

UKLA Technical Note

Sponsors: uncertain market conditions

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Sponsor procedures in uncertain market conditions

Uncertain market conditions can heighten risks that sponsor firms face from failures in their systems and controls. Sponsors should consider if their existing procedures, relating to working capital and new business take-on, are robust enough to deal with the challenges arising from such market conditions.

Working capital (LR 8.4.2R(5), LR 8.4.8R(3) and LR 8.4.12R(3))

In uncertain market conditions, there can be an increase in transactions with a 'rescue' element, or where particular attention should be paid to an issuer's working capital position.

When carrying out due diligence in an environment characterised by changeability and companies in financial distress, sponsors need to carefully consider how they assess working capital. In particular, the inherent unpredictability of the business environment could make assessing forecasts, assumptions, sensitivities and bank facilities more difficult. It is important for sponsors to carry out sufficient due diligence and in doing so specifically be aware of:

- the inherent difficulties in making accurate forecasts and projections;
- the need to have an appropriate basis for each of the assumptions used in the working capital model;
- whether sensitivities run consider all probable outcomes and give the necessary comfort that the issuer has sufficient headroom; and
- whether financing facilities are in place and will remain so throughout the working capital period.

Given the important role that the sponsor has to play in reviewing and challenging working capital exercises, sponsor firms should consider whether they need to revisit their systems and controls over working capital and make appropriate enhancements to reflect the uncertain environment. These may include introducing enhanced review procedures; the provision of additional training to staff on undertaking due diligence in times of financial distress and ensuring communication between the sponsor, the issuer and the reporting accountant is clear and effective.

New business take-on (LR 8.6.5R(3), LR 8.6.12G and LR 8.6.13G)

The effect of an economic downturn on work pipelines and the financial position of a sponsor firm itself can place pressure on a sponsor firm to introduce new business. This may mean that prospective transactions are considered that would normally be regarded by the firm as too risky to act on. It is important that a firm's risk appetite remains within sensible parameters, is consistently applied and not compromised. This is an area where compliance departments should play an active monitoring role.

As such market conditions may test sponsor firms' new business procedures, there needs to be an appropriate level of due diligence undertaken by the sponsor team and challenge from a firm's new business committee or equivalent challenge process. Sponsor firms should consider if their existing procedures should be enhanced or supplemented to deal with the challenges arising.