Margin Ratchets

Introduction

A margin ratchet is the mechanism by which the interest margin for a loan or a particular tranche of a loan may be reduced or increased depending on the financial performance of the borrower. A typical LMA style margin ratchet will allow the margin to be reduced after a certain period of time should the borrower reduce its (usually) leverage ratio (debt:EBITDA) to within certain defined limits. It is this type of margin ratchet that is the subject of this article. Typically the margin will start at its highest point (because leverage should be at its highest on the closing date) and ratchet down. The leverage ratio is usually tested quarterly on a rolling twelve month period.

Reasons

There are various reasons why a margin ratchet may be attractive:-

- It can provide an incentive to the borrower to reduce leverage and, if free cash is available, to prepay loans.

- As a loan amortises, the leverage should reduce and as such the risk to the lender reduces. The benefit of this risk reduction can be passed to the borrower in the form of a reduced margin.

- Where in-depth financial due diligence has not been undertaken the lender has the comfort of a higher margin when the loan is first made, while the borrower knows that this can be reduced if it performs in line with its business plan.

Issues

Whilst the concept of the margin ratchet is quite simple there are various issues and questions that can arise:

- A twelve month period after the loan has been established is commonly required before any alterations to the margin are made. This allows a settling in period to analyse how the borrower copes with the extra debt taken on and also for any acquisitions undertaken to bed down.

- Lenders will usually allow the margin to reduce only by one level at a time, even if strong financial performance indicates a greater reduction should apply. This helps to negate possible anomalies created by any unusual spike in EBITDA for a particular twelve month period. This weighting favours the lenders, as there is no similar restriction on the margin increasing.

- Will the margin re-set on a Default or an Event of Default? The general consensus is that an Event of Default should be required before the borrower is penalised. A point to note is that, should an Event of Default occur, the margin re-sets to the highest level and, if the Event of Default is remedied, it will again only be able to be reduced one level at a time, regardless of the margin level prior to the Event of Default. If the Event of Default was relatively minor in nature and quickly remedied this could be considered quite penal.

- Should the reduction apply to all loans? Borrowers may want the decrease to occur over all loans whereas lenders will often restrict this to the amortising loans.

- The financial covenants definitions will need to be carefully considered to ensure that the leverage test accurately reflects the financial condition of the borrower by reference to which the lender and borrower have agreed the margin should be adjusted.

- Will the leverage covenant be senior debt or total debt? The borrower should argue that a senior lender holding senior security should only be interested in the senior debt leverage. Inclusion of loan notes, bonds and other subordinated debt instruments could make reducing the leverage ratio more difficult to achieve than it should be to obtain the benefit of the margin ratchet.

[Covenant Lite

An interesting point in relation to covenant lite loans is that the inclusion of a margin ratchet would necessitate the provision to the lender of quarterly financial information to calculate the margin. This results in the lender receiving nigh on the same information that it previously received in a traditional deal. The lender could continue to run financial covenant tests. Whilst it would not be able to take action relating to any failure of such tests it provides an internal warning sign that could influence action taken following any other breaches. Whilst covenant lite loans may have disappeared for the foreseeable future it is a point worth noting should they make a comeback.

Tax

Where interest payable fluctuates on some sort of ratchet basis, consideration needs to be given to tax deductibility. Anti-avoidance provisions can operate to deny deductions if the interest rate is dependent in part on the performance of the borrower (by re-characterising the interest as a distribution). However, section 209(2)(e)(iii) ICTA 1988 provides some protection from these provisions for the situation where a margin ratchet works in such a manner that a decrease in the leverage ratio causes a decrease in the

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margin and vice versa. Any margin ratchet that works in a
different manner, on a different ratio or in any way that
substantially departs from the common ratchet described in
this article should be treated with caution and tax advice
sought if there is any element of doubt.

**Conclusion**

In the current economic climate borrowers should be
approaching their lenders for and lenders should look to
provide, bespoke solutions to their funding needs as opposed
to just following market norms. If EBITDA growth
temporarily stalls / reverses could margin ratchets actually
provide for movement to a higher ratchet that applies in the
early period (12-24 months) of a loan? Perhaps if the
covenants were set with slightly less headroom (against the
budget) this would be a workable solution for borrower and
lender. Covenant protection would still be set to provide the
lender with the early warning protection regarding the
borrower’s ability to service the debt but the borrower would
have a little more leeway (at the cost of more expensive
debt) should financial performance hit a rough but ultimately
manageable patch. Naturally any concessions offered by a
lender in this situation would be heavily qualified but it could
be an area to be looked at, assuming credit committees are
feeling generous.

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