

## What is a Financial Guarantee (Surety Bond)?

(Information contained herein may change at anytime without notice)

### 1. What is a Financial Surety?

A Financial Surety (Financial Guarantee) is created when a Funder agrees with a Borrower to repay a financial obligation at some agreed to future date.

In the case of an Investor, the Investee agrees to redeem the investor's preference shares at some agreed future date.

To achieve the above outcome the Funder and or Investor is provided with additional security by way of an irrevocable, non-cancellable Surety, to promptly receive payment of the agreed amount on the agreed future date should the Borrower default in its obligation to do so.

The Funder/Investor is protected by the above Surety Bond in the event that the Borrower defaults (does not perform his obligation of making the agreed payment on the agreed date) or the Borrower cannot perform his obligations because of insolvency.

There are a number of ways in which the above Surety can be used and structured depending on the transaction and creativity applied.

### 2. How does a Surety Bond work?

The Financial Guarantee (Bond) is securitised by the insurance markets to fully (100%) protect and guarantee the Funder/Investor receiving the agreed future payment. The insurance markets securitise this future obligation and creates an instrument of guarantee to the Funder/Investor.

The above creates a guarantee that the Funder/Investor will be repaid the principal and in some cases the interest when it is due and payable even if the Borrower defaults.

### 3. Where can a Financial Guarantee be Used?

Financial Guarantees can be structured in a number of ways and are only limited by international insurance treaties and how the concept can be creatively applied within these international treaties. Financial Guarantees can and have been utilised to provide significant transactional advantages and cost efficiencies for:

- a) M&A type transactions such as MBOs, MBIs, PIPE (Private Investment In Public Enterprise), Share Buy-Backs
- b) Preference Share Redemptions
- c) Capital Raising (via issuing Preference Shares)
- d) Purchase of Land
- e) Construction/Development Finance for Property Projects
- f) License Bonds

Surety Bonds are often used to remove the requirements of mezzanine finance, plug an equity gap, replace private equity, and convert private equity to a deferred payment to ensure that the Purchaser maintains the desired percentage shareholding.

Surety Bonds can also be used in property transactions such as property development, property construction and commercial property and land acquisition.

Surety Bonds work in the same way as a Bank Guarantee. However, a Bond in most cases is cheaper and does not require funds on deposit as required for a Bank Guarantee.

### **3. Advantages to the Purchaser/Borrower**

Financial Guarantees work as an alternative to debt, mezzanine and private equity financing. The cost of which is equal to or less than that associated with other forms of finance. Cost efficiencies that can be expected by utilising Financial Guarantees have been in the range of 40% to 73% depending on the financing structure utilised.

In addition to cost efficiencies, the amount of private equity a Purchaser/Investee has to find is significantly reduced or even eliminated. This can mean the Purchaser/Investee has no dilution of ownership and valuable cash reserves can be directed to fund business growth.

### **4. Advantages to the Funder/Investor**

The funds loaned or invested are guaranteed by a Surety which is irrevocable and non-cancelable. This removes the risk of the Borrower defaulting on repaying the principal and or interest.

The Funder/Investee is guaranteed payment regardless of the business's ability to generate future cash flows.

Should the Funder/Investee default, the Underwriter will honour the financial obligations of the Borrower and pay the Funder/Investor the agreed deferred consideration (outstanding amount owing).

### **5. When should a Financial Guarantee be Introduced into the Transaction?**

Financial Guarantees may not be appropriate in all transactions and for this reason it is critical that EQUILINX is introduced to the transaction as early as possible. There are no fees or charges associated with this stage.

The earlier a Financial Guarantee is introduced and integrated into the financial structure/proposal of the transaction, the greater the cost effectiveness of the instrument.

Early introduction ensures that the Financial Guarantee forms part of the formal Agreement, thereby guaranteeing deliverability and greatly speeding up the transaction process. Early introduction also produces significant cost efficiencies achieved by eliminating potential duplication of tasks, analysis and documentation

and the possibility of re-works/unwinding of key deal structure/strategy elements that may act contrary to the effective implementation of a Financial Guarantee.

#### 6. Claims against the Surety Bond

The wording of the Bond is bespoke (deal specific) therefore there is no generic policy wording. A claim can be lodged at anytime once insolvency triggers are met.

On pay out the Underwriter assumes the rights of the insured (Purchaser) under the “Subrogation” clause of the Bond. This is standard practice for the majority of insurance policies.

#### 7. Policy Beneficiaries

The beneficiary of the policy is the Funder/Investor and can accommodate any legal entity either individually or severally. Sureties will be offered to a single legal entity only, however, there may be multiple beneficiaries in each single legal entity.

#### 8. Time Period

This will vary and is dependent upon EQUILINX receiving the project documentation/information necessary for EQUILINX to complete its Risk Assessment and Due Diligence Report and Recommendation to the Underwriter. It is therefore essential that EQUILINX be engaged as early as possible to ensure time line effectiveness and cost efficiency.

#### Typical Time Lines

Initial Expression of Interest from an Underwriter	Within 72 hours from receipt of initial project documentation/information (depending on project complexity).
Non-Binding Term Sheet	Within 3 days from submission of EQUILINX’s Project Risk Assessment, Financial Due Diligence report & Information Memorandum (depending on project complexity).
Underwriter Offer	Within 7 days from receipt of EQUILINX Risk Assessment Report & Recommendation and Underwriter review (depending on project complexity)
Formal Offer	Within 72 hours of Borrower’s acceptance of Underwriter Offer
Bond Wording and Settlement	On completion of Policy Wording that satisfies both the Funder/Investee and Borrower and agreed Settlement date. Timing will depend to a large extent on the Party’s legal representatives.

## 9. EQUILINX Tasks & Activities

EQUILINX will state the tasks and activities that it will undertake in its Deed of Authorisation and Engagement. The following should be taken as a guide:

1. Review all documentation associated with the transaction and determine Borrower's/Investor's financial objectives
2. Ascertain whether a Financial Guarantee is appropriate for the transaction and the Party's objectives
3. Undertake initial 'Project Scoping' to ascertain Underwriter appetite and obtain an In Principle response
4. Managing the transaction process with Borrower and Funder/Investor and their respective advisers
5. Conducting a Risk Assessment of the transaction (Financial Risk; Business Risk; Management Risk; Investment Risk)
6. Preparing Risk Assessment Report & Due Diligence Report
7. Collating required Documentation/Information required by an Underwriter
8. Providing Client with feed-back on Risk Assessment and assisting in developing strategies to ameliorate identified risks
9. Prepare and submit Information Memorandum to Underwriters
10. Obtaining a non-binding Term Sheet from an Underwriter
11. Obtaining an Offer from an Underwriter
12. Undertake any tasks/activities necessary to ensure that an Offer is obtained from an Underwriter within the agreed time-frame
13. Be present on Settlement Date

## 10. The Process

To obtain a Financial Guarantee it is essential that the following process be adhered to if time lines are to be met within cost guidelines:

1. EQX to prepare draft Deed of Authorisation for Client review and comment
2. Client to sign EQUILINX's Deed of Authorisation as early as possible so that EQX can ensure that the process meets time lines and cost guidelines
3. EQUILINX prepares initial Term Sheet
4. Provide EQX with all the relevant documentation/information for Initial Project Summary and Review for its review so that a non-binding Term Sheet can be obtained from an Underwriter as early as possible
5. EQX will provide a documentation/information check list to Client to ensure that there are no duplications or re-works of transaction data, transaction analysis, transaction risk assessment and due diligence

### 11.0 Real-Life Example: \$8m Capital Raising

The Borrower's financial risk as rated as "High Risk" (T/O \$9.6m; EBITDA: - \$1.47m; Net Worth: -\$3.0m). EQX's Risk Assessment identified the other risk categories as follows: Management Risk: "Low Risk"; Execution Risk: "Low Risk"; Leadership Risk: "Low Risk"; Business Risk: "Medium Risk" There were significant business opportunities for the firm which it could not take advantage of due to the lack of capital, reliance on 100% debt finance and the effects of the Global Financial Crises.

The objective was to consolidate (\$7m) debt into one financial instrument (Preference share: cumulative, redeemable, convertible, Coupon 10% pa) with an additional \$1m for payment of Bond premium at Settlement, backed by a Financial Guarantee. The Financial Guarantee was essential due to the prevailing financial risk of the company and the effects of the Global Financial Crises on capital markets.

*Summary of Financial Guarantee:*

Amount:	\$8m AUD
Premium:	5% pa
Term:	3 years
Bond Structure:	Max of 8 beneficiaries IE \$1m x 8 investors/funders
Conditions:	Non-cancellable
Insurer:	A rated
Securities:	Provided by Borrower (FFCC, Personal Guarantee of Owner & Major Shareholder, Property Portfolio - \$5.5m)

**Result:**

Borrower managed to find an off-shore funder who accepted the Financial Guarantee as additional security who was prepared to provide the total amount of \$8m AUD and therefore there was no need for multiple funders/investors. The Borrower sourced an additional \$20m in equity to implement its M&A strategy, restoring Balance Sheet debt/equity ratios and Net Worth.

**11.0 Contact Details**

Contact EQUILINX to arrange a free consultation on how a Financial Guarantee may assist your financial needs, financial strategy or the funding of a business project.

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