ESG in PE Secondaries

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Key Takeaways

- Private equity secondaries have emerged as one of the fastest-growing private market asset classes in recent years, and while the secondaries market has matured, ESG integration targeted toward secondaries funds and investors remains relatively nascent.
- Secondaries present unique challenges and opportunities for integrating ESG management, and firms pursuing secondaries will need to develop ESG strategies for differentiated investment structures accordingly.

Overview of PE Secondaries

In recent years, private market investors have increasingly looked to the PE secondaries market as an attractive alternate asset class. Secondary transactions, which involve the sale of interests in funds or assets that remain under the same management, can be an especially popular strategy during M&A downturns. Once a niche investment strategy, secondaries have become the second most popular PE strategy behind buyouts, with over $100 billion in secondaries deals in both 2021 and 2022 and $37.2 billion raised in 1H 2023. In the current landscape of market volatility, premium priced liquidity, and PE exit headwinds secondaries have gained further momentum, accounting for 18% of total Q1 2023 PE fundraising, an 800% increase year over year. Private investors driving growth in secondaries transactions include large multi-strategy private equity firms, specialized secondaries funds, and impact-focused funds targeting specific assets on the secondary market.

Transaction Structures and Investor Considerations

The two prevailing PE secondaries deal structures, traditional limited partner (LP)-led transactions and more recently popular general partner (GP)-led deals, offer distinct benefits for GPs, LPs, and secondaries investors. GP and LP-led transaction structures also expose investors to different levels of ESG-related risk and opportunities to influence ESG initiatives, requiring differentiated approaches to integrating ESG considerations and management practices.

In traditional secondary market transactions, LPs sell their stake in an existing fund or fund of funds to a buyer who takes over the LP's position. LP-led transactions create a lever for fund investors to liquidate their stakes, enabling flexibility to avoid longer lock-up periods and rebalance portfolios of funds as needed. Since secondaries investors in LP-led transactions assume the traditional LP role across funds, their ESG focus should be right-sized and primarily focused on the ESG practices of investment managers at a macro level. Investors acquiring LP stakes should focus on evaluating investment managers' ESG maturity during transactions and engaging with GPs post-close on portfolio wide ESG management practices.

In GP-led secondaries, investment vehicles known as continuation funds can be set up for GPs to directly raise additional capital for existing portfolio assets that are rolled over into a new fund. Over the past decade, GP-led transactions, and particularly GP-led continuation funds that involve a single asset or a more concentrated set of assets, have gained traction. In 2022, GP-led transactions comprised 48% of total secondary market transaction volume, with 85% of GP-led deals structured as continuation funds and ~50% of GP-led deals involving just a single-asset, a 10x increase from 2018. PE firms with funds nearing maturity, who may be reluctant to divest from assets in the current ecosystem of deflated valuations, are looking to continuation funds to hold and develop assets, avoid premature exits, rebalance their portfolios, and raise additional capital from secondary market investors. Because GP-led transactions typically involve a single or more concentrated set of assets, investors should evaluate asset-level ESG considerations and conduct ESG diligence more closely resembling those typically conducted by investment managers. Post-transaction, investors may want to engage with GPs in developing targeted ESG initiatives for assets in continuation funds and to monitor assets' ESG metrics and performance over time.

For investors, secondary market transactions offer more flexible investment structures and off-cycle transactions, enhanced transparency into investments, and a faster return of capital deployed; LP-stakes offer investors historical data on fund performance, and GP-led continuation transactions give investors direct access to high-performing portfolio assets. Because secondaries investors in both types of deal structures are removed from asset-level operations and management of ESG issues, their primary channel for advancing ESG management in investments is through GPs.

Challenges of ESG Integration in Secondaries

Firms with secondaries investment strategies may have limited ability to analyze and manage ESG risks and opportunities relative to conventional PE buyout transactions. Investors acquiring fund-level stakes in LP-led transactions will have restricted capacity to influence management across assets on par with that of the typical LP role, which can reduce their ability to manage ESG risks and value creation strategies. The greater number of assets that may be acquired through fund-level LP stakes also simultaneously presents both a higher threshold for materiality of ESG risks to investors and a higher probability that a transaction will include an asset with material ESG risk exposure. In contrast, ESG risk exposure levels may be elevated, and materiality thresholds lowered for an asset in GP-led secondaries since investors will have a more concentrated dependency on the performance of one or several assets in a transaction. Investors in continuation funds may have limited access to management and visibility into non-financial information on portfolio companies that would typically be evaluated during ESG diligence and must adapt ESG analysis to a more streamlined investment process.

Opportunities for ESG Integration in Secondaries

Secondaries investors enjoy a key advantage in evaluating ESG risks and opportunities that primary investors do not: assets in a GP's portfolio may already have ESG assessments and KPI data to evaluate. While LPs investing in a standard PE fund do not know which assets their capital will be deployed towards in advance, secondary PE investors are able to screen existing assets or portfolios for ESG risks and may benefit from multiple layers of due diligence. While ESG oversight in LP-led transactions depends on GP's ESG diligence and management, investors in continuation transactions can also conduct a second round of lighter-touch ESG diligence of underlying assets within the scope of the transaction.

Since continuation transactions enable longer hold periods for GPs, greater continuity of ownership can also facilitate strategic planning for portfolio company management teams to develop and operationalize ESG management practices. GPs may be disincentivized or inhibited from fully committing to ESG transformations if there is a lack of available capital or time remaining in an existing fund; however, continuation vehicles can give GPs room to invest in longer-term, value additive ESG opportunities (e.g., GHG emissions tracking and reduction programs).

Because secondaries investors typically acquire stakes in funds and assets across a wide set of different GPs, they can play an important role in advancing ESG best practices throughout the PE market. As the secondaries market grows, investors can more readily set preference to assets and fund managers that align with their ESG values, incentivizing further adoption. Depending on the terms of an investment, investors in GP-led secondaries may also gain one or more seats on a portfolio company's board. Board seats are a critical determinant of leverage for secondaries investors to require more stringent ESG policies or controls.

ESG Best Practices in Secondaries

ESG best practices for secondaries investors are evolving based on the fundamentals of traditional LP and GP ESG management and due diligence. Investors in in LP-led fund-level transactions can lean on ESG initiatives developed by LPs to influence investment managers and investors in GP-led asset-level secondaries transactions can adopt the fundamentals of PE manager ESG programs. ESG best practices should be tailored to each stage of a transaction, evaluating ESG programs and risk exposure pre-close and integrating ESG management best practices post-close.

At the investment stage, investors in fund-level LP stakes can request information on GP ESG practices and perform formal evaluations of GP ESG management programs. Investors with stakes in different funds across GPs can share ESG diligence and portfolio management best practices they observe to help bolster managers' programmatic maturity. Investors in single or multi-asset GP-led deals should have more robust ESG risk assessments and can review original investment materials, directly screen assets with lighter touch ESG diligence focused on filtering for red flags and request historical and future ESG KPIs. If an area of ESG concern is identified for an asset, secondaries investors should reach out to the GP to understand how the management team is addressing the risk.

If ESG diligence and GP assessments reveal immature governance and management of ESG issues, secondaries investors can engage with GPs following a transaction through ESG-related side letters, resource sharing, and setting thresholds for ESG performance metrics. Once committed to a manager, secondaries investors will largely assume the role of LPs and monitor GP governance and asset performance on ESG metrics through AGMs and other LP-facing materials. Unless a board seat is held, secondaries investors will likely not be able to directly influence asset-level ESG management practices but should work to support GPs in enhancing ESG programs, policy creation, and operationalizing ESG management practices.

How Malk Can Support

As the secondaries market further matures, expectations and opportunities for ESG integration will continue to grow making the development of a leading ESG program a key consideration for secondaries investors. Malk is well positioned to support investors in tailoring their ESG approaches based on transaction structure to address ESG risks and capitalize on value creation opportunities. Malk can offer secondaries investors in LP-led transactions expertise in developing the right tools to assess GP ESG maturity during diligence and build strategies for engaging with GPs on ESG post-transaction. For investors in GP-led transactions and concentrated continuation funds, Malk can support investors with due diligence and engage firms in developing collaboration strategies for engaging GPs and portfolio companies on ESG topics and advancing ESG maturity.

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About Malk Partners

Malk Partners is the preeminent advisor to private market investors for creating and protecting value through environmental, social, and governance ("ESG") management and impact investing. Founded in 2009, Malk Partners advises many of the world's leading alternatives managers investing across private equity, growth equity, venture capital, and private credit by helping them define ESG goals, achieve ESG results, and guide their portfolio companies in driving value creation and mitigating risks. The firm is headquartered in La Jolla, California with a second office located in New York. For more information about Malk Partners, please visit www.malk.com.