to use credit to hire new employees, up from just 3% in 2010. Among mid-sized businesses, 9% plan to use the credit they can obtain for hiring, up from 4% in 2010.

Modest Improvement in CAPEX Outlook

Looking ahead to 2012, there is a clear, if modest, positive bias in plans for CAPEX spending among small businesses and mid-sized companies, and a growing share of companies plan to fund CAPEX increases with bank credit.

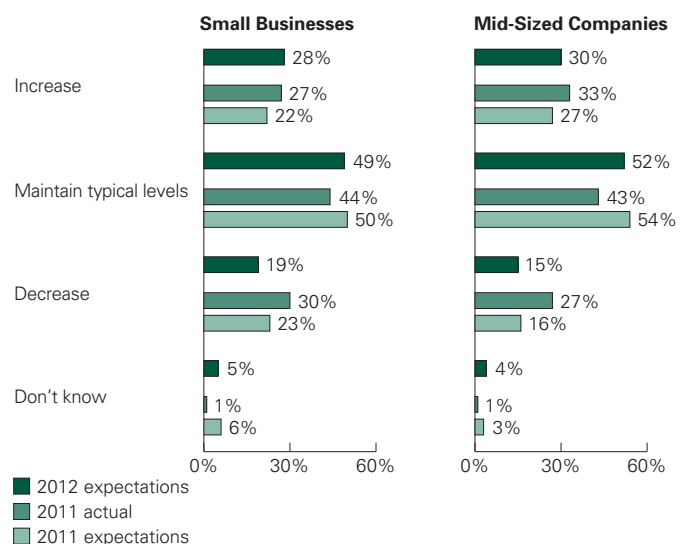
Among small businesses, 44% of firms kept capital expenditures unchanged in 2011 from the relatively low levels of 2010. Thirty percent of small businesses in 2011 decreased capital expenditures from 2010 levels, and 27% increased them. Among mid-sized companies, 43% held capital expenditures steady from 2010, one-third increased CAPEX spending and 27% reduced it.

Roughly half of small and mid-sized companies expect to maintain CAPEX spending at current levels in 2012. Twenty-eight percent of small businesses and 30% of mid-sized companies plan to increase CAPEX spending in the coming year, versus the 19% and 15%, respectively, planning reductions. Companies in retail and mining were the most likely to report plans to increase CAPEX, while companies in the wholesale and construction sectors lagged the overall average in terms of planned increases in capital spending.

A large majority of companies planning to reduce capital expenditures say they are taking the step due to uncertainty about the future of the economy or because they simply had no need for CAPEX spending in the current environment. “However, about one in five mid-sized companies and roughly a quarter of small businesses that reduced CAPEX spending last year’s aid they did so as part of broader, company-wide cost reduction efforts,” notes Greenwich Associates consultant Marc Harrison.

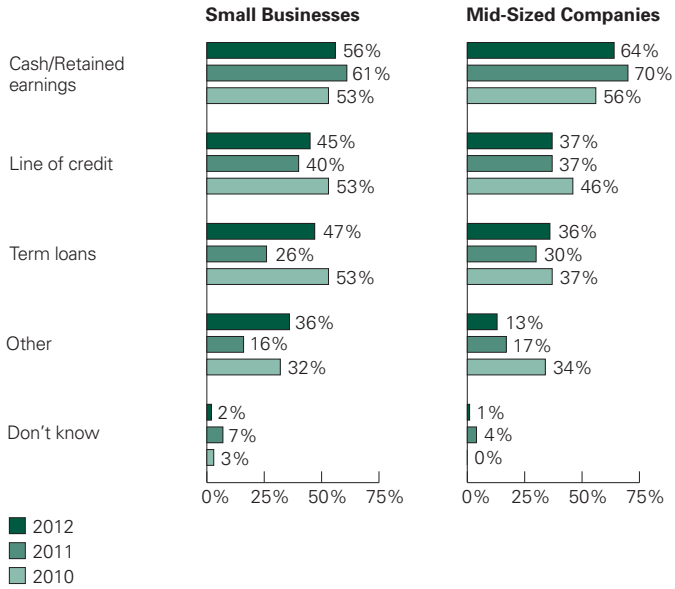
Reflecting the improvements in credit conditions that had taken place prior to 4Q 2011, a growing share of small businesses plan to increase CAPEX spending using bank credit for funding in 2012. Forty-seven percent of small businesses planning CAPEX increases for the coming year

Capital Expenditures: Expected vs. Actual



Note: Based on responses from 205 small businesses and 259 mid-sized companies in 2011. Source: Greenwich Market Pulse v43

Sources of Funding for Planned Capital Expenditures



Note: Based on responses from 205 small businesses and 259 mid-sized companies in 2011. Source: Greenwich Market Pulse v43

expect to fund those expenditures with bank term loans, up from just 26% at the same point last year, and 45% plan to fund increased CAPEX spending with lines of credit, up from 40% last year. Manufacturers and service industry firms planning to increase CAPEX will rely more on retained earnings to fund such expenses, while construction and wholesale firms expect to rely more heavily upon lines of credit.

Consultants Duncan Banfield, Larry Baily, Pete Garrison, David Fox, Don Raftery, and Marc Harrison advise on banking in the United States.

Methodology

The Greenwich Market Pulse is an ongoing research series that addresses the most important and timely issues facing small (\$1 million–\$10 million) and mid-sized (\$10 million–\$500 million) U.S. company executives and their banking relationships. The current study was conducted during October 2011 and included participation from 464 companies, including 205 small businesses and 259 middle market companies.

The findings reported in this document reflect solely the views reported to Greenwich Associates by the research participants. They do not represent opinions or endorsements by Greenwich Associates or its staff. Interviewees may be asked about their use of and demand for financial products and services and about investment practices in relevant financial markets. Greenwich Associates compiles the data received, conducts statistical analysis and reviews for presentation purposes in order to produce the final results.

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