CARLYLE

Switched On: The Deal Rebound & Its Implications

November 22, 2024

EXECUTIVE SUMMARY

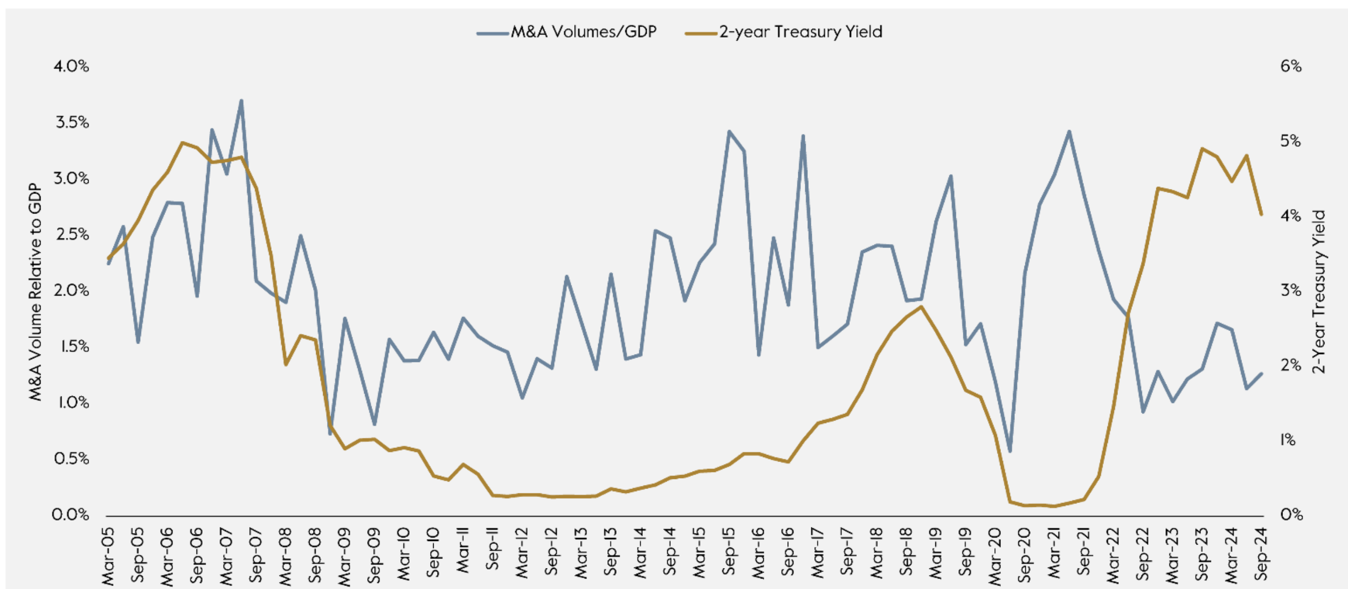
- Expectations that interest rates would fall sharply with inflation led buyers and sellers to wait on the sidelines, depressing investment and M&A activity.
- The result of the U.S. Presidential election has reduced the option value of waiting, while also resolving other sources of uncertainty that have slowed M&A activity.
- Just as "temporarily" elevated rates depressed acquisitions, they also increased the attraction of credit allocations, resulting in a supply-demand imbalance that led to a dramatic tightening of spreads.
- When coupled with the resolution of election and policy uncertainty, this narrowing of spreads should unlock a sharp increase in M&A activity that breathes new life into private equity while also facilitating a much-improved risk-return tradeoff in credit markets.

"REAL OPTION" TO WAIT FOR LOWER INTEREST RATES DEPRESSED M&A

The *level* of interest rates takes a lot of blame for the decline in M&A volumes 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 volumes (scaled to GDP). Indeed, the peak in M&A activity over this time occurred when interest rates were at the same levels they are today (Figure 1).

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 the same, 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.

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

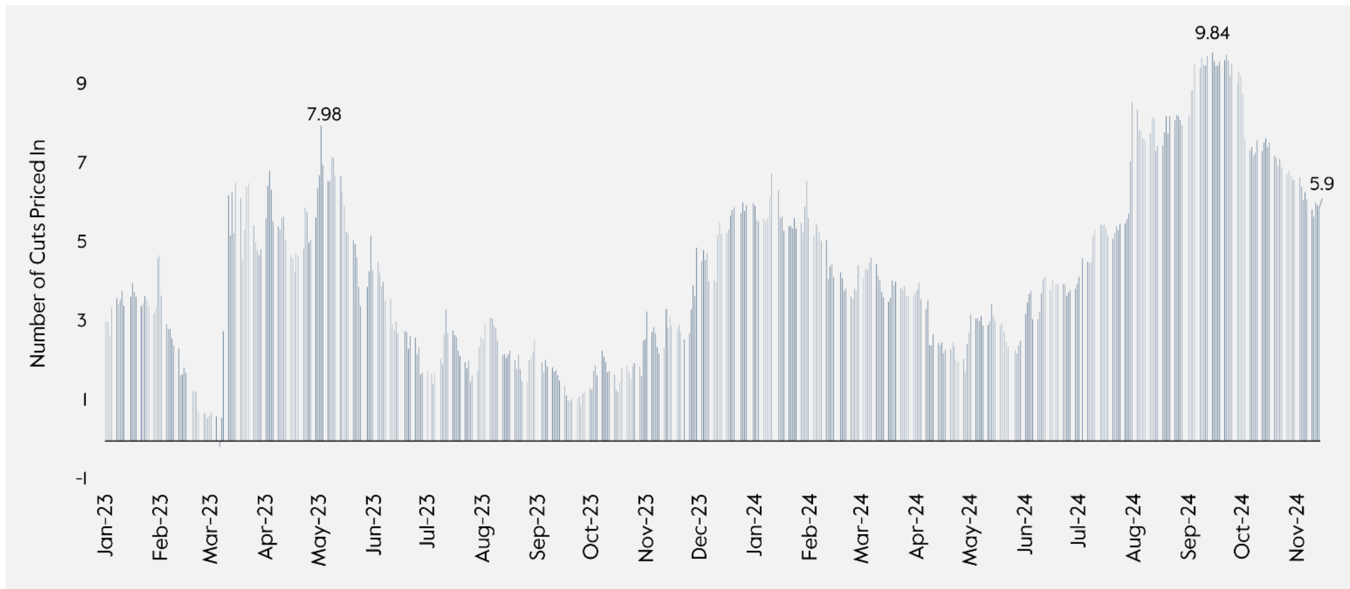


Source: Carlyle Analysis; Federal Reserve, Dealogic, November 2024. There is no guarantee any trends will continue.

That's exactly what's been observed over the past two years. Since Silicon Valley Bank's failure in March 2023, markets have 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 (Figure 2). Why borrow today at elevated rates when the financing costs associated with the transaction will be at more "normal" levels a year from now?

Expectations of lower interest rates in the future also deter sellers from accepting bids calibrated to current interest rates. If financing costs are expected to drop, a would-be seller 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 likelihood and magnitude of the potential fall in interest rates, incenting both buyers and sellers to wait until rates reset to more "normal" levels.

Figure 2. Cumulative Rate Cuts Implied by Futures Markets (Next 12 Months)



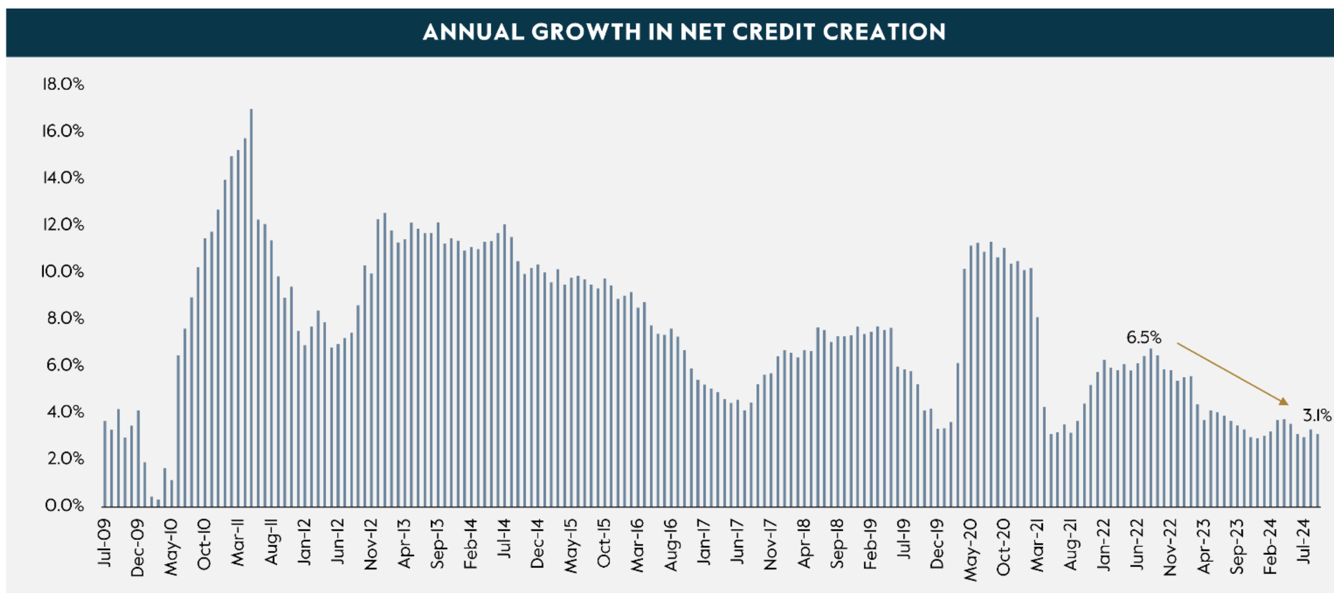
Source: Carlyle Analysis of Bloomberg Data, November 2024. There is no guarantee any trends will continue.

RESULTING SUPPLY-DEMAND IMBALANCE IN CREDIT

A fall in deals also depressed the net new supply of loans. Since the Fed started hiking rates, the annual growth in net credit outstanding across investment grade and high-yield bonds, broadly syndicated loans, and private credit has halved (Figure 3), as borrowers and would-be acquirers waited on the sidelines.

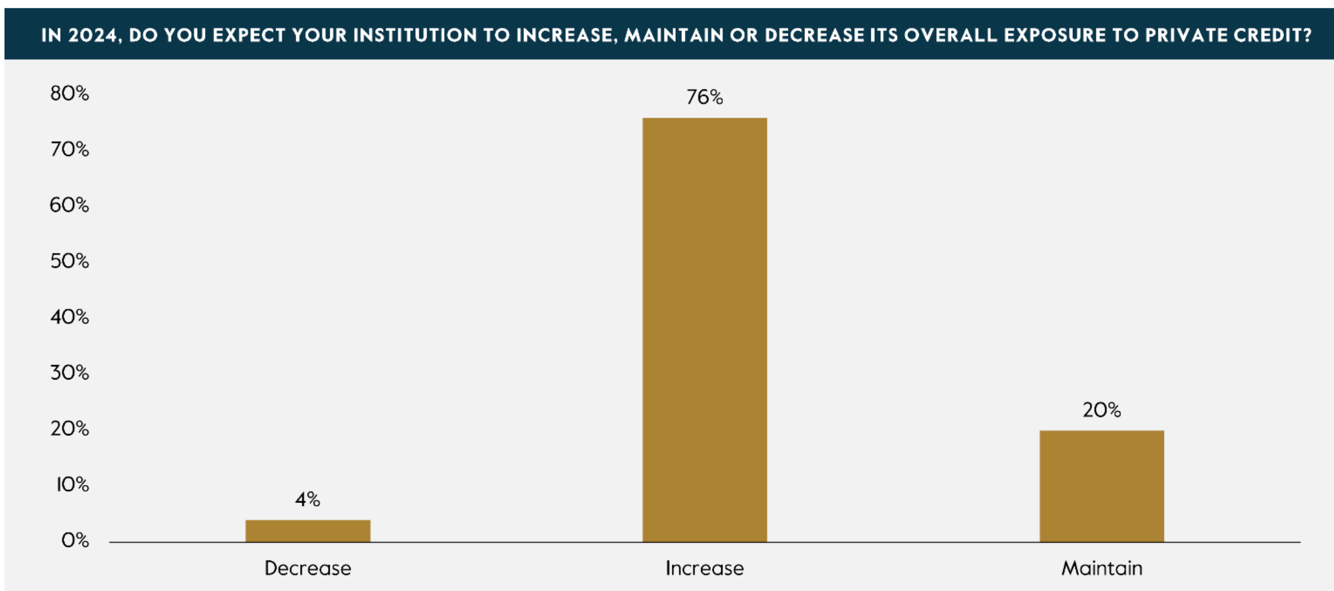
But at the same time higher interest rates deterred new deals, they simultaneously increased the allure of credit allocations. A year ago, the typical Business Development Company (BDC) loan yielded more than 11%, roughly 200bps above the 9% return most investors target for their stock market portfolios. But because these loans sit atop the capital structure, they're less risky, all else equal, than the equity they subordinate in the cash flow waterfall. No wonder allocations to private credit rose sharply in response (Figure 4).

Figure 3. Slower Growth in Credit Demand Depresses Spreads



Source: Carlyle Analysis; Bank of America, November2024. There is no guarantee any trends will continue.

Figure 4. Institutional Investors Scale Up Private Credit Allocations



Source: "Private Credit Allocation Outlook," CL Research. January 2024. There is no guarantee any trends will continue.

The result had been a supply-demand imbalance in credit markets—i.e., more lenders than borrowers—that led to a sharp tightening of credit spreads. Spreads on single-B corporate credit finished October at the tightest level in 17 years, just 50bps above their all-time lows. So while the all-in return on credit remains very attractive – especially in light of strong recent credit performance – the compensation for default risk has declined meaningfully relative to periods when the market was functioning more normally.

ELECTION REMOVES UNCERTAINTY, PAVING THE WAY FOR INCREASED DEAL FLOW

The outcome of the U.S. Presidential election has substantially reduced the option value of waiting, while also resolving other sources of uncertainty that have slowed M&A activity.

First, the conclusive nature of the election results eliminated the non-trivial risk of a disputed election and civil unrest. While it's impossible to know the extent to which this slowed investment activity, it's not unreasonable to think that management teams and financial sponsors decided to postpone some acquisitions until later in the year, or early 2025, until this uncertainty was resolved.

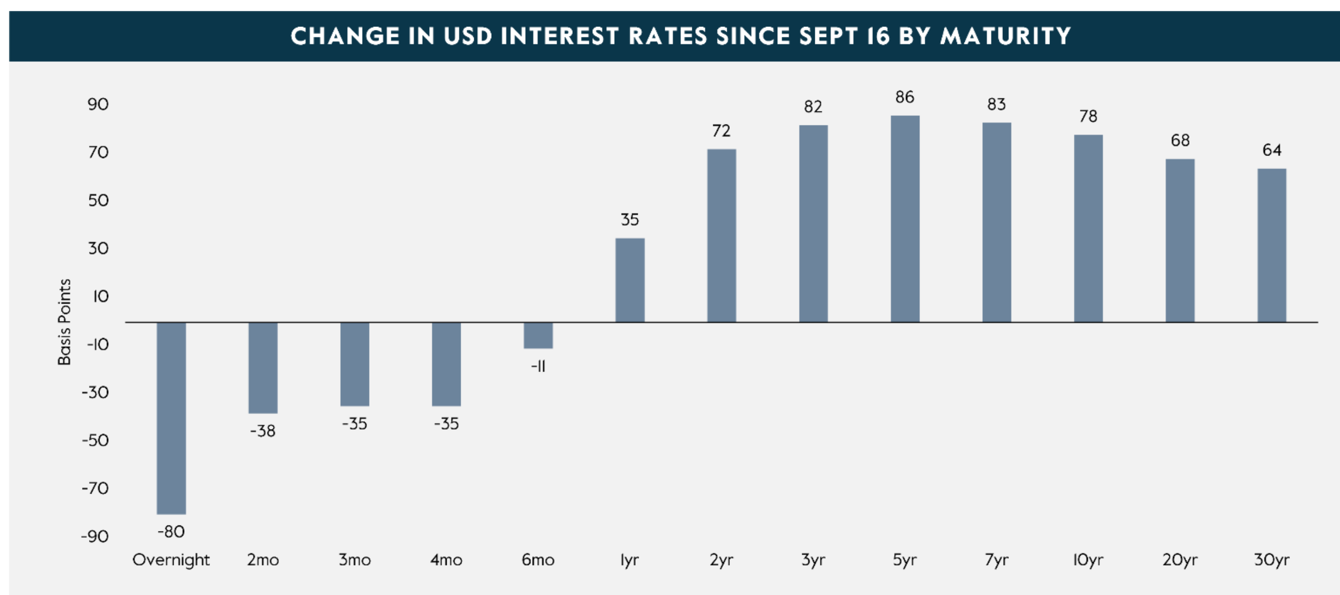
Second, the Trump victory and Republican control of Congress eliminated the risk of an increase in corporate income taxes, which makes it easier to construct *pro forma* financial statements needed to value assets. Any changes in corporate tax rates now look tilted to the downside, potentially unlocking "animal spirits" among prospective acquirers.

Third, the Trump Administration is likely to take a much lighter-touch approach to antitrust enforcement. Legal observers expect the incoming Federal Trade Commission (FTC) to eliminate the Biden Administration's 2023 Merger Guidelines, which looked skeptically at most business combinations and chilled M&A activity.[1] Though "Big Tech" may remain under elevated scrutiny, a less hostile approach to acquisitions should pave the way for a sharp rebound in M&A activity and private equity exits across most industries.

Fourth, the likely imposition of tariffs increases the likelihood that foreign businesses will look to acquire domestic, U.S. assets to maintain tariff-free access to the U.S. market. While regulators may look skeptically at cross-border deals in "sensitive" sectors affecting national security, there are many business combinations in consumer goods, services, and industrials that could make sense from the perspective of both foreign acquirers and the Committee on Foreign Investment in the United States (CFIUS).

And fifth and perhaps most consequentially, the potential for a more inflationary policy mix – tariffs, a contraction in the domestic supply of labor, additional tax cuts that could increase fiscal deficits and demand – has combined to reduce the implied probability of aggressive rate cuts. Since Trump moved into the lead in betting markets, Treasury yields have risen sharply (Figure 5) and futures markets imply far fewer rate cuts than previously anticipated. Rates will likely fall from here, but rather than assume the direction of rates is skewed sharply to the downside, a balance has returned to markets that has reduced the option value of waiting to complete transactions.

Figure 5. Change in USD Interest Rates Since September



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

1. C.f. https://www.legaldive.com/news/merger-guidelines-go-away-under-trump-second-term-ftc-doj-antitrust-law/732309/.

MARKET REBALANCING SHOULD IMPROVE CAPITAL DEPLOYMENT OPPORTUNITIES

Indeed, the combination of much tighter spreads and less prospective easing has raised the possibility that all-in finance costs may actually *rise* from here. Rather than wait for easier financial conditions, potential acquirers may want to act now in case current conditions don't last.

While overnight interest rates in the U.S. have only declined by 75 basis points thus far, all-in deal finance costs have declined by nearly 300 basis points and now sit just above levels that prevailed at the time of the first Fed rate hike. The decline in deal finance costs has also narrowed the bid-ask spread, as financial sponsors and strategics can meet sellers' price expectations and still hit target returns (20% or more) for a larger share of assets (Figure 6). Sellers' recognition that base rates may not decline as much as previously thought, and credit spreads could widen, might also result in some price concessions that further increase transaction volumes.

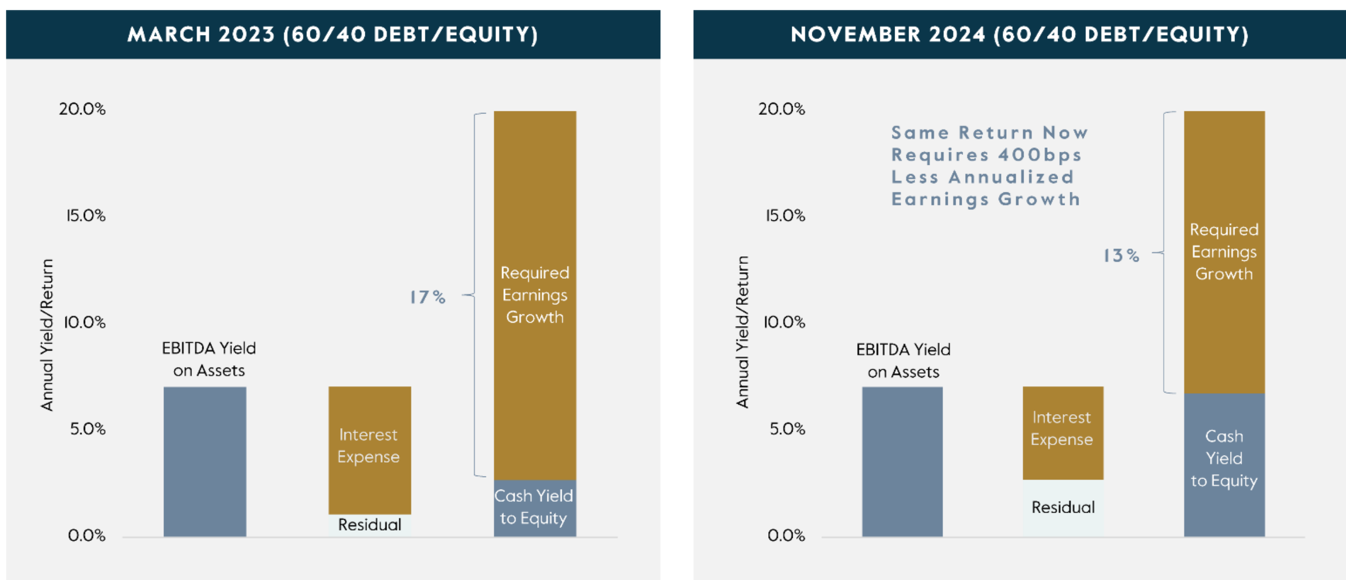
As a result, we expect a significant increase in M&A and private equity transactions in 2025, including a pick-up in exits through "trade sales" to strategic acquirers and further growth in the market for IPOs.

LOWER BASE RATES, WIDER CREDIT SPREADS

While great news for a private equity market that had become highly illiquid as buyers and sellers waited on the sidelines, the rise in deal volumes should also facilitate a rebalancing in credit markets.

More deals translate to more borrowers and a rise in the net supply of loans. As a result, the baseline expectation for 2025 would be for credit spreads to widen by 50 to 100 basis points as net credit creation returns to more normal levels. But there is upside from here; if the Fed keeps cutting rates in 2025, it's likely because of recession fears of the sort that have dramatically boosted credit returns in the past.

Figure 6. Improving Deal Mathematics



Source: Carlyle Analysis; LCD Database, November 2024. Presented for illustrative purposes. There is no guarantee any trends will continue.

Historically, credit spreads widen as short-term interest rates decline, often by a magnitude that leaves coupon income unchanged (Table 1). That's partly because interest rates and credit spreads are codetermined by the same macroeconomic factors. A weakening economy causes default risk perceptions to rise as base rates are cut. But there's more to it than that.

Credit spreads tend to rise nonlinearly and completely out of proportion to the increase in defaults. Historically, the 'credit risk premium,' or portion of the spread not explained by default losses, rises sharply with macroeconomic uncertainty. Credit does not participate in 'upside' like equity; any increase in volatility manifests as greater compensation per unit of risk on new loans. In the past, the credit risk premium has risen 20% more than spreads as base rates declined (101bps vs 83bps, Table 1), with a meaningful increase in spread per unit of leverage on new loans (measured in terms of debt to operating cash flow or EBITDA).

In other words, while defaults are obviously bad for existing loans, *fear* of defaults increases returns on new lending more than the associated decline in base rates. It is precisely during periods of elevated macroeconomic volatility that capital-constrained lenders pull back and the return premium to credit allocations reaches its highest level.

CONCLUSION

It's not so much the *level* of interest rates that depressed M&A activity but expectations that rates would fall sharply in the future. Buyers and sellers decided to wait on the sidelines for the "inevitable" decline in interest rates, which would reduce borrowing costs for acquirers and increase bid prices for sellers.

At the same time the increase in rates dented M&A volumes, it also increased the attraction of credit allocations. The demand for new loans increased relative to their net new supply. A tightening of spreads resulted, which has reduced deal finance costs far more than implied by the 75-basis point decline in base rates.

When coupled with the resolution of election-related uncertainty and prospective policy changes, the fall in finance costs should lead to a dramatic pick-up in M&A activity in 2025. While great news for private equity transactions and exits, the increase in M&A volumes should translate to a normalization in net credit creation that results in wider spreads and a more favorable risk-return tradeoff for lenders.

Table 1. Spreads Widen as Base Rates Decline

CREDIT SPREADS & BASE RATES

Variable	Impact of 100bps Reduction in Base Rates (2000-24)		
	Low	Median	High
Credit Spread	59	83	106
Spread Controlling for NTM Default Rate	62	85	108
Spread Per Unit of Leverage	10	15	20
Credit Risk Premium	76	101	126

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

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