
ILLIQUID MARKETS / PARTNERSHIP PHYSICS

Private Equity: *Waterfalls* and Power

Carry aligns incentives until exits arrive out of order; waterfalls decide who eats first when the story gets noisy.

SYSTEM ARCHETYPE 049

Private Equity / *GP-LP* /

Private equity structures encode economics between general and limited partners: fees for operating the franchise, carry for skewed upside, and covenants that govern pacing and replacements. Pair with

Pareto reality in return concentration, path dependence across vintages, inversion on clawback, and modularity so one GP bet cannot cascade household liquidity.

"Private equity is governance and waterfalls wearing a spreadsheet tuxedo."

1. GP-LP *Interface*

Secondaries price stale interests; discounts can be opportunity or diagnosis—know which story you are buying. The adult version of illiquidity is to document assumptions about two weak exits back-to-back and whether your household still honors the next call. Complexity without edge is an invoice. Pair modular systems so one GP failure cannot cascade household cash.

Clawback provisions matter when early exits looked brilliant until later write-downs reveal the waterfall was front-loaded optimism. If co-invest menus appear, interrogate fee offsets, broken deal expenses, and transaction fee

recycling that change net IRR math. Illiquidity is a feature with a maintenance bill. Budget entropy for K-1 season, amendments, and GP-led processes.

Vintage diversification is how families avoid betting one macro window disguised as five brand-name funds. Stress the commitment by assuming whether to sell secondaries, negotiate a strip sale, or hold through the awkward middle. LP stands for limited power—govern accordingly. Pair modular systems so one GP failure cannot cascade household cash.

Fund life extensions and continuation vehicles are forks in the road: liquidity versus more innings—read fees twice. Second-order planners ask how capital calls interact with information rights, most-favored-nation clauses, and side letter economics that differ from the off-the-shelf LPA. When doubt appears, shrink commitment size before optimism. Draw boundaries between personal balance sheet and LP capital calls.

The GP-LP interface is a contract over information, pacing, and replacement rights—not a friendship bracelet issued at the closing dinner. When distributions stall, the policy should specify target pacing, recycling provisions, and default remedies on missed calls. If two partners cannot explain the waterfall, do not sign. Run inversion on carry math: three ways waterfalls hide fee stacking.

Covenant-lite lending inside portfolio companies changes recovery shapes; LP memos sometimes bury it in adjectives. Quarterly reviews should reconcile public market correlation, credit lines used to fund calls, and spouse tolerance for illiquidity theater. Boring side letters beat brilliant handshake myths. Pair modular systems so one GP failure cannot cascade household cash.

2. Fees *and Carry*

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Private equity structures translate operating companies into fund economics: management fees for the machine, carry for the upside skew, and waterfalls that decide who eats first when exits arrive. Before subscribing, verify whether public market correlation, credit lines used to fund calls, and spouse tolerance for illiquidity theater. Carry aligns until clawback knocks. Draw boundaries between personal balance sheet and LP capital calls.

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Clawback provisions matter when early exits looked brilliant until later write-downs reveal the waterfall was front-loaded optimism. If co-invest menus appear, interrogate K-1 geography, state nexus surprises, and unrelated business taxable income footnotes. Illiquidity is a feature with a maintenance bill. Draw boundaries between personal balance sheet and LP capital calls.

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3. Waterfalls *and Clawback*

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4. Fund *Life and Extensions*

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6. Secondaries *and Pricing*

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7. Portfolio *Company Risk*

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LP SUBSCRIPTION GRID

01

Waterfall summary

Fees, carry, clawback—in plain numbers.

02

Pacing and calls

Line of credit policy; maximum annual call.

03

Diversification

Vintage, sector, GP count—minimums written.

04

Exit and secondary plan

Who approves sales; discount tolerance.

8. Atlas *Integration*

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