WHITE PAPER

Working Capital and Guarantees

If you do business outside Canada, your foreign customers may require various types of guarantees before they'll sign a contract for your goods or services. These guarantees are issued to your customer by your bank, in the form of a standby letter of credit (LC) or a letter of guarantee (LG) for a percentage of the contract amount. (In this paper, we'll use "LG" to refer to both LCs and LGs.)

If you don't comply with your contractual obligations, your bank has to pay your customer the value of the LG. To protect itself, consequently, your bank will require your company to put up collateral equal to the LG's value. But doing this for a large contract, or for several contracts at once, can add up to a substantial amount. So the question is this: How can your company provide the collateral required for guarantees without compromising your working capital? This white paper explores that question.

WORKING CAPITAL AND GUARANTEES

Guarantees for export contracts come in several different forms. They can be contractual guarantees such as bid, advance payment, performance and warranty guarantees; financial guarantees such as supplier guarantees; and regulatory guarantees such as license or permit guarantees. In this paper, we'll focus on contractual guarantees, which are the most common form, and refer to them generically as "guarantees." They work as follows:

1. You agree to provide your customer with a guarantee, which your bank will issue on your behalf. The guarantee is in the form of an LG, which has a value equal to a specified percentage of the contract value. In essence, the guarantee is a promise to your customer, backed by cash, that you'll fulfil your contract.
2. You provide your bank with cash collateral equal to the value of the guarantee.
3. Your bank issues the LG, which has an expiry date, to your customer. The expiry date will correspond to the contract completion date or to a contract milestone.
4. Assuming you fulfil your contract obligations, the LG and therefore the guarantee expire without any issues. When they do, the bank gives you back your collateral.
5. If you don't fulfil your contract obligations, your customer can "make a call" under the guarantee. This means that your customer will notify your bank that they are calling the guarantee. If this happens, your bank must immediately pay your customer the value of the guarantee as specified in the LG.

It's the collateral requirement, as given in step 2 above, that can cause problems with your working capital. This is because a typical contractual guarantee has a value of anywhere from 10 to 25 per cent of the contract's value, so providing a 20 per cent guarantee for a $1 million contract would mean finding $200,000 in collateral. You might have this in cash, or the bank could carve it out of your line of credit. Either way, however, you're minus $200,000 in working capital, which you can't use until the LG has expired.

So far, so good. But suppose you have a run of new or repeat business and several customers demand guarantees as a contract condition. If this happens, your total cash outlay for the collateral may escalate until your available working capital falls to risky levels. With no financial elbow room, you won't be able to take on new contracts. Nor will you have cash for things you might need, such as equipment and materials for fulfilling contracts you've already signed, or for cost overruns.

RUNNING OUT OF CREDIT?

If your credit line and cash reserves are large enough, maintaining your working capital while posting collateral to your bank for guarantees may not be a problem. But if you start nudging up against your credit capacity, it may be time for a re-think.

Let's look again at that $1-million contract and its $200,000 guarantee requirement. If your credit line is $800,000, you'll still have $600,000 after posting the guarantee collateral. Let's assume you need $450,000 in working capital to operate, so you have a cushion of $150,000 ($600,000–$450,000).

Now suppose you want to bid on a second contract, but the customer requires a $250,000 LG as a guarantee and your bank won't increase your credit line. You're short by $100,000, so there goes the contract.

Except it doesn't have to, because this is where EDC comes in. Its **Account Performance Security Guarantee** – Account PSG for short – can make the difference between landing that contract and losing it.

Through the Account PSG, EDC can partner with your bank to provide it with a 100 per cent risk transfer so it can provide the LGs you require. If you only need to post LGs occasionally, EDC offers the Account PSG on a contract-by-contract basis. EDC also offers an umbrella guarantee through its Account PSG Facility, which provides a 12-month, pre-approved limit that covers your guarantee needs for a year. Applying is simple, no matter which form of Account PSG you use, so you won't get mired in paperwork.

So let's go back to our example and assume that EDC approves your company's Account PSG application for that $250,000 LG you need. With the Account PSG in place, your company doesn't have to put up any collateral, so providing the guarantee won't push you past the limit of your credit line – and you can bid on that contract after all. And if EDC approves an Account PSG Facility for your company, you can cover your guarantee requirements for the next 12 months with almost no effect on your working capital or cash flow.

RISKY BUSINESS

If you have a lot of cash tied up in guarantees, and your company takes a big financial hit, you could find yourself in a cash crunch. The hit could be customer non-payment, but there's also a type of risk associated with guarantees themselves – the "wrongful call."

A wrongful call happens when a customer decides you haven't met your contract conditions. The customer then "makes a call" under the guarantee – that is, demands that your bank pay them the guarantee's cash value. The bank must comply regardless of the merit of the call, and you'll be out the money unless you can prove the call was wrongful. Depending on the size of the guarantee, the effect on your credit line and working capital could be shattering.

Fortunately, EDC can provide **Performance Security Insurance** (PSI) coverage to protect you from wrongful calls. It can be used by itself or with the Account PSG, and covers up to 95 per cent of your losses if your foreign customer makes such a call on your guarantee. This means that a wrongful call won't undermine your financial resilience, and EDC will investigate the call with the intent of recovering the funds from your customer.

ACCOUNT PSG AND YOUR SALES STRATEGY

Keep in mind, though, that you shouldn't think of Account PSG as just a financial tool – it can also be a vital part of your sales strategy. You can easily provide guarantees when you're covered by an EDC Account PSG Facility, and you can tell potential customers this when you start negotiating. It says a lot about your creditworthiness and reliability, and may help you obtain advance payments for paying suppliers or even winning more contracts.

The bottom line? By using EDC's Account PSG, you can increase your financial capacity, bid on more projects, get more customers and protect your working capital – all in one convenient package.

COMMON QUESTIONS ABOUT ACCOUNT PSG

Who can apply for an Account PSG?

Canadian companies who export goods and services abroad, and require guarantees for export contracts, can apply to EDC for an Account PSG.

How do I apply for an Account PSG?

You provide EDC with two years of financial statements and your cash-flow projections. EDC will also assess your company's financial, technical and managerial capabilities.

How much does an Account PSG cost?

This depends on several factors, but basically it's priced to the risk level and the duration of the guarantee. The advantage of an Account PSG Facility is that it provides your company with a pre-set rate for guarantees for a 12-month period.

Do you have questions about your specific situation? You can **submit a free online inquiry** for answers or **contact your local EDC office** to find out more.

Ce document est également disponible en français.

edc.ca

WP-WCG-0913