

Are We Back to 2007? (Second of a series)

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One of the most noted stories of the current loan market is the amount of investor cash that has re-entered the asset class since 2010. While it certainly has produced eye-catching frothiness, how does this liquidity compare with the definitional froth of 2007?

In our just-published series on the role of CLOs in both past and present markets [\[link\]](#), we saw that while post-crisis vehicles are enjoying a renaissance, it's due in large part to transitory regulatory pressures. CLOs will continue to be an important feature of the leveraged landscape, but it's unlikely they will dominate the buy-side as they did in 2007.

Prime rate funds (see *Chart of the Week*) have also peaked in terms of their market capacity. The Fed's dovish rate stance has driven investors to bonds, leading to more loan outflows than inflows. While that trend will reverse as we get closer to inevitable rate hikes, retail cash isn't driving loan demand in the broader markets at the moment.

One instrument of liquidity that is growing in popularity is the business development company. Since their advent in the 1980s, BDCs have provided public shareholders with access to loans, particularly private equity financings. At the dawn of the financial crisis, there were roughly twenty of these companies. Today, according to S&P/LCD, there are 44 publicly-traded versions alone, representing assets of over \$40 billion.

BDCs are great tools for asset managers, and we'll be featuring them in an upcoming special series. But their return hurdles make them less suited for broadly syndicated paper, more useful for higher yielding, middle market, and second-lien and junior capital investments. Relative to CLO capacity, BDCs are a fraction of market appetite.

Then there are the hedge funds, distressed and high-yield funds. As one might expect from these yield-driven buyers, the current environment of compressed spreads leaves little of interest for them on the field. In 2007 they spoke for almost one-quarter of all loan demand; today, they account for barely 10%.

Banks? A diminishing factor in leveraged loans well before 2007, regulated lenders have seen nothing but increased headwinds for the past four years. No reason to believe the next four years will be any different.

Rounding out the field are non-bank finance companies and credit opportunity funds. These do play important roles in middle market debt investing, but don't move the needle much in liquid markets.

So a quick survey of the demand side of the equation doesn't identify much greater capacity for loan froth today than at the market's peak seven years ago. If anything, the ability of the market to absorb significant loan volume is less than it was then.

That means if you're looking to compare current markets to 2007, you may have to look elsewhere than loan capacity as the sole culprit for market frothiness.

Next week, we'll look at the other side of the equation – loan supply – to see what the future pipeline of deals has in store for the leveraged market.