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Last of the Dinosaurs

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It was the finale of the longest, slow-motion credit tumble ever witnessed, and certainly the most anticipated spectator event since the long-awaited *Family Guy* movie. On April 29, *Energy Future Holdings* filed for bankruptcy creating the largest default – $19.5 billion – in the history of leveraged loans.

Creditors have been jostling for position for many months, a dance that will only intensify now that the restructuring has hit the courts. Whatever the outcome, the size of this transaction remains impressive. The debtor-in-financing for EFH of $11.775 billion represents the largest DIP in history. (Lyondell Basell's $8 billion deal from March, 2009 comes in a distant second.)

Known in its better days as TXU, the electric utility was bought by KKR, TPG, and Goldman Sachs Capital Partners in October, 2007. At $45 billion it was, and remains, the biggest LBO ever. But almost out of the gate, the company stumbled.

Created on the concept that its coal-supplied plants would benefit competitively amid higher natural gas prices, the company was helpless when prices instead plummeted. TXU then struggled to carry its immense debt load on declining cash flows.

When S&P included the company's debt in its speculative-grade default rate in November, 2009, the market also baked it into their forward default numbers. Having a ringside seat to the most visible and liquid credit in the market, institutional investors have for almost five years expected last month's denouement.

The impact on actual default rates has been dramatic. As S&P LCD reported, the number by volume jumped from 1.2% in March to 4.6% in April.

But does this default portend others to come?

There are always distressed credits on loan trading desk axe sheets, though none nearly the size of EFH. The combination of a low-rate environment and generally favorable economic conditions is considered salutary for leveraged borrowers. That healthy mix is expected to last into next year.

The failure of EFH is viewed by seasoned observers as a one-off commodity bet gone bad. Rather than a warning to today's loan buyers, it's seen as a museum piece originated in the pre-crisis market, a throwback to a time when giant, massively leveraged LBOs roamed the earth.

Now that the behemoth has finally fallen, how will its secured creditors fare in a restructure?

The company's loans traded consistently in the 70's for the past twelve months, suggesting holders are confident of a reasonable recovery down the road. But the complexity of this case, driven by EFH's mind-numbing legal and capital structure, will doubtless create uncertainty as the reorganization unfolds in the months to come.

Any good news in this story? Well, as one observer cheekily told us, "At least the loans had covenants."