PGIM
GLOBAL ASSET MANAGEMENT

2025 BEST IDEAS

ALPHA OPPORTUNITIES BEYOND THE MACRO VOLATILITY

CONTENTS

INTRODUCTION

Change would be an operative word to describe the state of financial markets and the broader global economy over the past year. Central banks' dovish pivot, a spate of major elections around the world, and a wide range of economic scenarios playing out across the globe have contributed to an outlook that remains in flux. The US economy remains a standout among its peers, exhibiting resilience against global headwinds, higher interest rates, and persistent inflationary pressures. Europe and China have struggled to jumpstart growth, while Japan and southeast Asia have begun to reap the benefits of shifting trade flows in the region.

Meanwhile, election results—punctuated by the US presidential race—signal new trade and fiscal policies that hold the potential to bring further changes to an already-volatile backdrop. These macro forces, and unexpected twists down the road, will make it crucial for investors to continuously examine the implications for asset allocation strategies.

With uncertainty a constant presence in the current investment environment, the challenge for investors will be to look beyond macro volatility and identify long-term opportunities. Active management will have a critical role in this endeavor. As investors pursue more resilient portfolios in an unsettled time, active managers with experience in a variety of market cycles will be uniquely positioned to uncover opportunities and manage risk.

The 2025 edition of PGIM's Annual Best Ideas is a collection of opportunities based on our breadth of experience and deep expertise across public and private asset classes. While they are not intended to predict the future, the ideas featured in this report represent strategies that can be attractive for investors seeking to capture alpha amid a fast-evolving outlook.

UNLOCKING LIQUIDITY: THE DISTRIBUTION EDGE OF LOWER MID-MARKET PRIVATE EQUITY

The era of private equity flourishing under low interest rates, followed by a blend of optimism after the COVID-19 pandemic, has shifted. We are facing a period of prolonged economic uncertainty with differing views on the economy's future. For the last 24 months, the private equity industry has experienced this uncertainty first-hand, taking its toll on the exit environment as fund managers increased holding periods of their assets.

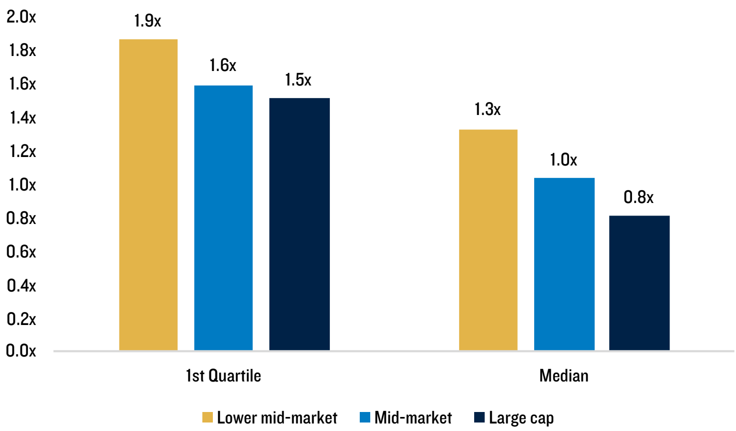
However, distributions to paid-in (DPI) performance of private equity buyout funds with vintages from 2003 – 2021 across lower mid-market, mid-market, and large cap funds,[1] demonstrates a divergent trend. Specifically, lower mid-market funds outperform their larger peers in both the first and second quartile. Over the past 24 months, this trend has persisted, with both lower mid-market and mid-market funds generating more liquidity than larger funds.

According to Pitchbook, there are currently 28,000+ portfolio companies backed by buyout funds, of which 46% have been held for 4+ years, comprising a total of $3.2tn+ in unrealized value – a historical record. The drivers of record-level inventories can be largely attributed to fundamental macroeconomic changes. First, interest rates have increased to levels we have last seen when the global financial crisis unfolded more than 15 years ago. Second, inflation has risen, which has last topped today's levels in the 1980s. Third, and potentially most importantly, views diverge in the industry towards what the future will bring. Consequentially, investors have become desperate for liquidity, seeking lifeboats in a market that recently provided one of the longest upcycles of the past century.

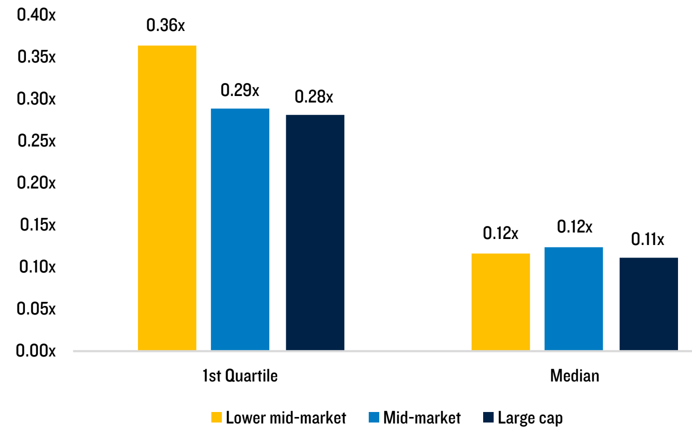
We believe the reasons for the liquidity advantage of the (lower) mid-market over the large end of the market are two-fold: Large transactions tend to rely on IPOs as a preferred exit channel to create liquidity – an exit route that has been virtually shut down in the last two years – and are limited in terms of potential strategic buyer audience due to their sheer size. Smaller transactions, on the flipside, typically benefit from a broader range of exit options, stemming from the imposed interest of a larger audience of financial buyers, specialized and traditional private equity funds, which have record-level dry powder to deploy, and strategic buyers that acquire companies to expand their market position, while the IPO markets tend to not be the preferred route of exits.

1. We define the size segments based on underlying fund sizes, with lower mid-market (LMM) including funds of $100m – $1.5bn, the mid-market (MM) including funds of $1.5bn – $5bn, and large cap (LC) funds of > $5bn.

DPI performance of 2003 – 2021 vintages



Incremental DPI over the last 24 months of 2012 – 2021 vintages



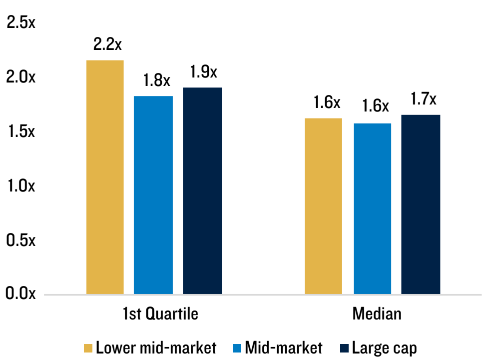
Notes: (1) Incremental DPI is calculated as DPI generated between March 31, 2022, and March 31, 2024. Source: Preqin, with data as of March 31, 2024. The analysis includes 2003 – 2021 vintage (total DPI) / 2012 – 2021 (incremental DPI) buyout funds across North America and Europe. Past performance is not a guarantee or reliable indicator of future results.

Some fund managers, including secondary managers, aggressively pursued leveraged transactions during the low-interest environment, and are now facing crushing debt servicing costs just as demand continues to plateau. Mid-market strategies, especially at the lower end, usually limit the use of leverage for value creation, leading to lower leverage multiples.[2] The outperformance of smaller over larger funds might further expand into 2025 and beyond as central banks cut interest rates, which might disproportionately benefit smaller companies.

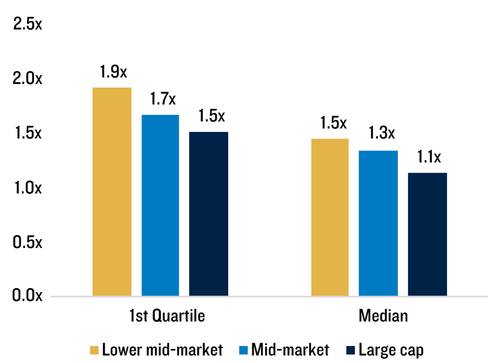
The observation towards higher distribution activity not only holds true in the current cycle but has been consistent over time when comparing 2003 – 2008, 2009 – 2017, and 2018 – 2021 vintage funds, all of which are signs that the lower mid-market tends to generate higher DPI in times of market uncertainty and stability alike.

DPI performance of 2003 – 2008 / 2009 – 2017 / 2018 – 2021 vintages

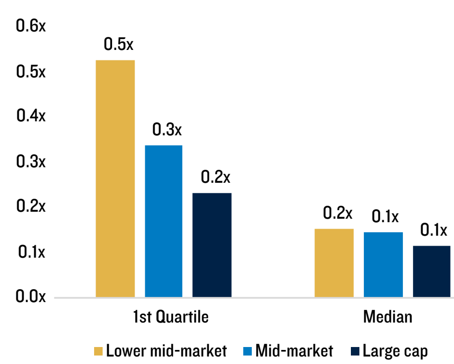
2003 – 2008



2009 – 2017



2018 – 2021



Source: Preqin, with data as of March 31, 2024. The analysis includes 2003 – 2021 vintage buyout funds across North America and Europe. Vintages from 2003 – 2008 include funds that invested during the Global Financial Crisis ("GFC"), while 2009 – 2017 include funds that invested during the bull market period following the GFC, and 2018 – 2021 vintages include funds that invested during the COVID-19 pandemic and recessionary environment at potentially elevated valuations.

2. Data from Cambridge Associates LLC supports this notion, with average leverage multiples of acquisitions between 2000 – 2020 of 3.2x for companies with enterprise value below $250m, 4.6x for companies with enterprise value between $250m and $1bn, and 5.9x for companies with enterprise value above $1bn.

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