PitchBook

US PE Firm Style Drift

Examining the trend toward PE firm specialization

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Credits & contact

Research

WYLIE FERNYHOUGH Senior Analyst, PE team lead
wylie.fernyhough@pitchbook.com
ANDREW AKERS, CFA Senior Data Analyst

Design

KELILAH KING

Contact PitchBook

RESEARCH
pbinstitutionalresearch@pitchbook.com

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Key takeaways

- The overarching trend in PE is for managers to specialize and focus on certain sectors. The proportion of specialist firms in the US is up nearly 50% from the last decade, while the proportion of generalists and target firms—a middle ground between the two—is lower.
- Established firms have trended toward specialization over the past decade. Many generalists evolved to targeted firms, while targeted managers became specialists.
- In recent years, nearly half of all newly formed managers were specialists—more than twice the rate from one decade ago. Looking at new GPs that qualified for classification in the past five years, just 16.5% were generalists, which is down from 37.9% during the 10-year period ended 2010.
- One caveat is our data likely underestimates the true specialization within the PE landscape. Our style classifications are done at the GP level rather than the fund level, which means large firms with several different sector-focused funds will likely be categorized as generalists.

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Preface

In an earlier analyst note, we introduced readers to our GP style metric, which uses the Herfindahl-Hirschman Index (HHI) to assign GPs a style score. The style score is based on the concentration of investments in specific sectors, wherein a low or high number is not inherently bad. Rather, it informs where a manager lies upon the spectrum of generalist to specialist. Firms that have no sector comprising approximately 50% or more of their deal activity are assigned as generalists. We categorize GPs that do between roughly half and two thirds of their deals in one sector as targeted. And finally, firms that do more than approximately two thirds of their deals in one sector are categorized as specialists.

Introduction

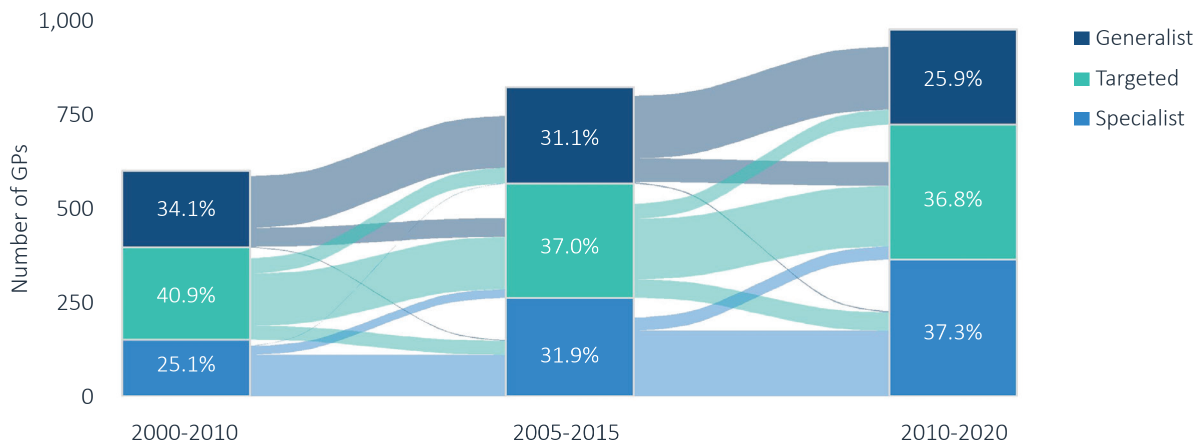
The rise of specialist firms—be it Thoma Bravo or Vista investing in technology or OrbiMed investing in healthcare—has been a dominant theme within private equity since the global financial crisis (GFC). Coming out of the GFC, GPs and LPs became more sophisticated with their approaches. To find an edge in an increasingly competitive environment, many GPs specialized. The larger firms with multisector strategies specialized with sector-focused teams, which meant spinouts tended to focus on just one or two sectors. LPs have also refined their approach. Many LPs no longer simply allocate to PE. Instead, they have honed their private market strategy to seek out sector-specific allocations, which allows them to under- or overweight their exposure—though less precisely than what many do in public markets. Capital has poured in as well, with a higher proportion of sector specialists finding success in the current climate than ever before.

Trends in dealmaking and fundraising have been easy enough to see, but the evidence was primarily anecdotal—until now. Using our internally developed framework, which looks at deal concentration using the HHI, we assign GPs a quantitative style score. Importantly, the scores are assigned at the firm level rather than the fund level. Additionally, we can assign multiple scores over time, which allows us to track the transition from generalist to specialist for both the industry and individual firms.

Manager style drift is a concern for LPs. While typically easier to measure in public markets, it is also a prevalent concern in private markets—especially when LPs are counting on specific fund allocations to slot into a broader portfolio. For example, as a public equity manager's returns struggle, some may look to deviate from a value tilt toward more growth-oriented equities. Several private market examples of manager style drift exist, though shifts are often subtler. Other types of drift—whether transaction size or geographic related—can also be measured with this framework. Our concern with this analysis is less about shifts between sector-specific investments or even about individual managers. Rather, it considers the ways the PE industry has shifted in the past decade.

The first look at GP style migration incorporates all GPs that have completed at least 15 deals in the past decade. Depending on the sector concentration of their deals over the trailing decade, the three buckets categorize firms as specialist, targeted, or generalist. For example, the leftmost column of 2000-2010 looks at firm categorization in 2010 based on deals completed since 2000. The rightmost column looks at the same universe of firms—including some new ones that were founded later—and categorizes their style based on deals done between 2010 and 2020. In each subsequent time frame, specialists account for a greater share of the population, while generalists' share diminishes. As of 2020, specialist PE firms account for 37.3% of the total universe compared with 25.1% one decade earlier—a near 50% jump.

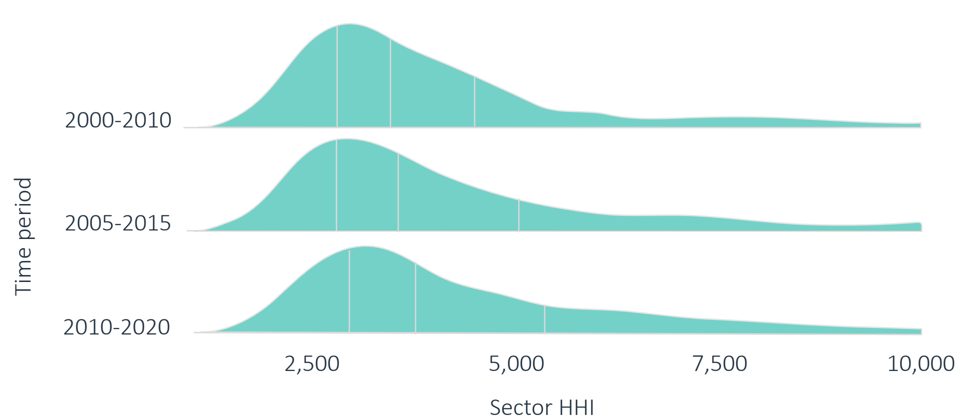
PE firms (#) by style score over time*



Source: PitchBook | **Geography:** US
*As of December 31, 2020

In the chart below, as many firms become increasingly specialized, the right tail of the distribution swells. Firms with a higher concentration of deals in one specific sector will land on the right side of the distributions. The farther right a firm lands corresponds with a higher concentration of deals in one sector. In each period, the median, bottom quartile, and top quartile firm sector HHI trended upward. Broken down, a firm that invested in 65% in its primary sector and was evenly split among the remaining six sectors demonstrates the approximate cutoff for top-quartile concentration in 2010. That same manager would need to have invested at least 72% in their primary sector in 2020 to be considered top quartile in terms of deal concentration.

Quartiles and distribution for PE firms (#) by style score over time*



Source: PitchBook | **Geography:** US
*As of December 31, 2020

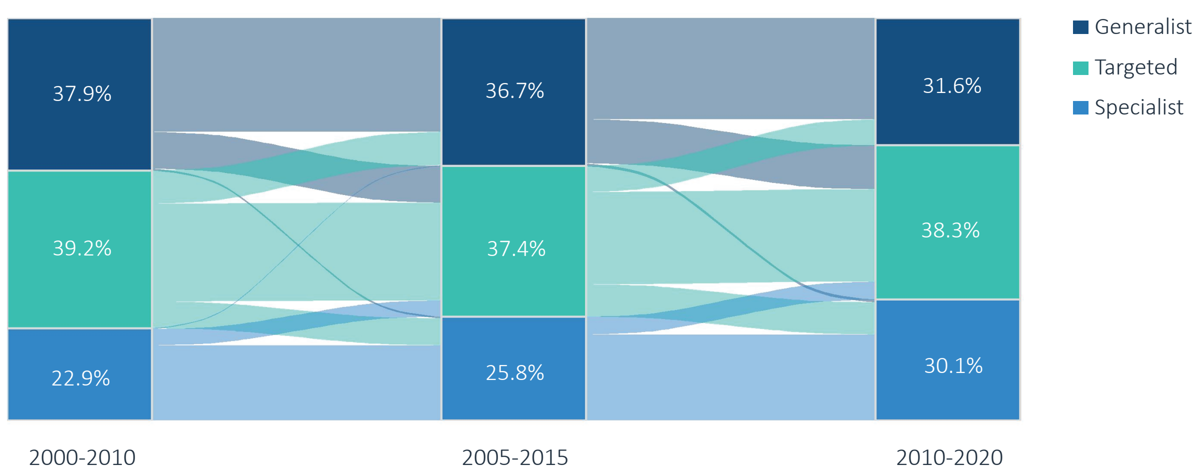
Established firms

Although much of the conversation around specialists tends to refer to newer managers, we decided to break out these cohorts and first examine established manager investment style changes. The comparison looked at firms that qualified for inclusion in 2010, 2015, and 2020. Of the 449 firms that qualified, the median change in HHI was +92. Simply put, this reading means most firms became slightly more specialized during the past decade—which went against our hypothesis that as firms got more established, they would also trend toward generalists. Our previous research on the subject illustrated that higher deal counts tend to correlate with less specialized managers. However, several instances exist of firms becoming significantly more or less concentrated over time. This type of style drift was rarer than anticipated.

As illustrated in “GP style classifications (#) over time,” in aggregate, established firms are slowly trending toward specialization. All three vintage cohorts contain the same GPs. The number of specialist firms swelled by over 30%—from 22.9% to 30.1%—and the count of generalists fell the most. Not only are newer firms specializing, but also established firms are specializing later in life.

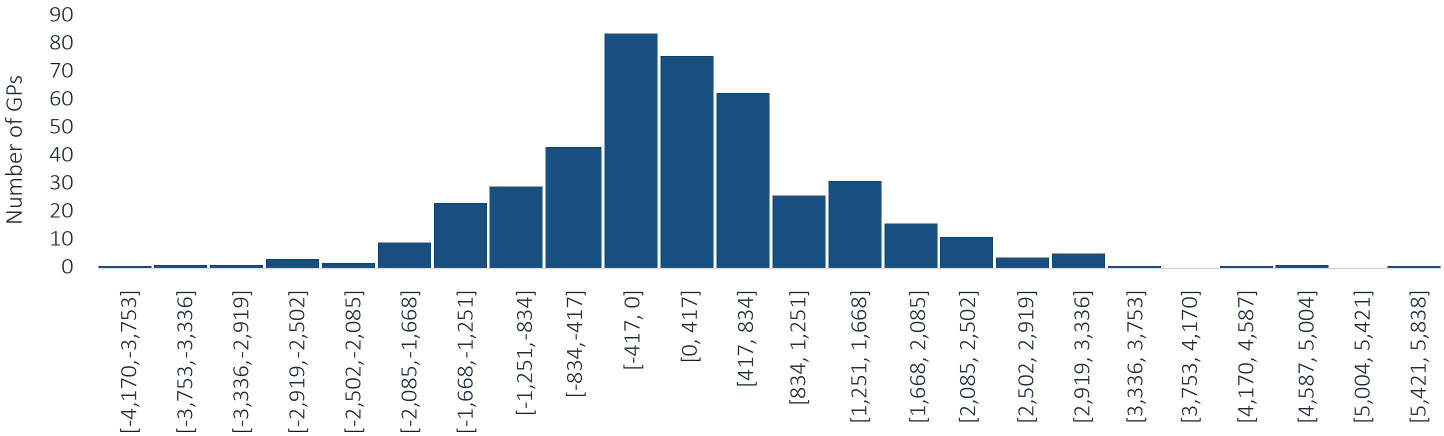
Established firms specializing over time ran counter to our expectations. As firms grow, many expand into numerous strategies and provide several fund offerings. For example, Bain has several regionally focused funds, one fund family targeting life sciences, and its broader flagship fund, among others. Because the style classification is attached to the GP level rather than the fund level, we expected firms to trend toward being generalists over time. However, the move toward specialization despite style tagging at the GP level—which means some specialized funds are miscategorized in this tagging—indicates that the trend toward specialization may be even more powerful than is visible in the data presented.

GP style classifications (#) over time*



Source: PitchBook | **Geography:** US
*As of December 31, 2020
Note: Only GPs that qualified for all three vintage cohorts are included in this chart. The style classification for each cohort is based on the previous 10-year deal history.

Change in HHI for established managers from 2010 to 2020*



Source: PitchBook | **Geography:** US
*As of December 31, 2020

Brynwood Partners is an example of a firm that became more specialized in the past decade. The firm completed a healthy number of investments in packaging companies alongside buyouts of food and beverage companies in the mid-2000s. However, in the past decade, Brynwood upped its concentration on the food and beverage industry and now boasts a much higher HHI—as most of its deals are in that sector. On the other hand, HPS Investment Partners was a heavy investor in the technology space one decade ago. As the firm scaled, it also started investing in the financial services and business services sectors. As the firm has done less concentrated investing, its HHI has gone down—which is neither inherently good nor bad—reflecting a firm that is more of a generalist.

Top 10 largest shifts to greater concentration*

Firm name	Sector HHI (2000-2010)	Sector HHI (2010-2020)	Change
Goense Capital Partners	3,223	8,951	5,727
Stonebridge Partners	2,934	7,734	4,800
Pharos Capital Group	2,847	7,531	4,684
Castanea Partners	3,906	8,412	4,506
Brynwood Partners	4,410	7,824	3,414
Seidler Equity Partners	2,608	5,900	3,293
Enhanced Healthcare Partners	2,574	5,852	3,278
Goldner Hawn	4,739	7,978	3,239
Summer Street Capital Partners	3,196	6,295	3,099
Concentric Equity Partners	2,042	5,067	3,025

Source: PitchBook | **Geography:** US
*As of December 31, 2020

Top 10 largest shifts to less concentration*

Entity name	Sector HHI (2000-2010)	Sector HHI (2010-2020)	Change
HealthEdge Investment Partners	7,734	3,565	-4,170
Cressey & Company	8,893	5,432	-3,460
HPS Investment Partners	7,405	3,984	-3,421
Altaris Capital Partners	8,762	5,702	-3,060
Quantum Energy Partners	9,556	6,518	-3,038
Transition Capital Partners	5,350	2,449	-2,901
Swander Pace Capital	7,855	5,007	-2,848
WindRose Health Investors	7,792	4,977	-2,815
GMB Capital Partners	5,410	2,903	-2,508
Volition Capital	6,995	4,652	-2,343

Source: PitchBook | **Geography:** US
*As of December 31, 2020

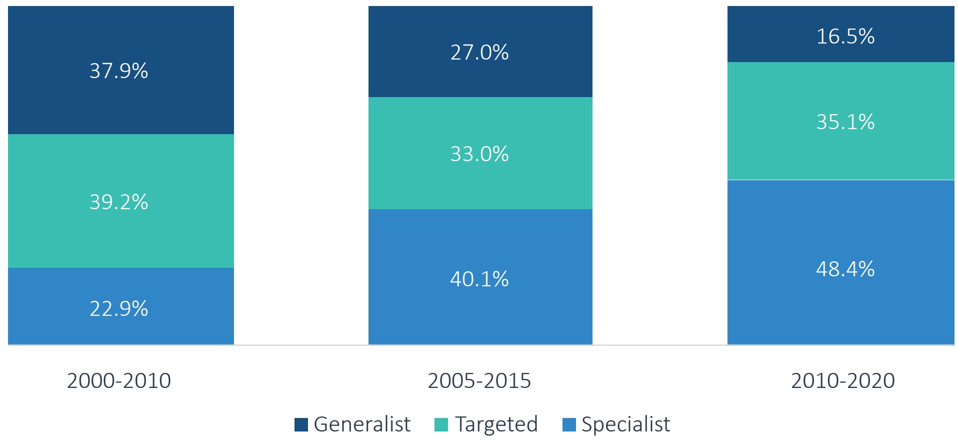
Emerging managers

Newly formed managers have been specializing at a rate far above more-established firms, and the shift has occurred rapidly. While just 22.9% of the emerging managers that qualified for our classification were specialists in the 2010 time frame, that number leapt by over 100% to 48.4% in the 2020 time frame. Now, nearly half of all newly formed managers are specialists.

To gain an edge in an increasingly competitive landscape, many larger, established firms have sector-focused strategies under their generalist umbrella and employ sector-focused dealmakers in their generalist funds. This means that when teams spin out of established firms, they often form specialist managers. Similarly, with the rise of the $50 billion+ AUM specialist firms—such as Silver Lake, Thoma Bravo, and Vista Equity Partners in the technology space—their numerous offshoots tend to remain specialists. For example, Sumeru Equity Partners and Luminate Capital Partners, two emerging managers currently each on their third funds, were both formed by dealmakers that once worked at Silver Lake. Going forward, we expect over half of all newly formed GPs will be categorized as specialists.

Some of the specialization trend also has to do with the kinds of firms that find success raising capital. As LPs have become more sophisticated in managing PE portfolios, many of them have built a target range around sector weightings. They may want consumer-focused GPs to account for 8%-12% of their PE portfolio, healthcare-focused strategies to account for 12%-18%, and so on. This exercise is much easier when allocating to a sector specialist, rather than splitting the allocation across sectors as they may do with a generalist.

GP style classifications (#) for new managers by vintage bucket and style*



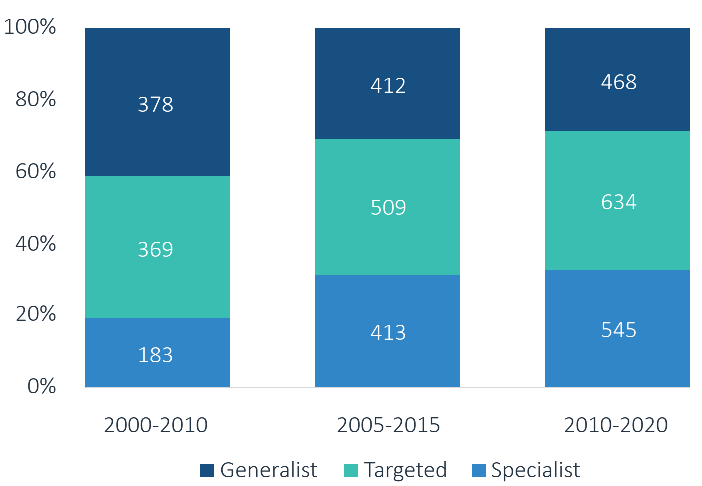
Source: PitchBook | **Geography:** US
*As of December 31, 2020

Note: GPs may qualify for this chart in only one of the three vintage cohorts. When a new manager completes enough deals to be classified, it is recorded in that vintage bucket and cannot be included again.

Fundraising

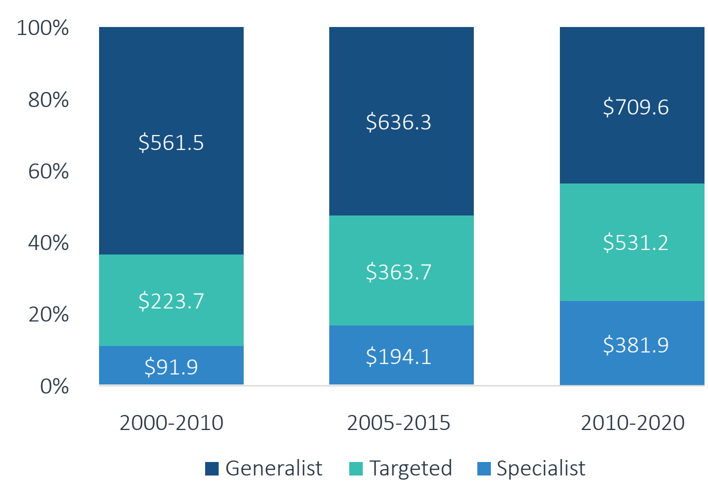
Fundraising figures for the three classifications also demonstrate the broad move toward sector specialization. However, the figures looking at fund count versus capital raised differ substantially. The data demonstrates that the average generalist manager raises substantially more capital than the average specialist, which makes intuitive sense because generalists by definition have a broader opportunity set than sector specialists. These charts also likely understate the amount of capital flowing into specialist funds. For example, because the tagging is at a firm level rather than fund level, funds including Bain's life sciences fund are counted in the generalist bucket.

Fundraising (#) by vintage cohort and style classification*



Source: PitchBook | **Geography:** US
*As of December 31, 2020

Fundraising ($B) by vintage cohort and style classification*



Source: PitchBook | **Geography:** US
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Conclusion

GP specialization is here to stay. Many GPs specialize in one or two sectors to create alpha in an increasingly competitive and cash-rich landscape. LPs also appreciate sector-focused funds and managers because of the added control it gives LPs over their PE portfolios. Our research suggests that, although older firms are tending to specialize over time, albeit marginally, the newcomers have a much higher likelihood of being specialists. Even at the firm level, many of the largest firms are specializing with sector-focused funds within their broader firm. For example, Blackstone (NYSE: BX) has funds focused on healthcare or financial services, several generalist strategies, and more. Going forward, we expect a high proportion of new GPs will be sector focused. As we conduct future analyses using the PitchBook GP style metrics, performance comparisons between specialist, targeted, and generalist firms will be a key focus.