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The Carlyle Compass

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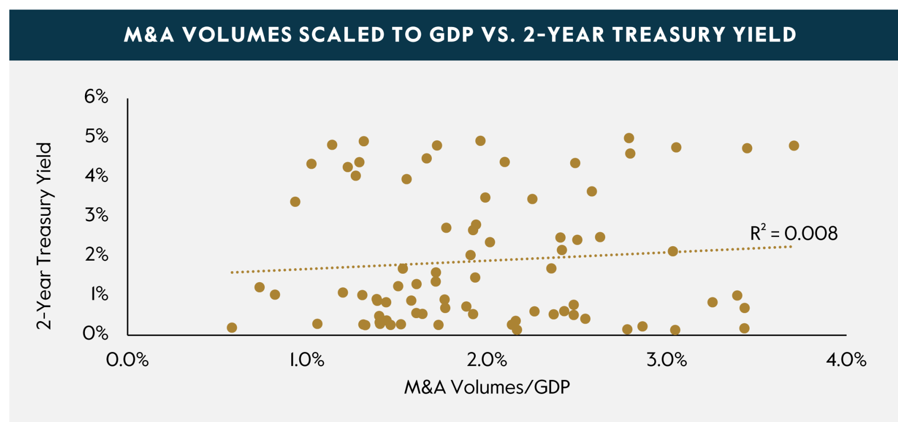
No Value in Waiting: The Looming M&A Boom

The *level* of interest rates takes a lot of blame for the slowdown in M&A since 2021, but there's nothing about the level of rates that should dent deal volumes. Over the past 20 years, there's virtually no correlation between the level of interest rates and M&A (Figure 1). Indeed, the peak in M&A volumes was observed when interest rates were higher than they sit today.

Figure 1: No Relationship Between M&A & Interest Rates



Source: Carlyle Analysis; Federal Reserve, Dealogic, November 2024. There is no guarantee any trends will continue.

Financing costs influence pricing decisions, creating a disconnect between the price expectations of sellers who acquired assets under one interest rate regime relative to the price expectations of prospective buyers operating under another. If interest rates were

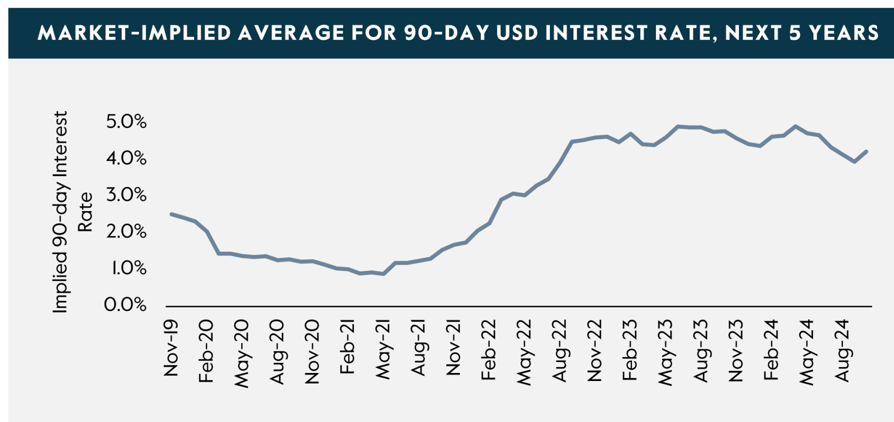
expected to remain constant, asset prices would simply adjust to the new reality and the market would clear. But if the current interest rate regime is expected to be temporary, a bid-ask spread emerges and transaction volumes slow.

Since Silicon Valley Bank's failure in March 2023, markets have routinely priced massive reductions in interest rates that encouraged financial sponsors and management teams to postpone acquisitions into the future when interest expense was expected to be lower. Why borrow today at elevated rates when financing costs will return to more "normal" levels a year from now?

Expectations of sharp declines in rates also deterred sellers from accepting bids calibrated to current financing costs. If rates are expected to drop, would-be sellers could expect to find a buyer willing to pay more for the asset in the future, making them less willing to sell assets today at prices they might soon regret. The value of the "real option" to postpone a transaction increases with the likelihood and magnitude of the potential fall in interest rates, incenting both buyers and sellers to wait until rates reset.

In recent months, the value of waiting has declined, if not evaporated entirely. Though the Fed seems likely to enact additional rate cuts (including at next Thursday's FOMC meeting, pending tomorrow's CPI data), the yield curve now implies that short-term interest rates are likely to average roughly 4% over the next five years (Figure 2). That would be consistent with almost three more rate cuts from here, saving borrowers an additional 65 to 75 basis points, on average.

Figure 2: Markets Don't Expect Rates to Decline Much from Here

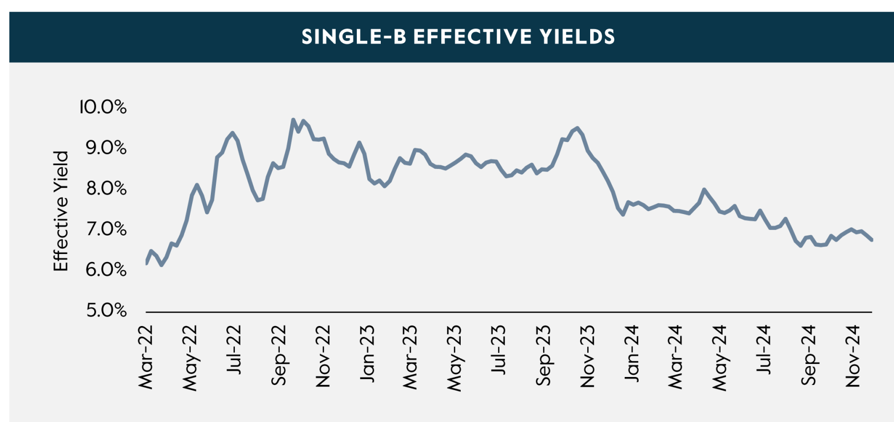


Source: Carlyle Analysis; Federal Reserve Bank of New York, December 2024. There is no guarantee any trends will continue.

But base rates are not the sole determinant of financing costs. The benefit borrowers derive from lower base rates could be more than offset by a widening of credit spreads, which currently sit at their tightest levels since 2007. Spreads on single-B bonds have declined to just the *second percentile* of the historic distribution, 275bps below their long-run average. While spread compression in first and second lien loans has been less dramatic, mean reversion here would be the equivalent of four to five rate hikes.

Perhaps full reversion to long-run averages is not in the cards for 2025. Credit performance has been strong, as inflation boosted corporate revenues and operating earnings relative to the face value of outstanding liabilities. But the balance of risks looks far more symmetric than at any point over the past two years, when rates seemed all but certain to be lower in 12 months' time. Indeed, all-in single-B financing costs finished last week just 58bps above where they stood the week before the Fed's first rate hike in March 2022 (Figure 3).

Figure 3: Borrowing Costs Just 58bp Above March 2022 Levels



Source: Carlyle Analysis; CME, December 2024. There is no guarantee any trends will continue.

Sometimes, the optimal decision in the face of uncertainty is to do nothing at all. By postponing sales processes until rates declined, sellers allowed asset values to compound at the rate of EBITDA growth, depressing exits and distributions but likely increasing total returns. But further postponement of seasoned asset sales seems hard to justify. Likewise, corporate management teams that wisely paused acquisition activity would be hard pressed to find more robust funding liquidity conditions than those prevailing today.

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