AIL STRUCTURED FINANCE

We bridge the gap

Spotlight AIL'services for SME

AIL Structured Finance's Services for Small and Medium-sized enterprises "SME"'s

Table of Content

1. Risk assessment
2. Structuring Solutions
3. Advice on Commercial Issues of Delivery Contracts
4. Pre-Shipment Risk
5. Working Capital Insurance
6. Contract and Counter Guarantees
7. Payment Security Concept
8. Supplier Credit vs. Buyer's Credit
9. Private Insurers
10. Financing Solutions as Sales Support

The services provided by AIL Structured Finance are available not only for major projects and large companies, but also for small projects (e.g. with a delivery value not exceeding CHF 5 million) with an international focus. During the past months, AIL has e.g. worked on several smaller transactions from the three main linguistic regions of Switzerland. The aim of this article is to explain by means of practical examples, how exporters can achieve a competitive advantage by offering tailor made financing solutions to their customers and financial sales support.

1. Risk Assessment

The evaluation and assessment of risks and its mitigation

AIL's mandate often starts with a detailed risk assessment of the project. A first evaluation aims to review the most relevant aspects of a project:

- The contractual and project structure (see also "Structuring")
- Specific commercial terms of the delivery contract (see also "Advices on commercial issues of delivery contracts")
- The profile of the customer, its creditworthiness, available security package and an assessment of the payment risk (see also "Payment Security Concept")
- Project cash flow (see also working capital insurance)
- Political and regulatory risk profile of the project
- Currency risk

Once the risk evaluation has been completed, AIL works out a project specific risk mitigation action list. Possible risk mitigation measures are described further down in this article within the relevant section.

2. Structuring Solutions

Suppliers occasionally receive special requests from customers that do not fit in their common contractual framework. In order to reduce the exporter's commercial risks or even just to come in a position to enter into a new contract, it might be necessary to adapt the contractual structure. Such amendments might also be necessary to get an export delivery contract in place which is eligible for a SERV cover (or to potentially maximise the SERV cover) in order to ease the financing of the delivery contract, if requested. Such structuring solutions are mainly based on a tailor made approach.

As an example, a client of AIL once received from a customer, a government entity in an Asian country, a request for the delivery of a printing machine amounting to EUR 4 million and rolling materials thereof (total value for 4 years of production: EUR 3 million) for the production of security printings.

This Asian customer made a request for financing to the exporter for the printing machine and to pay for the rolling materials only once the security printings have been paid to him. AIL's client proposed a five year financing solution for the machine and, on a cash basis, quarterly instalments for the rolling materials.

The financing of the machine, backed by a SERV insurance policy, was not the main issue in this project. The bigger challenge was the fact that, since the Asian customer wanted to avoid any potential cashflow shortfalls, he was not willing to prepay for the rolling materials if he had not been paid for the security printings before. Under these conditions an ordinary insurance which would cover the non-payment risk of the rolling materials could not been concluded. This at least as long as there was no firm commitment from the Asian customer to pay for the produced (but not necessarily sold to end customers) security printings.

A first step in the structuring of the contract was to define the different payment cash flows of the printing machine and the rolling materials. While it has been agreed that the printing machine could be financed under an ordinary supplier credit scheme with a repayment period of five years, further negotiations were needed to elaborate a scheme for the payment of the rolling materials. At this stage, AIL assisted its client in the development of possible structures and payment terms, still allowing a SERV cover and thus reducing the exporter's risks towards its Asian customer.

Finally, it was agreed that the Asian customer would firmly commit to buy a fixed amount of rolling material per year for the entire duration of five years. The amount committed was fixed and at the same time linked to a minimum of sales expectations. This procedure was defined in order to avoid that the Asian customer has to pay for rolling materials which could not be printed during the same year. The payment of rolling materials was defined to occur quarterly, on the basis of the effectively sold security printings. At the end of the year, and for the case that not all the security printing had been sold, the Asian customer was obliged to pay for the delivered rolling materials anyway. For the year's two to five, the same procedure applied.

With this solution, AIL's client was able to secure the cash flow streams for the deliveries of the rolling materials on a yearly basis, backed by a SERV insurance, covering the non-payment risk of its Asian customer based on his commitment to pay for a certain minimum of rolling materials at least at the end of each year.

3. Advice on Commercial Issues of Delivery Contracts

An important issue of the risk assessment is the study of the draft of the delivery contract. As a cornerstone of the commercial relation between the exporter and the buyer, the delivery contract shall also be analysed under the perspective of the risk exposure taken by the exporter. AIL does not give any legal advice; however certain clauses of a delivery contract are important to assess the level of risks. Typical issues and clauses to pay particular attention are for instance:

- Contractual partner: who is your customer? What is its financial strength and its track record? If its balance sheet is not sufficient for the value of the delivery contract, can the customer provide additional securities (e.g. guarantee of the mother company)?

- Payment terms: on the one hand, if a financing solution is requested, the payment terms must be compliant with the rules and regulations applicable by the export credit agencies such as SERV; on the other hand, are the advance and interim payments agreed sufficient to pre-finance the works and orders to sub-contractors?

- Guarantees: What sorts of guarantees are asked to be provided by the bank of the exporter? Is the requirement (type, amount, duration) in line with the common practice?
- Effectiveness of the contract: does the contract come into force at signing or are there preconditions to be fulfilled prior coming into

force? Is it possible for the exporter to start its work at contract effectiveness date or does the exporter faces any risks while starting the works without contract effectiveness?

- Termination: how is the termination defined? What are the consequences for the exporter in case of a termination? Is there an indemnification process defined in the contract?
- What are the contract language, the applicable law and jurisdiction? Is this an issue for the exporter?

4. Pre-shipment Risk

A supplier concluding a delivery contract can face the risk of a cancellation (for instance due to political events or the insolvency of the buyer) of a contract even before the delivery of its product has started. The longer the duration of the delivery period is set, the bigger the risk of a cancellation. In case the supplier delivers a standard machine or product, the risk may remain limited, as the machine or the product could still be sold without loss (or with limited loss) to another client.

However, in case of tailor made equipment, it could be difficult to find an equivalent buyer for the equipment produced. This pre-shipment risk, also called manufacturing risk, can be covered by SERV, alternatively another export risk credit insurance or also the private insurers.

The key drivers for the assessment of the pre-shipment risks are:

- The buyer and its country domicile
- The risk duration and the project specific delivery schedule
- The risk exposure/project cash flow profile during the delivery period

The risk exposure profile during the delivery period is the main factor that can be influenced by the exporter. First of all, every down and interim payment received by the supplier before a delivery help to reduce the exporter's risk exposure accordingly. Second, the supplier should bear in mind that a potential resale of equipment, or also only the resale or re-use only of certain components for other project(s) can substantially reduce the exposure.

AIL has a broad experience in the mitigation of pre-shipment risks and is glad to assist the supplier in the assessment of its risk exposure during the construction / delivery period and, consequently, find an appropriate insurance solution to mitigate the pre-shipment risk.

5. Working Capital Insurance

Financing solutions for export projects with a non-favourable cash flow profile for the exporter (e.g. managing a negative cash-flow and working capital situation during the delivery period)

A couple of years ago SERV launched a new insurance product called "Working Capital Insurance". This product aims to support small and medium sized enterprises (SME) to get an easier access to working capital credit bank facilities in order to finance their working capital needs in relation with a specific export project. This for instance due to unfavourable payment terms defined in a delivery contract (e.g. strong negative project cash flow during the delivery period).

AIL has supported different clients in several projects to receive a project specific working capital insurance coverage, making it easier to conclude a working capital facility with a bank to attractive terms and conditions. Another advantage of this finance instrument, in particular for SME's, is that a) it creates some flexibility for the supplier, since he has the choice of the percentage of the delivery contract which should be financed by the facility and which part out of its own means and b) SERV covered working capital facilities are normally based on quite standardized bank facility agreements; this helps to reduce the complexity of a credit agreement and to keep the legal costs to a reasonable level.

One of AIL clients has concluded a contract with a governmental entity in an African country for the delivery of a test facility amounting to approx. CHF 1.5 million. Payment terms had already been defined in the tender documentation and the supplier had no possibility to renegotiate them. The tender stipulated a down payment of 10%, with a final payment at delivery of 90%. As a consequence of these pre-defined payment terms, the project cash flow was strongly negative. In order to cope with the non-favourable payment conditions of the project without jeopardizing other projects or the company, the supplier decided to apply for a SERV working capital insurance coverage.

In relation with this project, AIL's services first consisted in the evaluation of the project specific risks as well as the assistance to the supplier to determinate its working capital needs. Based on these analyses, AIL prepared the application for a SERV insurance cover in favour of the supplier and coordinated with the client's house bank the application for a SERV working capital insurance (application for the working capital insurance has to be carried out by the financing bank). A final step was to

comment the bank's credit facility agreement on behalf of the exporter and to give advice on common market practise.

6. Contract and Counter Guarantees

After the conclusion of a delivery contract, the supplier often is faced with the requirement to issue a guarantee for the down payments to be received. SMEs may have difficulties to get the necessary bonding lines or only receive such bonding lines by depositing the corresponding cash amount. As a consequence and from a cash flow perspective the down payment agreed does not really make sense anymore.

AIL advised a SME-client, who signed a contract amounting to CHF 18 millions', represented a substantial part of its annual turnover, for the delivery of a furnace to an industrial customer in a country of the Middle East. As a pre-condition for the contract effectiveness, the supplier had to provide a guarantee of 5% of the total delivery value, i.e. CHF 0.9 million. The supplier's house bank would have accepted to issue the requested guarantee only against the deposit of an equivalent cash amount. Considering the supplier's rather tight cash situation, the bank's position strongly threatened the supplier's position to enter into this promising contract.

AIL supported its client in finding an appropriate solution and gave assistance in the SERV application process for the installation of a counter guarantee. Beside the due diligence of the project, SERV also exercised a due diligence of the supplier. Based on these results SERV agreed to issue a counter guarantee as applied to the supplier's house bank, which in its turn then issued the guarantee in favour of the supplier's customer.

7. Payment Security Concept

At the time of the conclusion of a delivery contract, one main risk of the supplier consists in the credit risk, meaning to be paid for the good or service delivered. It is primary in the responsibility of the supplier to make sure that its counterparty (the buyer) is creditworthy; this is also known as "know your client" principle.

Also in the case of a positive credit risk assessment, it is clear that still many factors (e.g. political, macro-economic, etc.) can affect the creditworthiness of the buyer. In order to mitigate these risks, several instruments can be used:

- A letter of credit
- An insurance of SERV
- An insurance of a private insurer
- Sales / discount of (future) receivables

All above listed instruments imply that the buyer has a sufficient creditworthiness and is well accepted by a bank (e.g. in the case of using a letter of credit or the discount of receivables), an insurer (in the case of the use of an insurance cover from SERV or a private insurer) or a factoring company (sales or discount of receivables). However, should the bank, the insurer or the factoring company refuse to take the payment risk of the buyer, there still can be other alternatives.

A first solution is to identify a solvent guarantor for the payment of the supplier's invoices in the environment of the buyer, for instance its mother company or a strong business / project partner. If the issuance of such a guarantee is not possible or not appropriate, banks, insurer or factoring companies may also accept "Letters of Comfort" or "Letters of Support". Such letters do not contain any constraint to pay on first demand and without objection, but, if the undertaking of the issuer is strong enough, may still be acceptable.

Another solution may consist in the securing of the buyer's payments. This by the request that part of its client(s)' revenues have to be paid into special (escrow) accounts, with limited access rights of the buyer, and which money only is transferred to the supplier directly.

Payment securities are usually tailor made solutions, for which AIL works closely with the supplier to find the best possible solution, mostly based on a cost-benefit analysis for the customer.

8. Supplier Credit vs Buyer's credit

Various types of export financing solutions (supplier credit vs buyer's credit)

Export financing is mainly composed of two types of credits both backed on SERV coverage: the buyer's credit and the supplier's credit. The purpose of a buyer's credit is to partially finance (up to 85% of the delivery value) a delivery contract directly on the buyer's balance sheet, secured by the insurance coverage of SERV and funded by a bank. In certain situations, this type of financing can be inappropriate:

- For smaller project, the transaction costs (loan & security documentation, legal opinions, due diligence costs etc.) could be unreasonable for the size of the project
- Certain buyers prefer to conclude only one single contract (delivery contract including financing / deferred or extended payment terms) with one counterparty rather than have two separate contracts with two different counterparties (delivery contract with the supplier and credit facility agreement with a bank) in place.

In case a buyer's credit seems not to be the appropriate solution, a supplier credit may be a true alternative. This also against the background that the supplier still has the possibility, subject to SERV consent, to get a respective SERV insurance coverage in place and based on that to apply for respective refinancing from a bank.

AIL Structured Finance has already structured and closed several supplier credit transactions.

For example, a client in the Italian speaking part of Switzerland has concluded a contract with an Indonesian buyer for the delivery of a machine in the amount of approx. CHF 0.5 million. AIL tasks within the transaction first included the reformulation of certain clauses in the delivery contract in order to directly integrate the financing terms and conditions in the delivery contract. Concretely, that meant that the buyer did not pay 100% of the contract amount at the time of the delivery of the machine, but within the duration of five years in 10 half-yearly instalments.

The second task of AIL was to manage the SERV application process in the name of the supplier. This process was started in order to get an insurance coverage in place for the exporter's credit risk during the delivery and the five years repayment period. Once SERV approved the insurance of the transaction, AIL coordinated the process on behalf of its client with the supplier's house bank to sell them the payment obligations of the Indonesian buyer. AIL in cooperation with the bank involved thereby computed the total interest amount to be paid by the buyer for the entire credit duration (five years) and add it, together with the SERV insurance premium due, to the amount to be paid by the buyer. The bank prepared the corresponding payment schedule. With the customer's signature and the acknowledgment of its payment obligation, the buyer made this financing effective. The beauty of such a transaction was that a) the exporter consequently received the entire value of the delivery contract at the time of delivery and b) due to the back-up of the SERV insurance policy for the payment obligation of the buyer this was achieved at very reasonable costs.

However, the supplier shall be aware that such a supplier's credit solution also contains certain risks:

- Increase of the interest rate during the delivery period: in order to mitigate the supplier's interest risk the supplier shall shift the risk to the buyer either by i) including an additional (security) margin on the top of the interest rate or alternatively ii) the delivery contract should contain a clause allowing the adaptation of the interest rate.
- In case of a default (non-payment of the buyer under the delivery contract), the deductible of 5% under the SERV insurance must be borne by the supplier.

9. Private Insurers

Managing of project specific risks with private insurers (e.g. coverage of political and credit risks)

As an alternative to a SERV insurance covering the credit, political or pre-shipment risk, a cover of a private insurer can also be considered. In our experience the private insurers in particular are a real alternative to SERV in the following situations:

- The Swiss content/sourcing under the delivery volume is not as big to be eligible for a SERV cover
- For EU / EFTA and OECD countries with a credit duration not exceeding 24 months
- For the tailor-made insurance of pre-shipment risks, as long as the delivery period does not exceed a duration between 18 and 24 months.

AIL has already cooperated with several private insurers in various projects. First, it must be stressed that every private insurer has set its own rules, practices and policies. Quite often they have country restrictions and credit limits and the focus may be limited to certain geographical areas. Usually private insurers can give an indication if a cover is possible within a couple of days. Another advantage of private insurers is that certain clauses of the insurance policy and terms can be negotiated.

Some of the main aspects to be considered, while analysing the policy of a private insurer:

- Coverage: does the insurance correspond to the supplier's need? Are both political and commercial (risk of non-payment) covered? If not, is the proposed coverage ratio sufficient?

- Pre-shipment / manufacturing risk: is the pre-shipment / manufacturing risk included in the cover?
- What are the exclusions mentioned in the policy? In case a specific risk which might be relevant for the project is excluded from the policy, a corresponding cover shall be negotiated with the private insurer.
- What type of project costs are covered under the pre-shipment / manufacturing risks? Usually, only direct costs are covered, overheads and profit margins not.

10. Financing Solutions as Sales Support

In many industries customers are interested to get comprehensive solutions from the supplier and not only a machine or an equipment. After sales service is not the single additional requirement. Overall maintenance, but also financing of the machine or the equipment is required. It is often challenging for SME's to offer a suitable and integrated financing proposal to their customers already in the phase of the bid process for the delivery of a machine or equipment.

AIL may assist such suppliers in the submission of financing proposals. The services may comprise in:

- The evaluation of the tender requests (financing and commercial aspects) and of project specific risks.
- The suggestion of risk mitigation strategies (setting up a risk mitigation strategy after submission of an offer may be too late).
- The definition of a project / financing structure in accordance with the needs of both the supplier and the buyer, taking into consideration the current financial market conditions.
- An informal enquiry or a formal application (for an insurance commitment in principle) to SERV for an insurance cover of the financing of the project.
- Approaching several banks out of the AIL international banking network to sound out the interest of the banking market for such financing, possible restrictions and to get an indicative pricing of the financing (interest rate, banking fees). The pre-selection of possible banks is strictly coordinated with the supplier or possibly with the buyer and is based on the project specificities considering the strengths of the bank(s) in relation with the project.
- The preparation of a financing outline presenting the proposed financing solution.

Most of the above mentioned activities are not a core business of many companies and in particular not of SME's. If a company is not constantly

active in this specific field of financing, it is hard to keep up with the developments and possibilities in this industry and to cultivate a network with professional business partners. Companies who run a pro-active approach in the field of financial sales support increasingly possess a competitive advantage over its rivals.

The individual members of the AIL team, consisting of highly-skilled professionals, with a proven track record in international project- and export finance, are glad to assist companies with their broad network of industrial and financial partners and to develop appropriate financial solutions to support exporters to be successful in a challenging market environment.

Contact

AIL Structured Finance Ltd
Schaffhauserstr. 418
CH-8050 Zurich / Switzerland
www.ailsf.ch
Attn: Andres Heusser
Phone: +41 43 299 62 11
Email: andres.heusser@ailsf.ch