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Townsend Insights

Risk and Opportunity in Late-Stage Fundraises

Background

Committing to a closed-end fund late in its fundraise has always carried both risk and opportunity. A later investor typically (i) buys into a fund's investments at cost plus some fixed rate of "catch-up interest", (ii) pays management fees back to the initial closing date, and (iii) bears its *pro rata* share of other fund expenses, along with interest. This mechanism is designed to put later investors on roughly equal footing with earlier investors. But the actual result can vary.

In some markets, a late commitment presents the opportunity to buy into an existing portfolio at a discount – either because the market has improved or because some value-add activity has already been completed. Under these conditions, a late investor can receive a significant boost out of the gate.

In other markets, investors may begin in a hole – because of accrued management fees and other expenses, because asset values have declined, or because asset values have simply failed to keep pace with "catch-up interest" and accrued expenses.

The calculation itself is simple:

Total Embedded Gain or Loss in a Fund[1]	=	Embedded Asset Gain / Embedded Asset Loss	*minus*	Catch-Up Interest to Earlier Investors Retroactive Management Fees Other Accrued Expenses (Including Interest)

Recent Developments

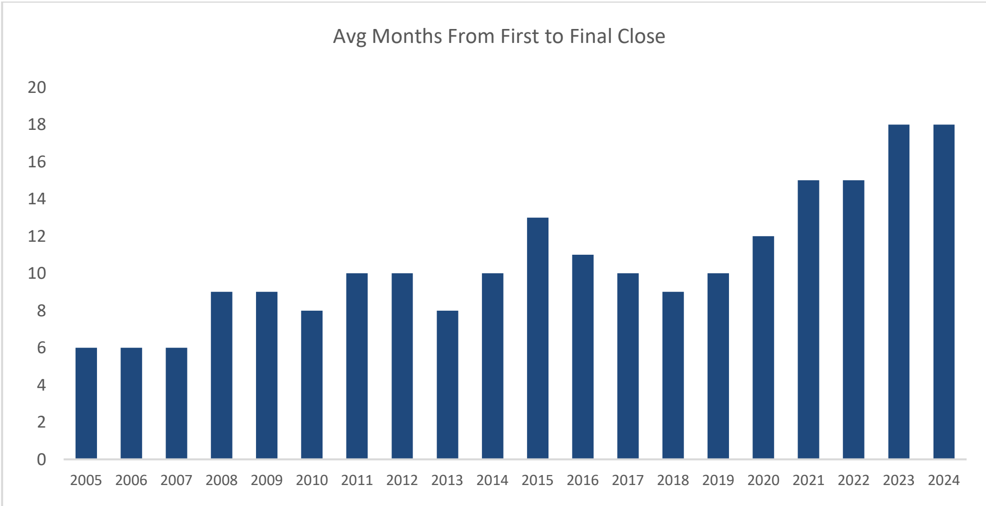
A few recent developments have combined to make late-close investing more challenging:

1. **Extended fundraising periods** have caused retroactive management fees to stack up.

   As shown in the accompanying graph, real estate funds that held a final close in 2024 took an average of 18 months to get from their first close to their final close. (This excludes the fundraising period that preceded the initial closing.) For a new investor entering a fund at its final close under those

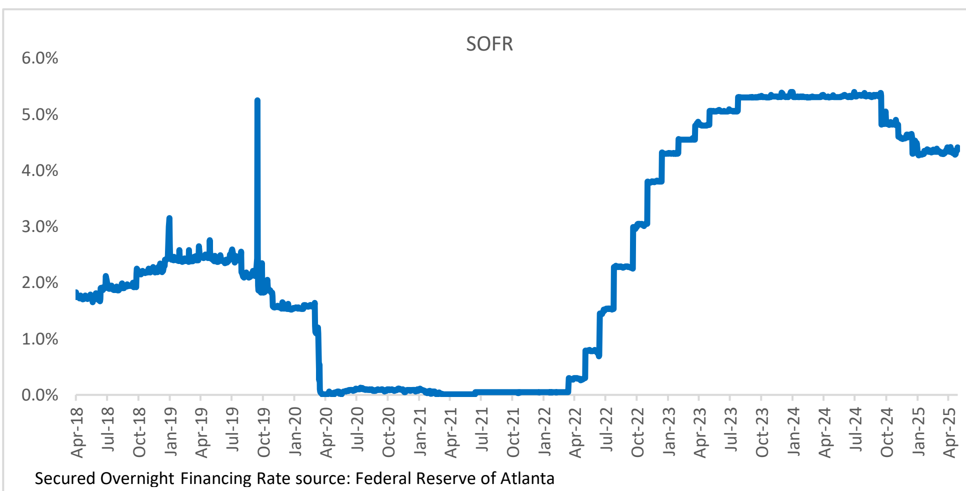
[1] Includes both gains and losses that have been recognized on a fund's books *and* an estimate of unrecognized gains and losses.

conditions, a $100 million commitment would be met with a retroactive management fee of $2.25 million (assuming that a typical 1.5% management fee is charged on committed capital, and assuming that the manager does not make an accommodation).



Source: Preqin. Bars represent the difference between the average month of final closing and the average month of initial closing. Data is filtered to include all real estate funds.

2. **Rising interest rates** have increased the cost of "subscription line" debt. Some managers use revolving subscription lines as equity placeholders, limiting the amount of equity that is actually called from earlier investors and, in turn, limiting the amount of "catch-up interest" that new investors have to pay to prior investors. With rising interest rates, subscription lines now have a real cost, which is borne by all investors regardless of when they close.



3. **Flat or declining asset values**, partially driven by higher interest rates, have eroded the embedded value (from both income and appreciation) that can sometimes be found in developing portfolios.

Result

Today, investors committing to a fund late in its fundraise may be starting in a significant hole. We have seen examples where a deficit is as high as 3% of an investor's total commitment *almost entirely because of fees and interest*.

Hypothetical Illustration		
Capital Commitment	$100	Initial $3 loss equals 3% of the total commitment.
Initial Drawdown[2]	$13	Initial $3 loss exceeds 20% of the initial drawdown.
Initial Net Asset Value	$10	
Initial Loss	$3	

Diluted across a full fund lifecycle, the impact is certainly not fatal – particularly for a good fund with the right strategy and a strong manager. But it is, in our opinion, an important factor that should be considered in today's environment when evaluating various investment options.

As markets shift, this dynamic will invert at some point, and greater focus will be placed on seeking opportunities to buy into funds that have built embedded value. And even today, determined investors can find embedded value in some cases.

[2] Includes the initial capital call and "catch-up interest" which is typically paid outside of the commitment.

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