Overview of secondaries market in Australia

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Introduction

Overview

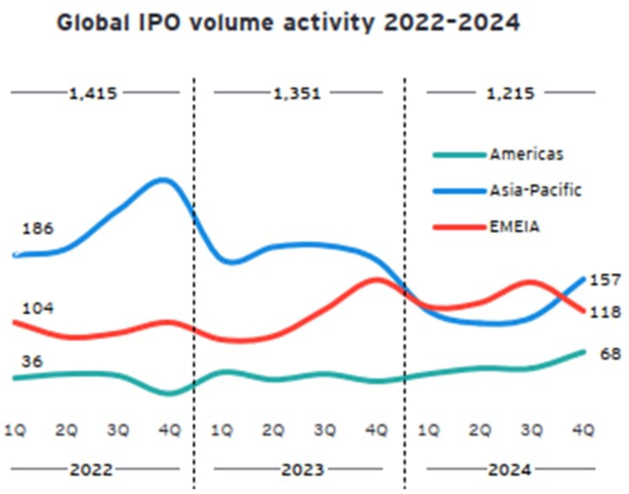
Australian secondaries, including both fund interests and single asset investments, are a growing market, providing an additional pathway for General Partners (GPs) and Limited Partners (LPs) to access liquidity and exit opportunities. For both sellers and buyers alike, valuation is a key consideration as sellers are looking to maximise their returns whilst buyers are looking to pay the lowest price. This paper explores Australian secondaries by examining key trends and opportunities in the market, liquidity and valuation considerations that should be contemplated, and an overview of best practices in governance over secondary transactions.

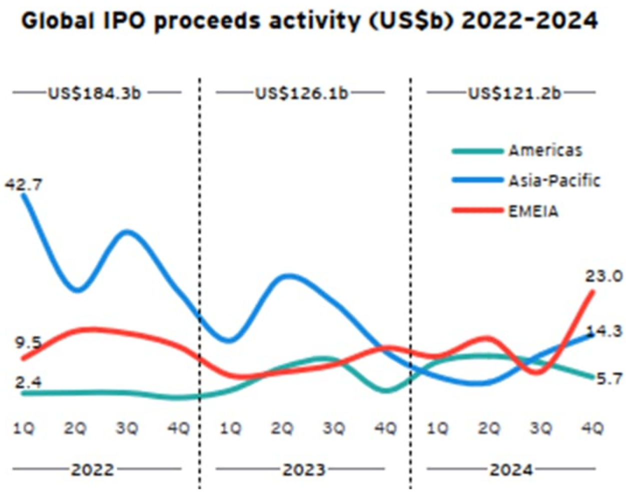
Key issues that may be of concern to GPs and LPs in considering approaches to secondary transactions include:

Liquidity → Valuation → Equitable treatment → Governance

Global and Asia-Pacific market trends

The global initial public offering (IPO) market experienced a downturn in 2023 which generally continued through 2024 as potential listers have delayed plans due to market and economic conditions. Although the equity markets have experienced an uplift, this has been mainly concentrated in the large-cap technology companies, with the remaining constituents in the index remaining relatively stable from a growth perspective. Investors' capital has flowed to these large companies and largely remained away from the unproven new businesses in the market, within the index constituents. The numerous after-market underperformance in recent years and the high-interest-rate environment has contributed to the slowdown in the IPO market. The number of global IPOs decreased from 1,415 in 2022 to 1,215 in 2024 (14% decrease) and consequently the proceeds decreased from USD $184.3b to USD $121.2b over the period (34% decrease).





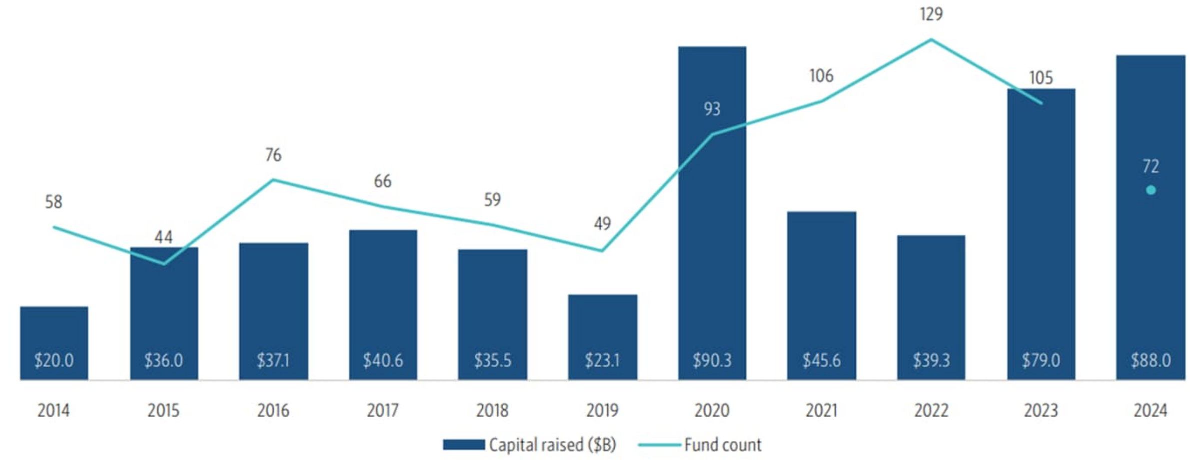
Source: EY Global IPO Trends 2024

Introduction (cont.)

- The Asia-Pacific region experienced the most significant decrease over this period.
  - 16% decrease in number of IPOs
  - 67% decrease in IPO proceeds
- The challenges the IPO market has been experiencing emphasises the importance of secondaries as an alternative liquidity opportunity for LPs and GPs alike in 2025 and beyond.

As the IPO market has retracted the secondaries market has seen growth, which is expected to continue through 2025, as an important alternative liquidity exit for LPs and GPs.

Secondaries fundraising activity



Source: PitchBook Data, Inc.

Secondary transaction types

LP-led secondaries

- For LP-led transactions, prices typically trade at a discount to net asset value (NAV), reflecting the illiquidity of the asset. The quantum of the discount is driven by market factors as well as investment specific factors, in particular the maturity of the fund in question and the purchaser often having greater clarity on likely capital call liability.
- There has been an uplift in secondary prices, driven by an increase in listed company multiples, as demonstrated by the increase in the S&P 500 and the NASDAQ indices in 2023 and 2024. The stabilisation of interest rates and growing dry powder available to deploy has also significantly contributed to higher secondaries market prices.
- The vintage of the funds and assets being sold on the secondaries market has decreased on average, with younger funds being traded (less than 5 years, historically 7 years), increasing the supply and opportunities for buyers to transact. Younger funds tend to trade at a smaller discount to NAV in comparison to more mature funds as early investors seek the upside tied to investing early while risks are the highest. As the initial costs and risks have been captured already, there may be potential for greater growth compared to more mature funds, typically resulting in a lower discount.
- With 2025 still shaping up to be a difficult and challenging IPO market, LP-led secondaries can assist in meeting LPs' demands for liquidity, resulting in reduced liquidity discounts and indirectly driving up the prices.

Introduction (cont.)

GP-led secondaries

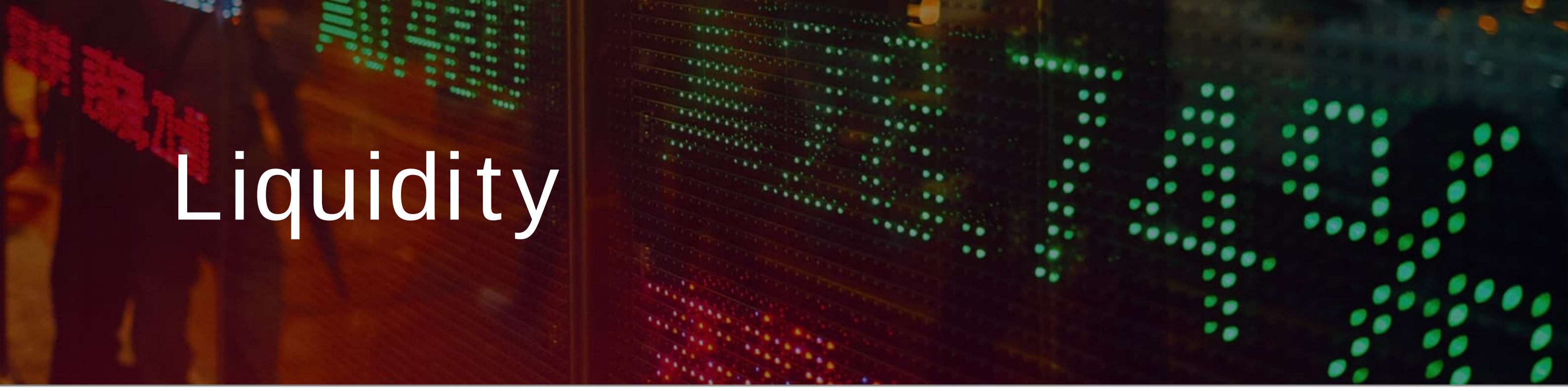
- GP-led secondaries involve offloading entire portfolios of assets (or a single asset) to a buyer. The prices tend to trade at NAV or at a premium as GPs generally will not accept a discount for their interests.
- Continuation funds are common transaction types within GP-led secondaries. Continuation funds are new funds created to take on portfolios of funds nearing the end of their lives and invest in follow-on rounds of the portfolio companies. A continuation fund may be formed to facilitated continued investment in a single asset of a vintage fund or may consist of a portfolio of assets. They allow GPs to retain control over their prized assets or those assets requiring additional time to achieve financial maturity. The aim is often to allow investors to remain exposed to the assets, while offering liquidity to investors who wish to exit.
- GPs should consider any conflicts of interest and duty that may arise from creating a continuation fund, including fair treatment of both liquidating investors and rolling investors, and, importantly, assess the independence of any valuation of transferred assets.

Australia’s secondaries market and outlook

- Australia has seen increased secondary market activity from superannuation funds, with the secondary market used as a rebalancing tool to address the denominator effect and allowing for more flexibility and liquidity in strategic decisions. The denominator effect occurs when the current private equity allocation exceeds the target allocation due to a significant downward valuation of another portion of the portfolio.
- Whilst secondaries transactions occur across all investment strategies, including venture capital, growth, pre-IPO, and private equity, Australia's market is primarily concentrated in middle market private equity. This focus is due to the structure and size of the Australian private equity market and superannuation funds.
- Aside from superannuation funds, Australia’s secondaries market is still immature relative to the US and Europe. As more funds are at or nearing the ends of their terms and seeking exit opportunities, there has been a significant increase in demand for secondaries in Australia.
- As observed in the global secondaries market, slow deal activity has driven GPs and LPs to explore other liquidity exits such as secondary market sales. The narrowing bid-ask price gap, shorter fundraising turnaround time by GPs, and geographic diversification are contributing to the growth in this market.
- In 2024, the outlook is positive for the global secondaries market as demand remains strong, with an increasing trend in dry powder available, increasing amount of PE firms entering the market and LP-led transactions remain strong.

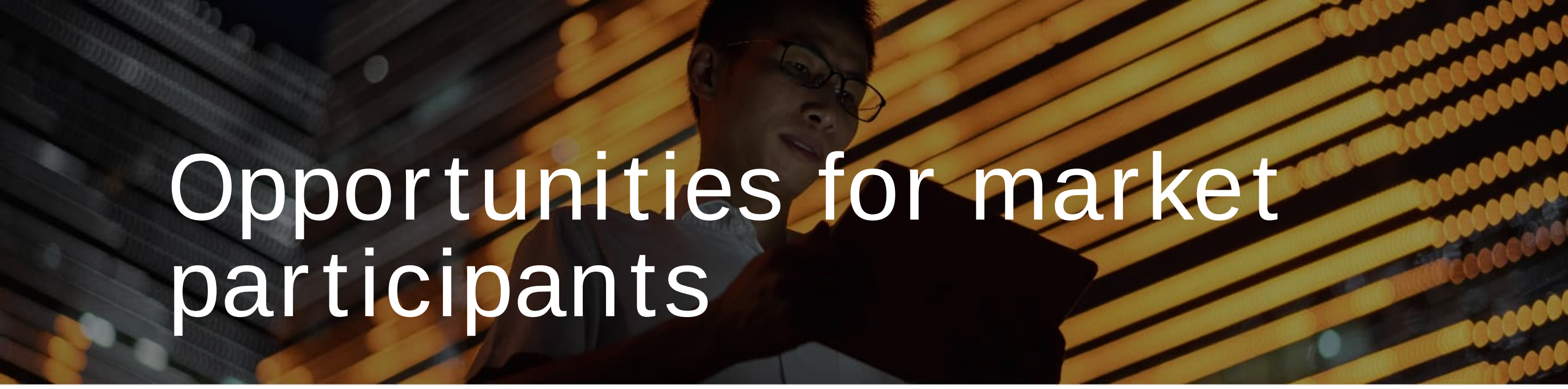
The growing importance of secondaries in portfolio management

- As the investment landscape evolves here in Australia, the role of secondaries in portfolio management has become increasingly prominent. Secondaries provide an important liquidity option for both GPs and LPs, allowing them to rebalance their portfolios and manage risk more effectively. This is particularly relevant in the current market environment, where the need for flexible and timely liquidity solutions is paramount. By participating in the secondaries market, investors can mitigate the impact of market volatility and economic downturns, keeping their portfolios aligned with their long-term strategic objectives.



Liquidity

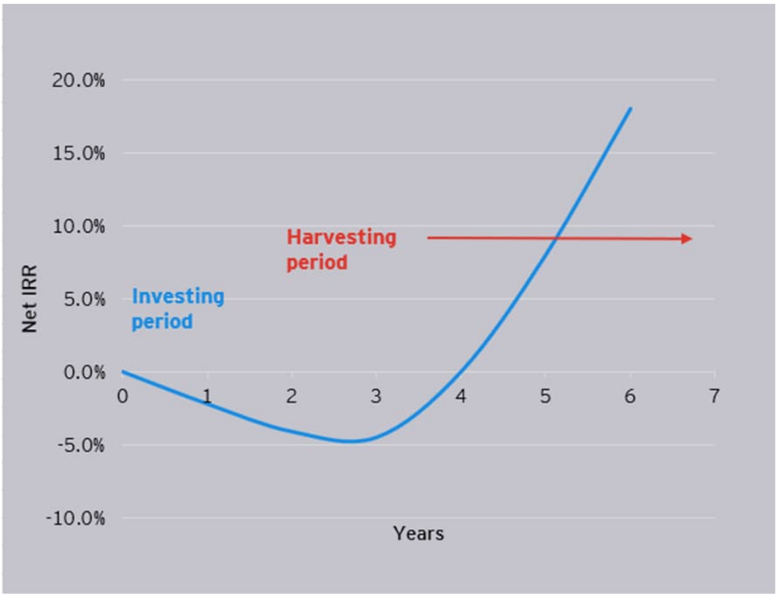
- GPs and LPs looking to exit private investments may transact through acquisition by another company, sale to private equity, through the secondaries market, or an IPO. Depending on the economic environment, and the stage of development of the asset, certain methods may be more favourable than others.
- In the current economic environment characterised by high interest rates and market volatility, the demand for liquidity has intensified, leaving investors desiring quicker capital returns, increasing the demand for liquidity for LPs and GPs alike. The secondaries market may benefit from this while other avenues for liquidity remain difficult.
- Furthermore, venture capital and private equity funds reaching maturity in Australia could further fuel the need for more liquidity exits. Given the current economic environment, secondaries may play an important avenue for fund managers if other liquidity exits are not favourable or possible. Those holding prized assets who do not wish to exit yet may consider setting up a continuation fund to allow GPs to retain control over the prized asset while fulfilling fund mandates and providing liquidity to investors who desire it.
- The significant transaction volume in the global secondaries market demonstrates its usefulness for providing liquidity exits, with the US and Europe leading the way. Given the current environment, the need for secondaries will be paramount in Australia.
- In the US and Europe, fund managers with proven track records that incorporate liquidity in their investment strategies have become highly attractive for investors.
- The long-dated nature of closed-end funds presents significant challenges, with many funds sitting on valuable assets but failing to deliver meaningful cash returns. This situation highlights the importance of liquidity, which should come with a premium to reflect the value of providing early exit options for investors. Such a premium compensates for the risks and opportunity costs associated with long-term illiquid investments and rewards investors for their patience and commitment.



Opportunities for market participants

Buyer opportunities

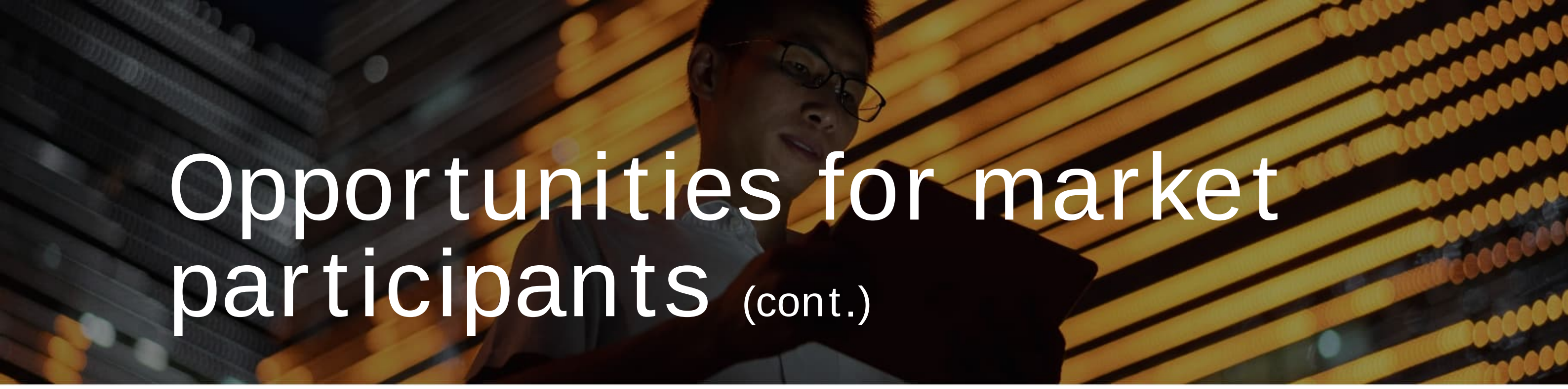
- When acquiring assets on the secondary market, buyers can avoid and/or reduce the initial capital outflow associated with early-stage businesses lacking a proven track record. This initial negative return is known as the J Curve decline. Secondary buyers avoid the J Curve decline and enter when the J Curve has bottomed out or is on the incline. This later entry strategy also decreases the “blind pool” risk and enhances investment visibility. It can also serve as a strategic tool for determining the entry timing into a target business and thus controlling the exposure to the investment’s life cycle.



- The secondaries market can help funds diversify the investment portfolio and open opportunities to invest in businesses suited to the fund manager’s specialisations or skills. LP-led secondaries transactions typically sell at a discount – an incentive that can be further amplified by a seller’s intent to divest, creating potential profitable deals for buyers. Increasing supplies of younger funds in the global secondaries market, notably in the US and Europe, also offer more diverse investment opportunities as historically secondaries offer an attractive risk adjusted return.

Seller opportunities

- Sellers, on the other hand, benefit from portfolio management and rebalancing capabilities to prevent portfolio overallocation. Changes in the valuation of a portfolio’s private assets can cause the portfolio to fall outside the fund’s allocation policy, thereby inducing a need for liquidity. Founders can also access additional liquidity pathway to enable better financial management and focus on their business's future growth. Similarly, fund managers can realise gains to return capital through investor distributions or use the proceeds to invest in new businesses, while simultaneously accelerating incoming cash flows to increase the fund’s internal rate of return and, in turn, increase the carried interest earned.
- Exit timings can be strategically managed to shorten the investment life cycle, thereby maximizing the divestment opportunity in the best interests of the investors. Greater liquidity in the market has led to narrowing bid-ask spreads, meaning higher sale prices for sellers. This trend allows sellers to price their assets closer to NAV and achieve higher returns for their investors and themselves.

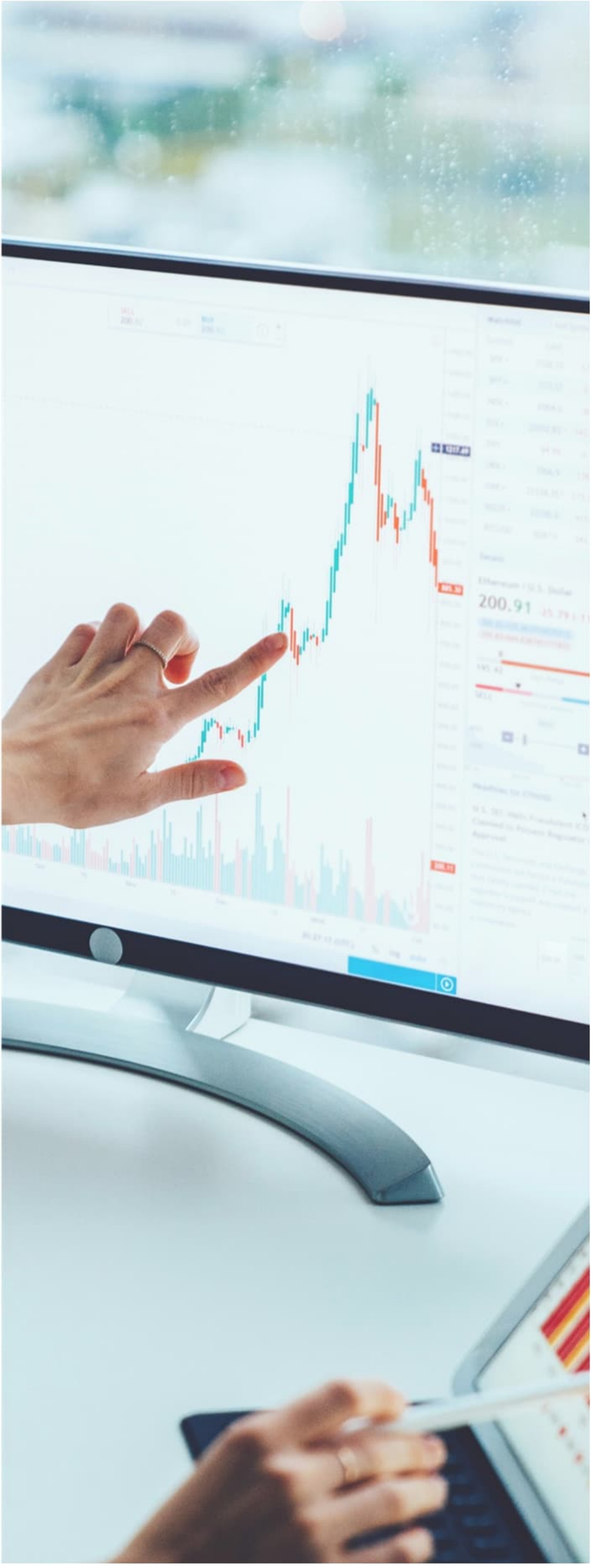


Opportunities for market participants (cont.)

Continuation funds

- Continuation funds are another avenue for GPs to provide liquidity for investors while retaining control of their assets. This allows more time for the GP to extract further growth from the asset that they believe has potential before exiting, while investors can lock in returns or continue their involvement with the investment by rolling over their commitment to the continuation fund.
- The use of continuation funds, whilst capable of solving liquidity challenges for GPs and delivering value for LPs, raises governance questions that should be carefully navigated. GPs are inherently conflicted as they are incentivised to sell assets out of the vintage fund to the continuation fund at a high price in order to maximise their carried interest, which aligns with their responsibilities to the vintage fund investors. Conversely, they have a duty to seek out an attractive price for continuation fund investors. The nature of the transaction is a transfer of value from one group of investors to another, each of whom the GP has a duty to transact at the best price they can achieve.
- Managing these conflicts and duties requires a robust system of governance and controls; however, with appropriate safeguards, a fair continuation fund process can be achieved. Policies that can aid in constructing a fair process may include:
    - Separate GP teams across the vintage and continuation fund who are not cross-incentivised
    - Use of conflict management resolution mechanisms, such as LP advisory committees
    - Obtaining valuations from independent pricing experts
    - Matching third-party terms

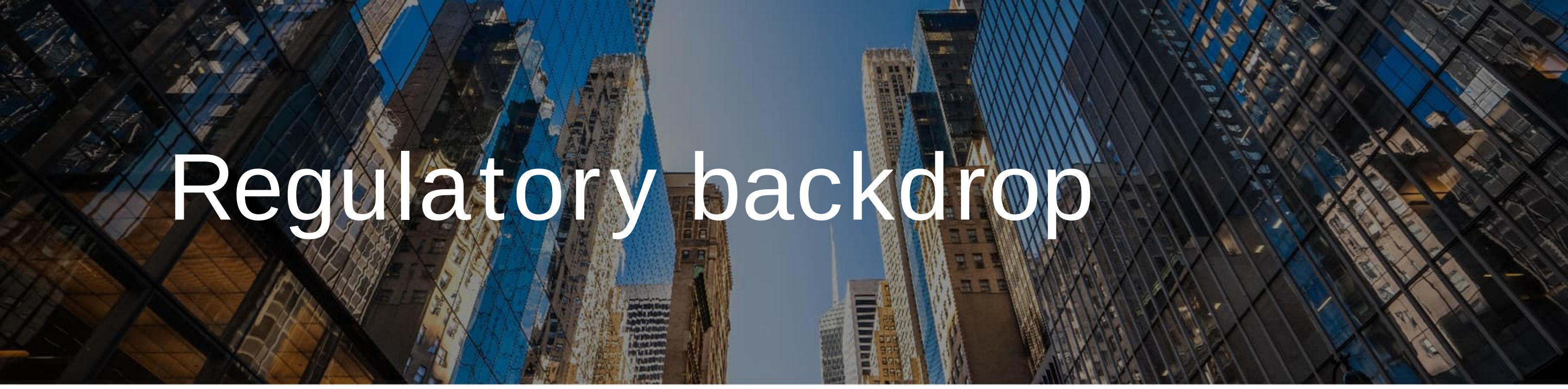
Valuation considerations



- Access to quality information is crucial for determining an appropriate secondaries market valuation. Given the private nature of the asset, obtaining reliable data for valuation assessment can prove challenging. It necessitates due diligence to ascertain the information and often involves a third-party expert to perform the valuation assessment and conclude on a fair value. In Australia, the current landscape of venture capital investment valuations is very much in favour of the founders. As the market grows, the power may shift from founders to investors as information becomes more transparent.
- When a fund or portfolio company has completed a recent capital raising round, valuations may approximate the price of the round. The more time that has passed since a round, the more likely a fair value methodology will be utilised. Valuations of secondaries often include a discount or a premium. Typically, LP-led secondaries involve discounts to the NAV. Secondary sales of a portfolio of assets may warrant a higher discount if the holdings are non-homogeneous, as investors generally favour “pure plays” in which a portfolio consists of assets with similar characteristics that may provide potential efficiencies. A higher number of assets in a portfolio will result in increased valuation complexity as more information is required to appropriately assess the value of each individual position, in addition to assessing the portfolio as a whole, to arrive at a valuation mark.
- In some GP-led secondaries, an illiquidity premium may be appropriate to compensate existing investors for tying up capital in an illiquid investment. Conversely, the buyer may expect a discount for acquiring an illiquid asset. These opposing objectives may give rise to a valuation mismatch and an independent third party may be required to perform this assessment.
- Valuations in the secondaries market require a comprehensive evaluation of both quantitative and qualitative inputs. Quantitative inputs such as EBITDA (and any EBITDA adjustments), discount rates, growth rates, and comparable public company or recent transaction multiples, are necessary components requiring detailed assessment as a part of a valuation. However, it is equally important to consider qualitative factors, including the economic environment and related trends, the management team's expertise, the competitive landscape, the impact of regulatory changes on company’s prospects, geopolitical events, and the strategic direction of the underlying assets. A thorough assessment that integrates both types of inputs leads to a more robust and defensible valuation.

Valuation considerations (cont.)

- The motivations to buy or sell will also impact the valuation. For instance, a seller might be offloading an underperforming asset to an uninformed buyer, or a buyer might identify an opportunity to acquire an undervalued asset from a motivated seller. This potential for lack of transparency and information asymmetry should be considered when valuing secondaries. Additional qualitative factors that should be considered include the complexity of the fund structure if more than one asset is being sold, the management team's history and the future strategic plans of the private asset, including who has control of the asset.
- Conflicts of interest need to be assessed in a transaction between a vintage fund and a continuation fund, with the buyer and seller being controlled by the same entity. Proper processes and policies as part of a robust governance framework will be required to mitigate conflicts of interest when arriving at a transaction price. There are competing obligations for the fund manager between maximising the value for existing investors and maintaining adequate upside for the incoming investors. The fund manager should provide fair treatment between these two groups of investors and not put one group’s interest over another. Complexity of the valuation will increase when more than one asset is being rolled into the new fund.

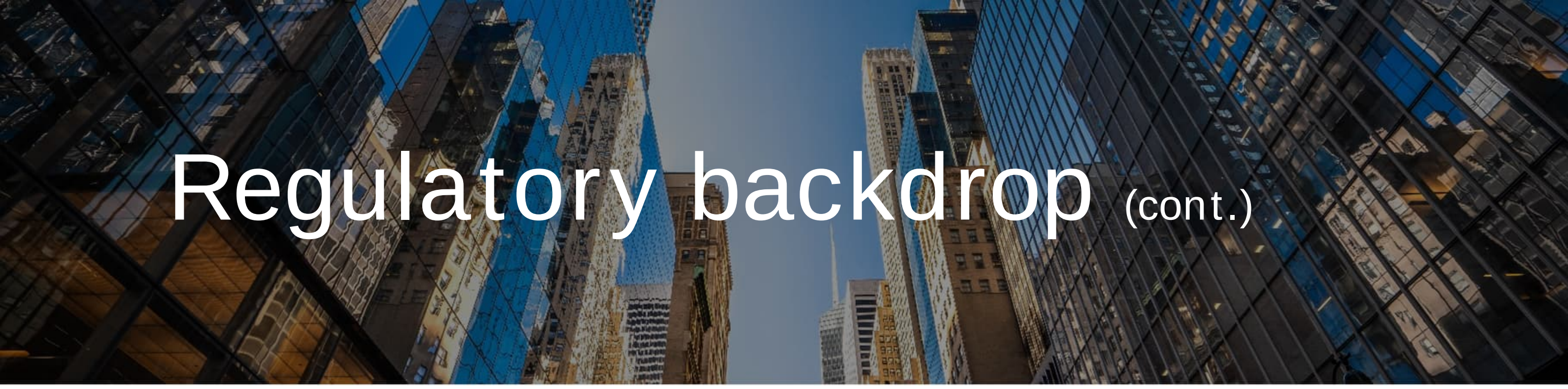


Regulatory backdrop

Various regulatory bodies have been working to improve the fair treatment of investors in both public and private markets.

United States Securities and Exchange Commission

- In the US, the Securities and Exchange Commission (SEC) had adopted new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act) to enhance the regulation of private fund advisers. The rules included requiring private fund advisers registered with the Commission to obtain a fairness or valuation opinion for an adviser led secondaries transaction, and prohibiting certain types of preferential treatment that have a material negative effect on other investors and prohibit other types of preferential treatment unless disclosed to current and prospective investors.
- The final rules were overturned in the courts on the grounds that the SEC did not have the authority to issue such rules in relation to private fund advisers. Despite the court ruling, the SEC remains focused on oversight of private funds. In their FY25 Examination Priorities, the SEC advised it would focus on the disclosure of conflicts of interests and risks, and adequacy of policies and procedures for private fund advisers. Examples of products or practices for the focus of such conflicts, controls, and risks reviews include: (1) use of debt, fund-level lines of credit, investment allocations, adviser-led secondary transactions, transactions between fund(s) and/or others; (2) investments held by multiple funds; and (3) use of affiliated service providers.

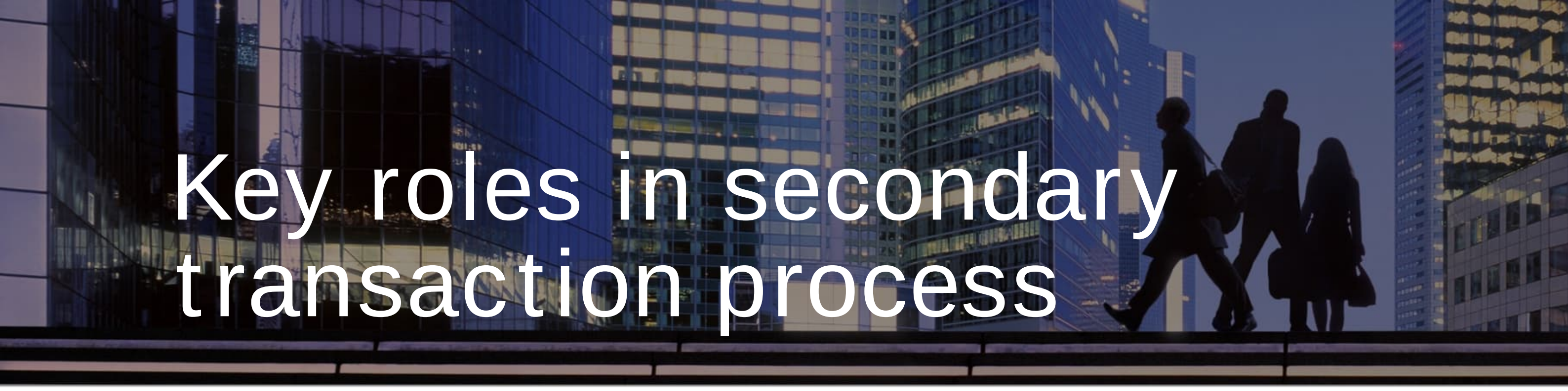


Regulatory backdrop (cont.)

Australian Prudential Regulation Authority

Prudential Standard SPS 530 Investment Governance

- Valuation of assets trading in the secondary market is in the regulatory spotlight after an Australian Prudential Regulation Authority (APRA) review identified significant areas for improvement in registrable superannuation entity (RSE) governance of unlisted asset valuations and liquidity risk management.
- The review, which prompted APRA to update Prudential Standard SPS 530 Investment Governance (SPS 530) to enhance valuation and liquidity management requirements, emphasised the need for strict board oversight and conflict of interest management. According to APRA's findings very few RSE licensees used dedicated valuation committees, leading to potential conflicts of interest when investment staff are involved in the valuation process.
- Further concerns were raised about the reliance on external investment managers for asset valuations, with the regulator's major concerns being insufficient independent challenge or monitoring post initial due diligence. This reliance means there is a risk inaccurate valuations may negatively impact investor returns.
- Consequently, APRA has stressed the importance of independent oversight and expertise in unlisted asset classes to enhance governance frameworks.
- SPS 530 specifically addresses the unique challenges associated with valuing unlisted assets like secondaries. As part of these changes, APRA now expects funds to develop a comprehensive valuation policy that details the methodology for each asset class, including secondaries. Expectations are for valuations to be conducted at least quarterly to prevent stale valuation marks. For externally managed investment options, the external manager's valuation policy should be consistent with the fund's valuation policy. To uphold the integrity of the valuations, operational and structural independence between investment decision-makers and valuers is required. APRA also expects funds to consider seeking regular independent valuations across all asset classes, including secondaries. Independent valuations may be more reliable and can remove the bias that may exist in internal valuations, particularly when an asset is part of a secondary transaction between related parties.
- During periods of heightened market volatility, the frequency and level of reporting and valuation oversight should be increased to address potential risks. APRA also requires that the investment governance framework considers member equity risk, which could increase scrutiny on GP secondary transactions, where secondary assets are sold to a new vehicle managed by the same or a new GP. Additionally, funds must establish processes to monitor and quantify equity impacts from events and implement enhanced monitoring arrangements when revaluation and liquidity impacts are significant. These measures assist in maintaining a robust valuation process for secondary investments that remains reflective of current market conditions.



Key roles in secondary transaction process

Governance

Trustee role

The role of the trustee is to oversee a process to produce fair asset valuations which reflect the true market price. This involves balancing existing investors' interests, who should receive fair value for their assets, against the interests of incoming investors, who must not overpay for the asset they are buying.

External, stringent, independent appraisals improve the credibility of asset valuations and mitigate potential conflicts of interest. A trustee should check that all parties involved in a transaction adhere to the fund's valuation policy and that the transaction conforms to local and international accounting standards.

Disclosures around related-party transactions are an important aspect of secondary market asset sales and trustees have a critical role to play. This includes being upfront with investors when related parties are involved in asset sales, keeping all sides adequately informed throughout the process.

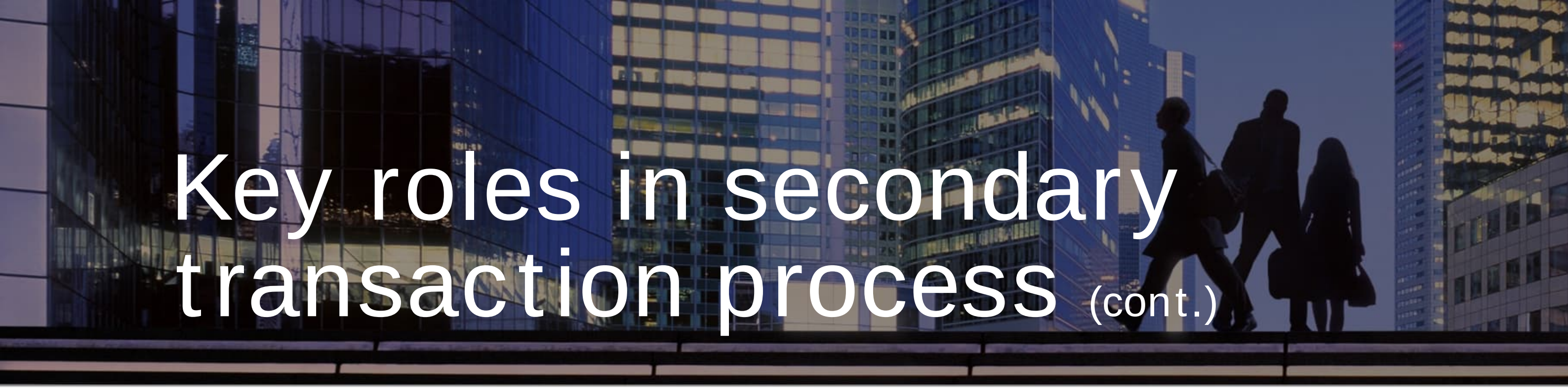
Legal

Role of legal adviser in secondaries transactions

In supporting the acquisition of secondary investments, the role of a legal adviser is multi-faceted, encompassing documenting the basis on which those assets are acquired, verifying that the assets have been properly conveyed to the purchaser, and performing legal due diligence to check that a purchaser possesses the requisite information about the asset to make an informed decision on its acquisition and the necessary commercial terms on which it is willing to do so.

Given the complexity of the assets that may be the subject of a secondaries transaction there may be the need for detailed legal due diligence to confirm that the asset being acquired is reflective of a purchaser's commercial expectations. In the context of a secondary acquisition of an investment in a fund this is likely to include diligence as to the terms of the fund in question and in particular any fees and costs that may be borne by the investor. In particular, a side letter will be necessary to obtain any additional rights granted to the vendor.

In any secondaries transaction, it may be necessary to review and negotiate pre-emptive rights of existing investors which may grant those investors a first refusal right over the vendor's interests. Where the transaction involves a related party acquisition, such as by a continuation vehicle from a vintage fund, it is important to obtain specific legal guidance on the management of conflicts of interests and how these should be disclosed to investors.



Key roles in secondary transaction process (cont.)

Accounting and administration

Proactive valuation management

As an accountant or fund administrator, it is crucial to adopt a proactive approach to valuation management in the secondaries market. This involves establishing clear and robust valuation policies that align with industry standards and regulatory requirements. Regular valuation reviews as part of a systematic process with comprehensive documentation is critical to maintain transparency and accuracy in financial reporting. This proactive stance not only enhances the credibility and defensibility of valuations but also facilitates smoother interactions with auditors and stakeholders.

Coordinated valuation reviews

To manage valuation complexities effectively, it is essential to implement a coordinated review process involving key stakeholders, including the investment manager, trustee, and administrator. Regular valuation meetings should be scheduled to assess the performance of assets, review any significant changes or triggers, and update valuation models accordingly. This collaborative approach helps to identify potential fair value changes early on and establishes a process in which all valuation decisions are well documented and justified.

Comprehensive valuation documentation

Maintaining detailed and well-organised documentation is a cornerstone of effective valuation management. This includes keeping a register of all investment triggers, such as EBITDA changes and market conditions, and tracking these over time. A thorough documentation process supports the valuation methodologies used and provides a clear audit trail. This not only aids in internal reviews but also when providing evidence to auditors.

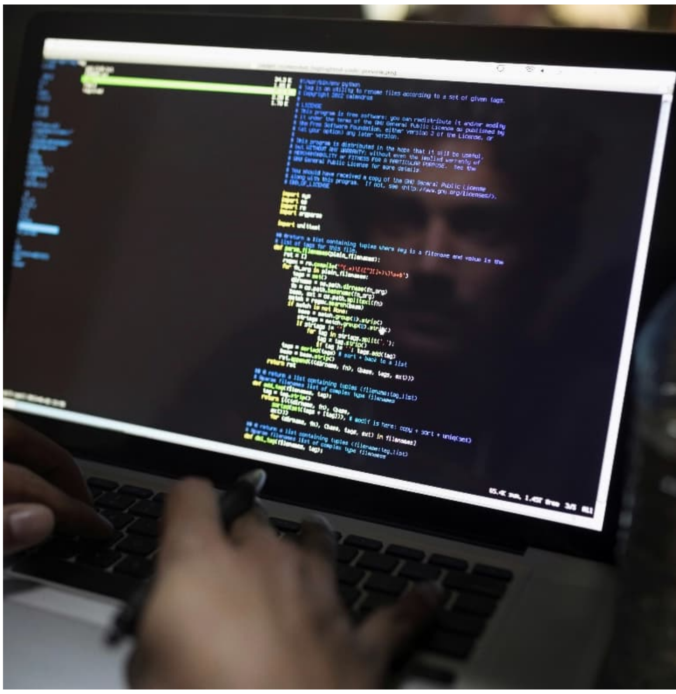
Key roles in secondary transaction process (cont.)

Assurance and other services

Audit

In respect of secondary transactions, auditors of funds are focused on a number of areas of risk:

- Fraud, including whether managers have an incentive to achieve a favourable outcome for themselves at the expense of certain investors and whether there is evidence of managers acting on this incentive.
- Valuation, including assessing whether the consideration involved in the transaction was representative of fair value for the asset(s) exchanged. This will involve evaluation of third-party valuers used to determine the transaction price and examining the reasonableness of the selected valuation approaches, key assumptions, and data used as inputs in the model.
- Related party relationships and transactions, including whether they are properly and accurately disclosed in financial reporting to investors. If disclosures purport transactions to be at arms-length, auditors will test whether those disclosures are accurate, potentially by auditing the asset that was sold from an entity to its related party through valuation testing.



Operational due diligence

- Regulators and investors are holding firms to unprecedented standards of accountability. It is essential for trustees of superannuation funds to understand whether existing or potential investment managers in their portfolios are meeting their standards for governance, trading processes, reporting, and valuations, and equally important for investment managers to show they are meeting these standards to retain and attract capital from current and future investors.
- An operational due diligence assessment (ODD) is a report from an independent service provider over an investment manager's operational risks with respect to their structure, governance, and policies in a number of areas aligned with SPS 230 Investment Governance. ODDs are a must for investment managers seeking capital from superannuation funds and many other institutional investors. Audit firms can act as independent service providers to conduct ODDs on behalf of managers, providing a balanced and collaborative approach and issuing a clear and concise report that meets investor and regulator expectations.
- A proper governance framework is essential to achieve fair treatment of investors when transacting in secondary investments. Asset managers' governance, compliance, and risk management framework, policies, and procedures are all examined as part of the operational due diligence assessment.

Case study

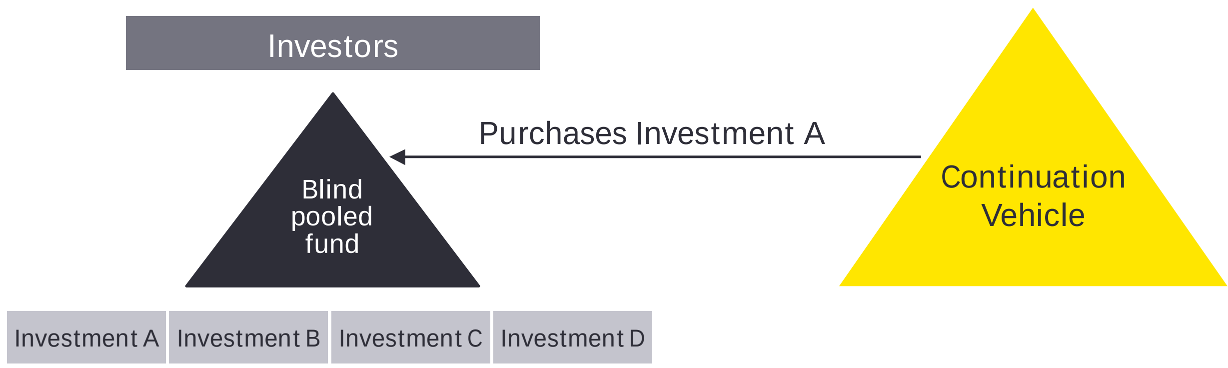
Continuation vehicles

Case study
Continuation vehicles

In order to assist to synthesise the issues presented in this paper, a useful example to highlight the considerations involved in a secondaries transaction is the instance of a continuation vehicle.

Broadly speaking, continuation vehicles are funds established by a fund manager aimed at retaining one or more investments held by a previous vintage fund. Typically, a new vehicle is formed which acquires the assets in question from the existing fund. The continuation vehicle may be capitalised by both new investors as well as investors in the existing vehicle. This allows investors requiring liquidity to exit the investments whilst enabling investors other to continue to be exposed to the investments in question.

Example



- An investment manager (Manager) is the manager of a blind pooled fund (Fund) with a number of investments.
- The Fund is approaching the end of its term, and the Manager considers that Investment A may generate greater returns on exit in the future.
- The Manager proposes to establish a continuation vehicle (CV) and purchase Investment A from the Fund.
- Under the terms of the Fund, the Manager is entitled to earn carry on the realisation of investments, subject to a preferred return. Depending on the amount returned to investors of the Fund from Investment A, the carry the Manager will earn from the Fund may be materially higher.

Legal and governance issues

Central to the Manager's legal obligations is its conflicts management protocols. In particular the following issues arise:

- The Manager has a duty to investors in the CV to acquire Investment A for the best possible (typically the lowest) price.
- The Manager has a duty to investors in the Fund to dispose of Investment A for the highest price.
- The Manager would be effectively using the CV's investors' capital to pay itself carry.
- The Fund, as vendor, would provide a number of representations and warranties to the CV (as purchaser) in the event these are not correct, the CV may have remedies against the Fund.

Case study

Continuation vehicles (cont.)

Whilst in practice the above issues may present themselves and be resolved in different ways, there are a number of factors and methods that can be considered in managing the above questions:

Disclosure and approvals	Clear disclosure to the CV investors as to the terms and price (as well as the relationship between the Fund and the CV) on which Investment A is being acquired, and providing the basis for valuations can assist in enabling investors to make an informed decision. If possible, the use of approval mechanisms in the Fund, such as an LP Advisory Committee, or an investor resolution, can assist in facilitating appropriate consideration of the Fund's investors' interests. It may be appropriate to disclose the effect that the transaction will have on the Manager's carry entitlement.
Valuations	Many managers would take care to obtain independent valuations of the asset in question, as well as to seek offers from external purchasers, in order to verify that the purchase price is similar to that which would be obtained on an arm's length basis.
Fiduciary	It may be appropriate to use independent trustees in order to foster greater independence.
Separation	In larger fund managers it may be possible to have separate teams negotiate the terms of the transaction, where the CV team is not remunerated from the carry referable to the Fund.

Accounting and tax perspective

Finance function's focus areas should be:

- Income tax cost for of continuing investors – The fund would need to satisfy the conditions for capital gains tax (CGT) relief if available.
- Performance fee or carried interest cost for continuing investors – is this a cost that should be borne by continuing investors? Does this require contemplation of a rebate for ongoing investors? A sweetener may assist the incentive for investors to continue.
- Valuation – a valuation of the acquisition would be a must for a number of reasons:

Tax	The transaction involves related parties, and there is potential for relief, so a valuation would be required to support CGT relief and the appropriate computation of CGT on exit.
Fiduciary obligation	Overseeing that performance fees are calculated appropriately and the price for exiting investors is independently assessed.
Costs	Costs to sell may be reduced given there is no broad tender process required to attract and engage with interested buyers.

Case study

Continuation vehicles (cont.)

Auditor perspective

Auditors will be focused on:

- Proper disclosure of this related party transaction in the financial report, including the related parties involved, the nature of their relationship, and the terms of the related party transaction.
- Any assertion that the transaction was at arms-length will need to be tested, including an assessment of whether the transaction price reflected fair value.
- Assessment of the investment manager's incentive to transact at a price favourable to one fund over the other in order to benefit itself through increased performance fees or protecting the financial interests of important investors.

Governance perspective

The manager faces significant challenges handling real or perceived conflicts of interest. The manager is obliged to acquire Investment A at the best possible price for the continuation vehicle, while maximising the sale price for the original fund's investors. This is complicated by the manager's potential to achieve higher carried interest based on the realised value of Investment A.

Transparency and rigorous governance protocols are the way to address these issues. Full disclosure of transaction terms, including the impact on the manager's carry, must be provided to continuation vehicle investors. Independent valuations and third-party offers should be sought to validate the transaction price.

Separating negotiation teams within the management firm can also boost impartiality, removing potential bias from carry considerations tied to the original fund to achieve fair treatment of investors in the continuation vehicle.

These measures uphold the manager's fiduciary duties, balancing stakeholder interests with diligence and transparency.

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