

# **Waterfalls: Behind the smoke screen**

**Setting the right foundations - what is carried interest and why does it exist?**

**The distribution waterfall is one of the key components of the private markets model. But how do waterfall calculations work in practice and why is this crucial mechanism so important?**

In private markets investing, a distribution waterfall is a way to allocate the capital gained by the fund between the limited partners (“LPs”) and the carried interest partner (“CIP”) which is typically the general partner (“GP”), investment advisor or other parties deemed to be responsible for value creation. When distributing capital back to investors, hopefully with significant added value, this amount is allocated based on a waterfall structure previously agreed in the limited partnership agreement (“LPA”). The structure is designed to encourage key individuals who earn carried interest to maximise the performance of the fund.

There are typically four tiers in a distribution waterfall schedule: (i) return of capital; (ii) preferred return; (iii) the catch-up tranche; and (iv) carried interest.

Carried interest is extremely important to a fund manager and the calculation process needs to be efficient and accurate to ensure a smooth distribution. There are many parties involved so collaboration and organisation from the outset are essential.

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## **What we'll cover in this guide:**

- What is carried interest?
- Key definitions
- A typical cash flow movement
- Waterfalls in practice
- What could go wrong and how to keep things on track

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