

INVESTOR PERSPECTIVES / SEPTEMBER 2026

GP/LP Structures & Waterfalls 101

How control, capital, preferred returns and sponsor participation shape the investor's outcome.

AL T E R R A E Q U I T I E S

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08

THE INVESTMENT QUESTION

Who gets paid, in what order, and how much of the investment's profit does the investor actually keep?

For first-time private-market investors and the advisors reviewing their terms.

Executive perspective

A property can perform well while two investors receive different results. The ownership documents and distribution waterfall explain why.

The general partner or sponsor typically organizes and manages the investment. Limited partners provide capital and receive the economic and governance rights defined in the agreement. An LLC may use manager and member terminology instead. The legal form and actual documents control; labels in a presentation are only a starting point.

Term	Plain-language meaning
Capital commitment	The amount the investor agrees to contribute, potentially through future calls.
Preferred return	A contractual distribution priority, calculated under specified rules.
Promote / carried interest	The sponsor's negotiated participation in profits beyond its ordinary capital interest.
Waterfall	The sequence that allocates available cash among investors and the sponsor.
Catch-up	A tier that can accelerate sponsor distributions after an investor hurdle is met.
Clawback	A mechanism that may require repayment of excess prior sponsor distributions.

Read the economic promise precisely

An "8% preferred return" is not necessarily an 8% annual cash payment, an 8% IRR, or a guarantee. Accrual, compounding, payment priority, cash availability and remedies depend on the agreement.

ILPA's Principles emphasize alignment, governance and transparency in private-market partnerships. [1] These are useful diligence objectives; they do not replace negotiated terms or impose a universal market waterfall.

01 / Separate the three layers

First identify the property's capital stack. Next determine the entity's available cash. Then apply the investor waterfall. A waterfall does not create cash or override a lender's contractual rights.

Layer	What to understand
Property capital stack	Debt, any mezzanine or preferred capital, and common equity have different claims and remedies.
Cash available to distribute	Operating expenses, debt service, taxes, capital expenditure, reserves and fees can reduce available cash.
Investor waterfall	Capital return, preferred return, catch-up and residual splits allocate the remaining amount.

The sponsor may earn acquisition, asset-management, property-management, financing or disposition fees in addition to a promote. Ask which parties receive each fee, the base on which it is calculated, whether affiliated providers are used and whether offsets prevent duplication. A modest promote can coexist with substantial recurring fees.

Cash distributions and taxable allocations are separate. IRS partnership guidance distinguishes distributions, distributive income and basis adjustments. [2] The tax-distribution provision should be reviewed alongside the waterfall, particularly when taxable income is recognized without corresponding cash.

What the model should reveal

Ask for a complete schedule from property revenue to investor distributions. It should show contributions by date, every fee, debt and capital expenditure, the definition of unreturned capital, preferred-return accrual and the cash allocated at each tier. An IRR percentage without these inputs cannot be independently checked.

"LP" and "GP" are used as convenient economic labels throughout. This paper does not determine legal liability, tax status or the rights of a particular LLC member or limited partner.

02 / A waterfall without a catch-up

Assume the LP contributes \$1,000,000 at inception. Five years later, \$1,800,000 is available after all property debt, expenses, fees and reserves but before investor taxes. There are no interim distributions or additional calls. The example omits GP co-investment solely to isolate promote mechanics.

The agreement returns LP capital first, then pays an 8% simple annual preferred return on that unreturned capital, then splits remaining cash 80% to the LP and 20% to the GP. The preference is $\$1,000,000 \times 8\% \times 5 = \$400,000$. It does not compound.

Distribution tier	LP receives	GP receives	Cash left
Starting distributable cash	–	–	\$1,800,000
1. Return LP capital	\$1,000,000	\$0	\$800,000
2. Pay accrued preference	\$400,000	\$0	\$400,000
3. Split residual 80% / 20%	\$320,000	\$80,000	\$0
Total distributions	\$1,720,000	\$80,000	–

The investment has generated \$800,000 of profit after the costs already assumed in available cash. The GP receives \$80,000, or 10% of that profit. “20% promote” describes the residual split here; it does not mean 20% of all profit.

Investor result

The LP receives a 1.72× equity multiple. With one contribution today and one distribution exactly five years later, its annualized IRR is approximately 11.46%, before investor taxes. The calculation is $1.72^{1/5} - 1$.

Exhibit 1. Original hypothetical example, not Alterra fund terms, a target return or a forecast. The ordering is assumed for illustration; other agreements use different priorities.

03 / The same deal with a full catch-up

Keep all assumptions from the prior page, but insert a 100% GP catch-up after the \$400,000 LP preference. The GP receives cash until it has 20% of cumulative profit distributions to both parties. The required catch-up is $\$400,000 \times 20\% / 80\% = \$100,000$.

Distribution tier	LP receives	GP receives	Cash left
1. Return LP capital	\$1,000,000	\$0	\$800,000
2. Pay accrued preference	\$400,000	\$0	\$400,000
3. Pay full GP catch-up	\$0	\$100,000	\$300,000
4. Split residual 80% / 20%	\$240,000	\$60,000	\$0
Total distributions	\$1,640,000	\$160,000	–

The GP now receives \$160,000, or 20% of the \$800,000 profit. The LP receives \$1,640,000. The property outcome is unchanged; the contractual allocation changes.

Same \$1.8 million available cash	No catch-up	Full catch-up
LP equity multiple	1.72×	1.64×
LP five-year annualized IRR	11.46%	10.40%
GP promote	\$80,000	\$160,000

The catch-up reduces LP proceeds by \$80,000 in this example. It may be commercially acceptable, but it should be visible. Partial catch-ups, multiple hurdles, different compounding conventions and GP co-investment change the calculation.

Exhibit 2. The 1.80× pre-promote equity multiple corresponds to approximately 12.47% annualized over five years. It is already after the costs assumed in available cash; it is not an unlevered property return. Investor-level taxes are excluded throughout.

04 / What happens when performance disappoints?

A priority is useful only to the extent cash exists. Under the same simplified five-year waterfall, \$1,200,000 of available cash pays the \$1,000,000 capital return and only \$200,000 of the \$400,000 preference. The sponsor receives no promote. At \$800,000 of available cash, the LP loses \$200,000 of its contributed capital.

Cash available at year five	LP receives	GP promote	LP annualized IRR
\$800,000	\$800,000	\$0	-4.36%
\$1,200,000	\$1,200,000	\$0	3.71%
\$1,800,000; no catch-up	\$1,720,000	\$80,000	11.46%
\$1,800,000; full catch-up	\$1,640,000	\$160,000	10.40%

The unpaid preference does not create money, and the agreement determines whether it carries forward, compounds, expires or gives rise to a remedy. Do not assume that an unpaid equity preference is equivalent to a missed contractual debt payment.

Cash timing also matters. Returning capital early can reduce the balance on which a preference accrues; refinancing distributions may affect future hurdles. An IRR hurdle depends on dated cash flows and is not interchangeable with a simple percentage accrued on capital.

Model the difficult cases

Require examples for a partial capital loss, a delayed exit, an unexpected capital call and an early refinance. Check that the agreement's calculation and the marketing model produce the same result.

Exhibit 3. Original scenarios; all cash arrives at the end of year five. With no GP capital in this teaching example, the GP receives only the promote shown. Actual GP co-investment must be modeled as a separate capital interest.

05 / Governance completes the economics

A waterfall is one part of alignment. The ability to obtain information, manage conflicts and enforce rights can matter as much as the stated profit split. ILPA's framework provides a useful lens for examining these issues. [1]

Term to review	Question for the sponsor and counsel
GP commitment	How much actual cash is at risk, who contributes it and is any portion funded through fee waivers or borrowing?
Whole-fund versus deal-by-deal promote	Can the sponsor receive carry on an early winner before later losses are known?
Clawback and escrow	Who owes repayment, what limits apply and what resources support collection?
Key person and removal	What happens if essential people leave or defined misconduct occurs?
Conflicts and related parties	Who approves affiliated contracts, asset transfers, valuations and changes to strategy?
Capital calls and defaults	What are the notice period, remedies, dilution terms and commitment limits?
Reporting and calculations	Who verifies fees, valuations and waterfall calculations, and what can investors inspect?

Have counsel compare the term sheet, subscription package and governing agreement. Ask the administrator for a worked example under the signed language. Marketing shorthand such as "8% pref, 80/20 split" leaves too many material questions unanswered.

Alterra perspective

An understandable structure gives investors a clear view of both upside sharing and downside exposure. Sponsor compensation is easier to evaluate when every fee, capital interest and distribution tier can be traced to the governing documents.

Sources, methodology & important information

Methodology: all waterfall numbers are original hypothetical calculations. One LP contributes \$1 million at inception; all distributions occur exactly five years later. GP capital, interim cash flows, additional calls and investor taxes are excluded. Available cash is assumed net of property debt, expenses, fees and reserves. The 8% preference is simple, not compound; cash priorities are explicitly assumed. Actual legal terms govern.

Primary sources

[1] ILPA: Principles and best practices

Principles 3.0 overview: alignment of interests, governance and transparency. Guidance, not binding law or universal terms.

[2] IRS Publication 541 (12/2025): Partnerships

Distributive shares, distributions and partnership basis are distinct tax concepts.

Use of this paper

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Sources accessed September 11, 2026. Data cutoffs and dated rules are identified where used. Verify later changes and the investor-specific position before a transaction. Analytical frameworks and uncited worked examples are Alterra's original educational analysis; source organizations do not endorse this paper.

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