

selected topic

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A Persistent Myth

Are Small Private Companies Really Riskier Than Large Public Firms?

Are Big Customers a Less Risky Bet? No!

It's often fun to challenge our preconceived notions, isn't it? For example, we all know that small private companies are much more likely to fail than the big famous firms of the Fortune 1000, right? It is a lot harder for a small firm to survive, right? Well, actually the statistics say the opposite is true. Over many decades, the probability of a big public firm defaulting has been higher, on average, than the risk of a small private company failing. And in bad times the risk of a big public firm failing is actually many times greater—compared to small private companies. Time to re-adjust your expectations and see the real risks to creditors...

Contrary to Our Experience ...

It certainly seems as if small firms are much more likely to fail. They do fail in very large numbers, too. In 2006, there were over 31,000 business bankruptcy filings in



failures. No wonder it seems like the risky companies are small.

Not So Safe After All

A completely different picture emerges when you compare the percentage chances of failure between small and large firms, over time. According to a dataset provided over the years by Dun & Bradstreet to the Statistical Abstract of the United States,¹ the average failure rate of commercial and industrial firms from 1920 to 1998 (when the series of data ends) averaged 0.65%, just over one out of 150 firms each year. The vast majority of these firms are very small and only an insignificant fraction are public companies, so we can safely say that the average probability of failure for “small private companies” is a lot less than 1%. Looking at individual years, the highest number reported in this Statistical Abstract

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the U.S., and that was actually a low number, compared to prior years. Most of these failures were small companies. In 2007, the default rate among large public companies was the lowest in over 20 years, at about 100

series is 1.54% in (you guessed it) 1932. The best year for small business (from the point of view of failures) was the “war year” of 1945, when failures were only 0.04%, about 1 of 2,500 firms each year.

What about large, mostly public companies? Well, unfortunately there’s no widely available, reliable database of public company failures covering this whole period. The Statistical Abstract certainly doesn’t tell us. But Moody’s provides a service to the public, publishing the default statistics of rated companies²—nearly all of whom report their financial data to the SEC or other financial regulators even if they don’t trade stocks, so they are nearly all “public” in the financial-reporting sense. It’s pretty safe to assume that the vast majority of these firms are large, given how Moody’s selects firms it will rate. So, here we have published statistics on a big sample population of large public firms.

Table 1

Data available 1920-1998			
	Average failure rate	Maximum	Minimum
Large public	1.00%	8.40%	0.00%
Small private	0.65%	1.54%	0.04%

What does Moody’s tell us? The average default rate of rated firms from 1920 to 1998 was almost exactly 1%. That’s more than one-and-a-half times the average risk for small private firms. Even more interesting, Moody’s tells us that the worst year during this period was 1933, with a default rate of over 8%. That’s five times the failure rate of small private companies in 1932. Why was it a year later? We can speculate that big public companies take a little longer to fail, failing in “slow motion” compared to small firms. Whatever the reasons, the data says that failure risk is much greater in bad times for large public companies than for small private ones. Finally, there were several good years when none of the Moody’s-rated companies failed. When times are good, big public companies do have less risk than small private ones.

Nearer to Today

We can extrapolate the 1920-1998 data series to 2006 if we are willing to switch to a new number series. The U.S. bankruptcy courts publish the number of new business bankruptcy filings each year,³ a series that’s available back before 1998. We can divide this “all business bankruptcies” number by the total number of U.S. employers, available from the Census Bureau.⁴ [This implies a rough assumption that employer firms file business bankruptcy, and non-employer firms (aka “sole proprietors”) file for personal bankruptcy.] In 1997, the D&B/Statistical Abstract number was 0.89% vs. 0.97% for this new number series. In 1998, the comparison is 0.76% vs. 0.90%. So, the new series is a bit more pessimistic, but in the same ballpark. As you can see in Chart 1 (next page), over the whole

period of 1920 to 2006, the large public firms rated by Moody’s were much riskier than the small private companies.

One important note about the Moody’s data: there is a big difference between “Investment Grade” (AAA to Baa) and the rest of the rated companies, called “Speculative.” From 1920 to 2005, annual defaults by “Investment Grade” issuers averaged just 0.15%, while the average for “Speculative” borrowers was a whopping 2.70%. There are a lot more “Speculative” issuers than “Investment Grade,” so watch those ratings.

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Does this make sense? Of course it does. The most obvious reason for a company to be “public” is so it can finance itself with the public’s money, and that includes debt. When times are good and lenders make credit easily available, there’s little chance for a big public company to fail with easy access to credit markets. Of course, with easy access, many will borrow too much, increasing their financial risk. Then, when credit is tight, these companies are much more likely to fail, because of their debt burden. By contrast, small private companies find it more difficult to borrow and, taken as a group, that relatively lighter debt means they are less likely to fail.

So, contrary to our preconceived notions, small private companies are actually less risky than large public companies. In the worst years, the large public companies are about five times more likely to default. This is pretty scary, considering that your sales to a small number of large public companies can be a big fraction of your total accounts receivable. Unlike small customers, just a few failures among these firms could seriously impact your business results. As Table 2 illustrates below, the average payable of large public non-financial companies is over 1,000 times larger than the average payable of private U.S. non-financial employers.⁵

Table 2

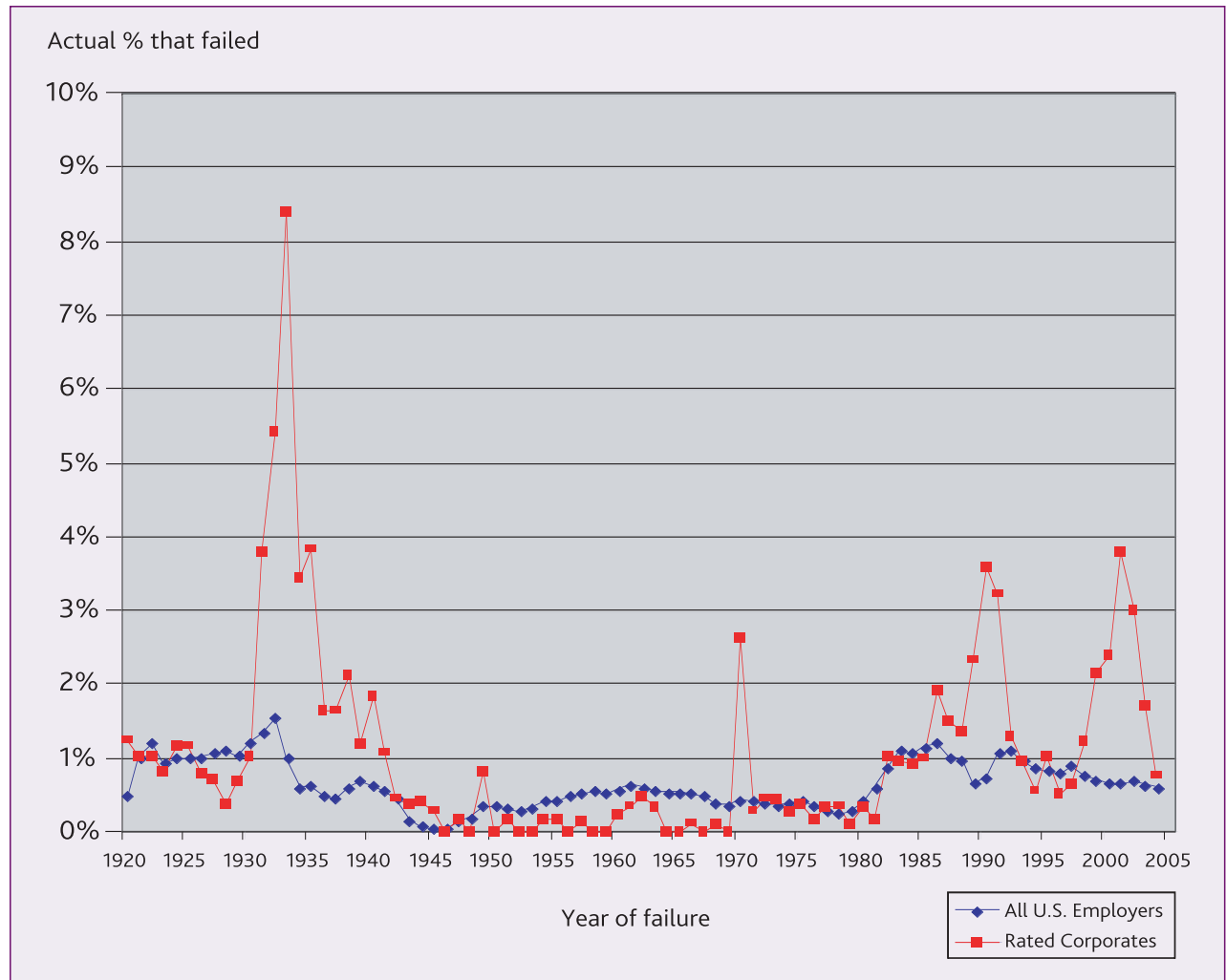
	Average Payables
Large public companies (non-financial)	\$ 153,000,000
Small private companies (non-financial)	\$ 141,000

Check Those Exposures, Now

In 2007-2008, we have moved from a period of easy credit to a period of tight credit. Moody’s, S&P and others are predicting a large and rapid increase in defaults during 2008, compared to the historically unusual low rates of default experienced in 2006 and 2007. Now is the time to revise your

Chart 1

Which do you think are riskier? Rated corporates or all employer firms?



expectations about where your risks really are—and carefully review your large public company exposures—before your company experiences a “slow motion” creditor’s ride into bankruptcy court. ●

1. *Statistical abstract of the United States*, various volumes, especially Table Series V 20-30, Business Formation and Business Failures: 1857 to 1970; No. 972. Industrial and Commercial Failures—Number and Liabilities: 1946-1979 (1980); No. 876 New Business Incorporations and Business Failures—Number and Liabilities: 1970-1988 (1990); No. 860 New Business Incorporations and Business Failures: 1970-1994 (1995)

2. Corporate Default and Recovery Rates, 1920-2007, Moody’s Investors Service, February 2008

3. 1990-2002 Calendar Year Bankruptcy Filings by Chapter and District, 2003 Calendar Year by Chapter, 2004 Calendar Year by Chapter, 2005 Calendar Year by Chapter, 2006 Calendar Year by Chapter, Administrative Office of U.S. Courts

4. *Statistical abstract of the United States*, Source U.S. Small Business Administration, Office of Advocacy, Statistics of U.S. Businesses, Table 737, “Establishments, Employment, and Annual Payroll by Enterprise Size: 1990 to 2004”

5. Statistic for public firms from queries of the CreditRiskMonitor database. Statistic for private companies derived from *Statistical abstract of the United States*, and B. 102 Balance Sheet of Non-Farm Non-Financial Corporate Businesses, Flow of Funds Accounts of the United States, Federal Reserve Board, 2006

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