WHITE PAPER

Finding the Treasures in Your Balance Sheet

HOW YOUR ASSETS CAN HELP YOU FINANCE YOUR GROWTH ABROAD

Getting a foothold in a foreign market can be difficult for a small to medium-sized enterprise (SME) if it has to depend solely on its own financial resources. Consequently, most SMEs turn to their banks when they need financing to develop and sustain their international operations.

Such financing may come in the form of bigger operating lines, capital expenditures loans for new machinery, term loans for acquiring an asset abroad, and many other kinds of support. In this white paper, we'll show you how the assets in your balance sheet can help you finance your business abroad.

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THE CHALLENGE OF EXPORT FINANCING

Foreign trade comes with inherently higher risks than domestic trade. Payment is slower, logistics are more difficult and the risk of non-payment is higher, to name just a few of the hazards. As a result, exporters often find it harder to obtain financing for their foreign operations than for their domestic business. Access to financing, in fact, is cited by Canadian SMEs as one of their biggest problems when they're trying to grow abroad.

If an exporter's existing operations and/or its current level of credit can support its international growth, financing may not be a problem. But if the company's foreign business increases sharply, or it starts taking on larger overseas contracts or wants to invest abroad, it may soon reach its credit limit with its bank. Without additional credit, the company may be unable to take advantage of new opportunities and its foreign growth may slow down or even stop.

Payment timing can also affect the need for credit—for example, when the company has to pay its bills long before it gets paid by an international customer. Payment terms of up to 180 days are common in foreign trade, and the exporter will need dependable access to credit to cover its expenses (such as paying its suppliers) during these periods of low cash flow. If its credit capacity is limited, it may not be able to take on new business until its cash flow rebounds. This, obviously, makes it harder for the company to grow.

For many exporters, one solution is to use their assets to help them increase their credit capacity—that is, the maximum amount of credit the bank will extend to them. In addition to cash on hand, these assets can be both foreign and domestic, and can include the company's receivables, inventory, real estate, physical plant and equipment. Depending on the type and value of the assets, the bank may (or may not) decide to provide the financing the exporter needs.

Before approaching its lender, though, the company should be clear on what banks will and won't support. Typically, they're in the business of providing working capital and will finance this from the kinds of assets described above. On the other hand, they're very unlikely to advance money for purposes such as marketing, salaries, rent and R&D.

THE VIEW FROM A BANKER AT RBC: WHAT DO WE LOOK FOR IN A COMPANY?

"Canadian banks are balance sheet lenders," says Greg Matthews, Commercial Account Manager, RBC Royal Bank. "This means that bankers tend to lend based on assets, so we always look at the company's balance sheet and certain metrics within it. This includes examining how much the company is leveraged—is it borrowing heavily and is it heavily indebted? Is the company liquid—that is, if things turned down for it tomorrow, could it pay back all its current debts? What kind of tangible net worth does it have—is it reinvesting in its business or taking money out as dividends? We look at all these items as a package, and ultimately we're asking whether the company can generate enough cash flow to service the loan if we provide it—that is, is the loan affordable for the borrower?"

TURNING YOUR RECEIVABLES INTO CASH AND CREDIT

Banks routinely margin receivables to provide financing for their clients' businesses. But while Canadian banks are quite willing to do this for domestic receivables, they're more cautious about margining foreign sales. Margining percentages are generally lower for overseas receivables, and a bank may consider some markets as too risky for any margining at all. This is because the risk of non-payment is generally higher with customers outside Canada, and if you don't get paid, you might default on your bank loan. The bank, understandably, has to allow for this when deciding whether to margin your foreign receivables and if so, for how much.

SOURCES OF RECEIVABLES INSURANCE

In addition to EDC, there are numerous private-sector financial institutions that provide Canadian companies with various types of receivables insurance. You'll find an extensive list in the **members** section of **Receivables Insurance Canada**.

So what are you to do if your export business is growing, but borrowing against your domestic receivables no longer provides enough working capital for your foreign operations?

The answer to your problem may lie in receivables insurance. This can do more than protect you against customer non-payment—using it can also increase your company's borrowing power. Why? Because when you insure a receivable, your bank knows you'll get paid even if your customer defaults. This greatly reduces its margining risk, so it may be willing to lend against the receivable and thus provide you with more credit capacity.

EDC provides a range of receivables insurance designed for both SMEs and larger companies. These products include Trade Protect, Accounts Receivable Insurance and Contract Frustration Insurance.

Trade Protect

EDC's **Trade Protect** can insure up to 90 per cent of your losses from risks such as customer non-payment or bankruptcy. If you put such a policy in place, your bank may be willing to increase your credit capacity according to the insured portion of the receivables. If you have a small number of international customers and want to protect against non-payment, this may be the ideal policy for you.

Trade Protect can significantly increase your ability to borrow. For example, suppose you land $50,000 worth of orders in an emerging market where your bank won't margin receivables. Without Trade Protect, you're limited to your existing credit. But with it, your bank may be willing to lend you up to 90 per cent of these new receivables—an increase of $45,000.

DON'T WANT RECEIVABLES INSURANCE?

If you prefer not to use receivables insurance, EDC's **Export Guarantee Program** (explained later in this paper) is an alternative that may allow your bank to lend against your foreign receivables.

Accounts Receivable Insurance

EDC's **Accounts Receivable Insurance** (ARI) insures up to 90 per cent of your losses from a wide range of commercial risks. As with Trade Protect, using ARI to cover your foreign receivables may allow your bank to include them when determining your total credit capacity.

The increase in your borrowing power could be substantial—at a 90 per cent coverage rate, ARI-protected foreign sales of $500,000 could translate into another $450,000 of available working capital. This could make a big difference to your cash flow and your ability to expand your overseas business.

THE VIEW FROM A BANKER AT RBC: MARGINING IN DOMESTIC AND FOREIGN MARKETS

"It is common for banks to margin up to approximately 75 per cent of bank-approved Canadian accounts receivable," says RBC's Matthews, "net of priority claims and with aging less than 90 days. For international bank-approved accounts receivable, the percentage varies within the market. For the United States, for example, it's typical to also margin up to 75 per cent of receivables, while in European countries such as the U.K. and Belgium, it's up to 65 per cent. Those levels of margining, though, may not provide the company with all the working capital it needs. But if it uses EDC's ARI to insure the foreign sale, we may be able to increase our margining to as much as 90 per cent of the receivable. So suppose you're selling to the United States, where we already margin 75 per cent, but you need just a bit more working capital. In that situation, EDC's ARI could help you access an extra 15 per cent of the receivable, which could be enough to fill the financing gap."

Contract Frustration Insurance

As with ARI and Trade Protect, your bank may be willing to increase your credit capacity if you take out EDC **Contract Frustration Insurance** (CFI) on a contract. This insures up to 90 per cent of eligible losses if you don't get paid owing to a range of commercial and political risks. For example, CFI can cover to up to 90 per cent of the costs incurred against the cancellation of your contract by your foreign buyer, even before those costs are invoiced and become a receivable. If you need working capital for a single export contract for services, goods or projects, CFI may be precisely what you need.

Factoring

In factoring (also known as receivables discounting), a financial institution purchases your receivable(s) at a discount. In doing so, it accepts the risk of non-payment, so you don't have to reimburse the institution if your customer fails to pay. The advantage of factoring is that you get your cash, minus the discount, as soon as you invoice your customer. This means you don't have to wait for your money, which can help maintain your cash flow if you've given your customer long payment terms.

There are several Canadian financial institutions that partner with EDC to provide receivables discounting. You can **contact them** directly to find out more.

FIDUS SYSTEMS SECURES ITS FUTURE WITH EDC CREDIT INSURANCE

Based in Ottawa and founded in 2001, Fidus offers electronic product development and consulting services to clients in the communications, semiconductor, computing, video, aerospace and defence fields. One challenge for the company's foreign operations is ensuring that it gets paid. "A big loss because of non-payment," says Vicki Coughey, the company's CFO and COO, "could pose an unnecessary financial risk for the company. We are not a large firm with deep reserves, so having our receivables insured with ARI is extremely important for our international business." Fidus has been using ARI for several years and Coughey considers it an integral part of the firm's credit management process.

LEVERAGING YOUR ASSETS WITH GUARANTEES

As we've described above, receivables insurance or factoring may provide all the cash your company needs to support its foreign operations. But suppose you need more credit than your bank is willing to issue. If this happens, have you hit an insurmountable wall?

Not necessarily. Many Canadian exporters have found themselves in this situation, and have discovered a solution that works for both them and their banks—EDC's **Export Guarantee Program** (EGP). Under the program, EDC can issue a guarantee to cover the financing you require, and this can give your bank the comfort it needs to extend more working capital for your operations abroad. And because the EGP is so flexible, it can support many different financing scenarios. Here are a few examples:

Increasing your operating line

Your company sells most of its production in the United States. Your U.S. sales are increasing quickly and you need a bigger operating line to support your growth. Your bank, however, is uneasy about the risk associated with your rapid expansion and is unwilling to agree. The solution is to arrange an EGP guarantee that will cover up to 75 per cent of the amount of your new line. Since the bank now carries only 25 per cent of the total risk, it can extend more financing so you can expand your U.S. market.

APPLYING FOR AN EGP GUARANTEE

You and your bank will need to work together to apply for a guarantee under the EGP. To do so, your bank must be willing to set up a loan for your company. For your part, you'll need to provide financial statements to support the application.

Margining your foreign receivables

Your bank has routinely provided you with working capital by margining your Canadian receivables. Now, however, you need cash to finance your international growth, so you ask the bank to margin your receivables in your current foreign markets. But the bank is uncomfortable with the non-payment risks of these markets, and declines to do so. To solve the problem, you and the bank turn to EDC, which issues an EGP guarantee for 65 per cent of the value of the receivables. This leaves the bank with an acceptable risk, so it can now provide you with the cash you need.

Margining your foreign inventory

Your bank is willing to margin against your Canadian inventory, but won't lend against inventory you hold in your foreign markets. In this case too, an EGP guarantee can reduce your bank's risk so it can margin your foreign inventory at the same level as your domestic inventory.

THE VIEW FROM A BANKER AT RBC: PURCHASE ORDER FINANCING

"We sometimes see situations where a company has a wonderful opportunity in a foreign country," says Matthews. "But although it has the purchase order in hand, it doesn't have enough working capital to support the new contract. In this case, the solution may be purchase order financing, which helps a company access money earlier in the business cycle, at the pre-accounts-receivable stage. This isn't something a bank might be able to handle on its own, but with EDC to help, your bank may be better positioned to finance this type of work in progress. In other words, once we have an EGP guarantee in place we may have more comfort around the project or transaction ahead of delivery. With the EGP, we can potentially provide financing against the purchase order so the company can fulfill its contract and drive sales growth."

Margining your R&D credits

Your company exports most of its production and wants to increase its R&D activities. To obtain the necessary working capital, you ask your bank to margin your end-of-year tax credits from the federal government's Scientific Research and Experimental Development (SR&ED) program. Your bank considers such margining to be too risky, but the EGP provides a solution—it guarantees 75 per cent of the SR&ED tax credit, leaving the bank with only 25 per cent of the risk. This allows the bank to extend more financing so you can carry out your R&D plans.

Loans for capital expenditures

Your foreign sales are growing quickly and you need a capital expenditures loan to buy more production machinery. But your bank is uneasy about increasing its exposure to your company, and its reluctance threatens your expansion plans. Once your bank and EDC arrange an EGP guarantee, however, the loan falls within the bank's risk limits. It issues the full amount of the loan, allowing you to buy the equipment and meet the growing foreign demand for your products.

Loans for foreign acquisitions

Your company has decided to buy a U.S. firm and you need a bank loan to help with the purchase. However, the amount would put your debt-to-equity ratio beyond your bank's upper limit, so you and your bank turn to EDC. Working together, you set up an EGP guarantee that secures up to 100 per cent of the loan for a period of three years. With the loan in place, you can acquire the U.S. company.

FOURQUEST ENERGY EXPANDS WITH A CAPITAL EXPENDITURES LOAN

Since 2008, Edmonton-based FourQuest Energy has been providing the oil and gas industries with pre-commissioning and commissioning services for facilities such as refineries. In 2010, the company found an opportunity to work on a major project in Kazakhstan, but needed a substantial capital expenditures loan to buy equipment. "What made the loan possible," says FourQuest's President Nik Grgic, "was EDC's Export Guarantee Program—without that guarantee, we never could have raised enough money to do the project. It was EDC's willingness to support FourQuest's first international venture that was the deal maker for us."

PRESERVING YOUR OPERATING LINE

Finding more credit capacity isn't the only financial challenge that exporters may face. In some situations, a company must avoid a *decrease* in its usable credit capacity—for example, when it needs to post collateral for a loan. Banks often obtain such collateral by reducing a company's operating line, which effectively shrinks the business's access to credit.

You may find yourself in this situation if you have to provide a performance guarantee as a condition of a foreign sale, or if you want to purchase a foreign exchange (FX) contract to protect yourself from unfavourable shifts in the value of the Canadian dollar. EDC may be able to help you in both these cases.

Contractual guarantees

The most common types of contractual guarantees are bid, advance payment, performance, labour, and material and warranty guarantees. Your international customers may require you to post such guarantees as a condition of a sale, or even as a condition for bidding on a contract.

If a guarantee is required, your bank will issue it on your behalf, usually in the form of a standby letter of credit (LC) for a percentage of the contract amount. The guarantee is a promise to your customer, backed by cash, that you'll fulfil various elements of the contract. If you don't, your bank has to pay your customer the value of the LC.

To protect itself, the bank will require you to put up collateral equal to the LC's value. If you don't have the cash to do this, the bank will normally freeze an equivalent portion of your operating line. This can erode your working capital at the very time you most need it, or even force you to decline a profitable foreign contract.

ACCOUNT PSG HELPS CANADIAN HYDRO COMPONENTS GROW ABROAD

Based in Almonte, Ontario, Canadian Hydro Components (CHC) has been building turbines for hydroelectric projects since 1987. "For a larger hydro installation," says Andrew Treble, the company's CFO, "the guarantee requirement is almost a given and these can be sizeable. Being a small exporter in the power industry, however, makes it hard to get economically viable support for our guarantee needs. As a result, EDC's Account PSGs are integral and essential to our operations. Without them, the collateral demands on our working capital would significantly limit our ability to manage and grow our export-led business."

You can avoid this by using an EDC **Account Performance Security Guarantee** (Account PSG). Under this arrangement, EDC will provide your bank with a 100 per cent guarantee for the value of the LC. This means your bank will no longer need collateral, so you can carry out the foreign contract while retaining full access to your operating line.

You should be aware, though, of a risk that's associated with the standby LCs themselves. This is the "wrongful call," which can happen if your customer decides you haven't lived up to your contract. The customer then "makes a call" under the guarantee—that is, they demand that your bank pay them the cash value of the LC. Since these LCs are unconditional and irrevocable, the bank must comply even if the call is unjustified, and you'll lose the money.

Fortunately, EDC can provide **Performance Security Insurance** 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 it is deemed that your international customer made a wrongful call against you.

Foreign exchange contracts

Unfavourable shifts in the FX rate of the Canadian dollar can lead to substantial losses for an exporter's bottom line. This risk can also increase sharply when payment terms are long, as they often are in international transactions.

To protect yourself, you can work with your bank to build an FX hedging strategy for your operations, or simply purchase an FX contract from your bank. The contract locks in the exchange rate so you won't lose money on your deal if the rate moves in an unfavourable direction. But before your bank will provide the contract, it may require you to post collateral of up to 15 per cent of the FX contract's value.

Banks often obtain this cash by freezing part of a company's operating line. This means that on an FX contract worth $1 million, you could lose $150,000 from your line and not get it back till you're paid—possibly months later. That's money you could be using to do more business.

If you find yourself in this position, EDC's **Foreign Exchange Facility Guarantee** (FXG) may offer a solution. With the guarantee in place, your bank knows it's protected and won't demand collateral for the FX contract.

EIGHT TIPS FOR TALKING TO YOUR BANK

While EDC may be able to help you obtain more export financing from your bank, it's ultimately your job to convince the bank that lending you the money is a good idea. You'll be more likely to succeed if you know what the bank will want from you. Here are some of the basics:

1. Before you approach your banker, understand what can be financed and what won't likely be financed. It can also be a good idea to seek out specialized lenders that are linked to your industry.
2. Help your banker understand your business—where you've been, where you are now and where you want to go. Provide an executive summary of your business and the industry in which you operate, and the market you hope to address.
3. Be specific about how much you want to borrow, why you want to borrow it and precisely how you intend to use the money. To help make your case, provide financial forecasts.
4. Show that you have a regularly updated business plan and that this plan lays out a strategic direction for the company. Provide current data that describes your financial progress in the context of your plan.
5. Demonstrate a reasonable level of financial and business sophistication in your overall operations, and in your use of professional experts such as accountants, lawyers and other advisors.
6. Bankers typically want to be part of a growth story, so you should show that you're investing in the business for the long term. If shareholders are aggressively taking out profits as dividends, for example, this may not be an ideal time to request financing for expansion.

7. If your company has annual revenues of $1 million or more, you might consider adding the discipline of holding formal, regular board meetings. As companies grow and become more complex, demonstrating good board governance may give comfort to lenders that might provide financing.

8. If your bank is reluctant to lend you money because the loan seems too risky, or if you're seeking to grow in new international markets, suggest asking EDC for help.

Financing. Asset protection. Risk management.

EDC can help you with all these and more:

- Need financing to grow your international business? We can help you **find it**.
- Want to protect your foreign receivables? We can help you **secure them**.
- Need to manage risks abroad? We can help you **control them**.

To find out more, call our Solutions toll-free number at 1-800-229-0575, or go online and **submit a question.** We'll answer your inquiries within one business day, weekdays between 9 am – 5 pm EST.

For more information, please visit **edc.ca**

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