Hurdle Rate Unit Trust

**Last Updated – 1 November 2023*

Dear Unitholders,

This is the master document for the Hurdle Rate Unit Trust, a working document that is updated monthly inclusive of all monthly letters and a thesis tracker. The rationale for this document is to provide a written account of the journey of the Hurdle Rate Unit Trust, from Inception in May 2023.

Prior to the inception of the Hurdle Rate Unit Trust, I studied accounting and financial planning for 4 years before moving on to working in accounting and financial advice for 6 years whilst honing my investment skills for the same period. Within the Hurdle Rate Unit Trust, I intend to take the skills I have culminated through my studies and career and utilise them to great effect by identifying mispriced investment opportunities in professional and financial services globally.

Tristan's Track Record (Gross Returns)

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2017								(0.25%)	(2.22%)	2.24%	(2.16%)	5.82%	**3.24%**
2018	(0.85%)	(3.97%)	(4.12%)	1.81%	(8.40%)	(5.88%)	0.98%	1.61%	(0.72%)	(4.37%)	(3.94%)	(5.87%)	**(29.42%)**
2019	6.89%	4.99%	(3.20%)	1.33%	(1.97%)	4.86%	5.52%	(6.54%)	5.54%	8.98%	(0.44%)	2.69%	**31.22%**
2020	5.10%	(7.32%)	(18.89%)	9.48%	3.22%	(6.81%)	(6.51%)	19.21%	5.28%	14.27%	0.61%	18.58%	**33.09%**
2021	1.71%	3.77%	(3.03%)	21.80%	(5.57%)	17.55%	9.93%	(6.84%)	(7.37%)	3.51%	(0.93%)	8.25%	**45.71%**
2022	8.34%	3.61%	1.29%	(0.38%)	(11.90%)	(7.20%)	17.24%	0.35%	(2.54%)	1.12%	(1.73%)	0.23%	**5.76%**
2023	(3.49%)	(0.07%)	1.87%	(0.32%)	(1.48%)	3.61%	2.74%	1.73%	3.23%	(3.58%)			**3.99%**
												Total	**103.94%**
												CAGR	**12.08%**

Hurdle Rate Unit Trust (Net Returns)

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2023					(1.48%)	3.20%	2.07%	1.38%	2.45%	(3.66%)			**3.84%**

Key Facts:

Trustee	Hurdle Rate Pty Ltd
Domestic Broker	Selfwealth
International Broker	Interactive Brokers
Inception Date	11 May 2023
Net Asset Value	$314,549
Unitholders	12
Management Fee	NIL
Performance Fee	25% over 6% hurdle
High Water Mark	Yes
Application/Redemptions	Monthly
Buy/Sell Spread	0.25% / 0.50%
Distribution Frequency	Annually

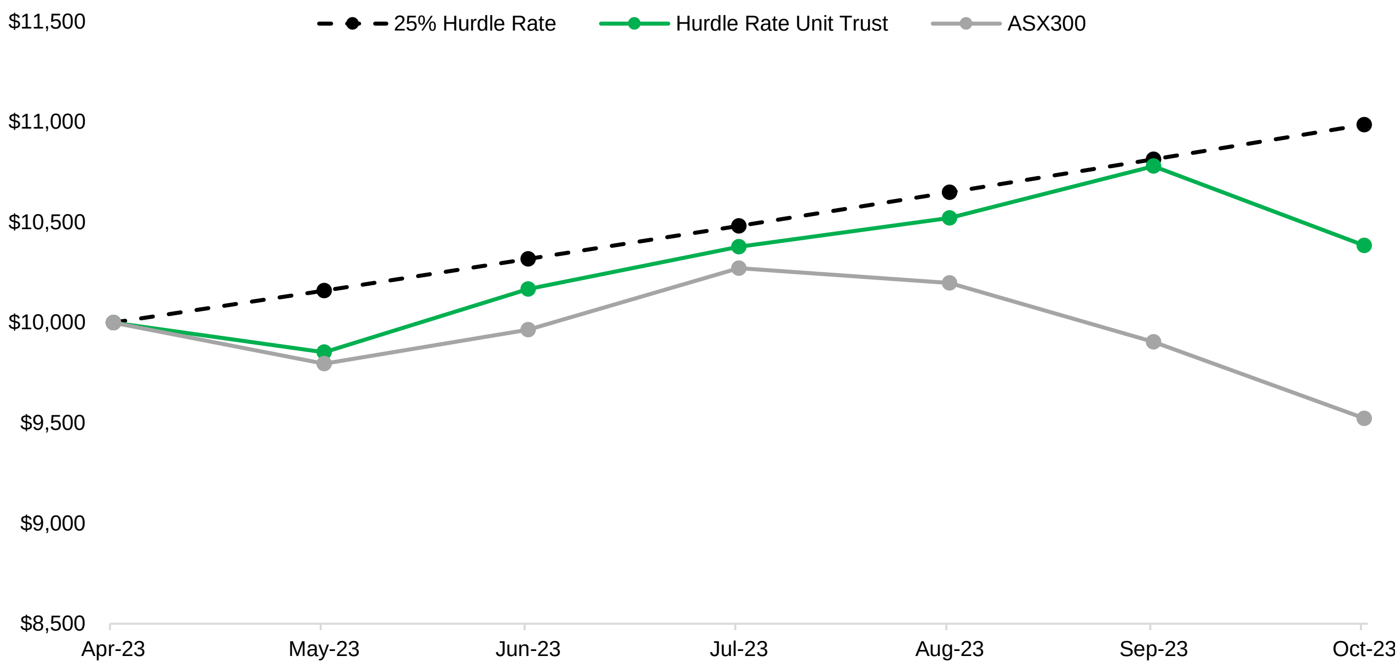
Unit Prices:

Entry Price	$0.9598
Unit Price	$0.9574
Exit Price	$0.9526

Performance:

Period	HRUT (Net of Fees)	ASX300
1 Month	(3.66%)	(3.87%)
1 Year	-	-
3 Years p.a.	-	-
5 Years p.a.	-	-
10 Years p.a.	-	-
Since Inception	**3.84%**	(4.79%)

Performance of $10,000 Invested at Inception (Net of fees)



Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

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Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

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October 2023 - Letter

Dear Unitholders,

This month the Hurdle Rate Unit Trust generated a **Gross return to unitholders of (3.58%)** Including performance fees, the **Net return to unitholders was (3.66%).** The unit price as at month end is **$0.9574**. The full history of performance data can be found on the first page of this document.

The end of October 2023 marks 6 months since the inception of the Hurdle Rate Unit Trust, and I am happy with the progress made so far. Of course, 6 months is not a long-time span, as I expect our average holding period to be between 3 and 5 years, but it is good to see a trend in the right direction. For comparison's sake, I have added in a chart along with the ASX300 (XKO) market index, which given that this is an Australian domiciled trust with solely Australian unitholders, is the index I thought would be the most relatable for the average unitholder. The intention remains to strive for a 25% hurdle rate, and our fee structure is still based on the 0/6/25 performance fee structure utilised by the Buffett Partnership.

This month, I want to talk all about portfolio management which I hope will work for me. To kick things off, I would like to set the scene with a discussion on diversification.

Diversification

One thing which has become apparent since beginning the trust is that the time, I have on hand is much greater than I have ever had since starting investing. When I started this trust, I thought managing 6-8 names felt right, but I was overlaying my prior experience of working in a full-time role and underestimated just how much time was freed up when leaving employment. As a result, the pace at which I am researching ideas has multiplied, and I have begun to think that I can use this to my advantage by keeping hurdle rates static and narrowing the range of outcomes around this hurdle rate by investing in more positions.

The common criticism to this is that each idea is incrementally worse, but I have the dilemma of putting 'too much' time into just 6-8 ideas would be counterintuitive and worsen returns, rather than improve them, due to entrenchment and commitment bias. Sure, you can just put this extra time into researching more things which do not make it into your portfolio, but I think moving up the count of both total researched ideas and invested ideas is a good move given my duty of care to Hurdle Rate Unitholders. Especially given that as of October 2023 some 2/3 of the NAV is external capital. Here is Magellan fund manager, Peter Lynch to explain through an excerpt from his book "One Up on Wall Street":

> *In my view it's best to own as many stocks as there are situations in which: (a) you've got an edge; and (b) you've uncovered an exciting prospect that passes all the tests of research. Maybe that's a single stock, or maybe it's a dozen stocks. Maybe you've decided to specialize in turnarounds or asset plays and you buy several of those; or perhaps you happen to know something special about a single turnaround or a single asset play. There's no use diversifying into unknown companies just for the sake of diversity. A foolish diversity is the hobgoblin of small investors. That said, it isn't safe to own just one stock, because in spite of your best efforts, the one you choose might be the victim of unforeseen circumstances. There are several possible benefits:*
>
> *(1) If you are looking for ten baggers, the more stocks you own the more likely that one of them will become a ten bagger. Among several fast growers that exhibit promising characteristics, the one that actually goes the furthest may be a surprise.*
>
> *(2) The more stocks you own, the more flexibility you have to rotate funds between them. This is an important part of my strategy.*
>
> *Some people ascribe my success to my having specialized in growth stocks. But that's only partly accurate. I never put more than 30–40 percent of my fund's assets into growth stocks. The rest I spread out among the other categories described in this book. Normally I keep about 10–20 percent or so in the stalwarts, another 10–20 percent or so in the cyclicals, and the rest in the turnarounds. Although I own 1,400 stocks in all, half of my fund's assets are invested in 100 stocks, and two thirds in 200 stocks. One percent of the money is spread out among 500 secondary opportunities I'm monitoring periodically, with the possibility of tuning in later. I'm constantly looking for values in all areas, and if I find more opportunities in turnarounds than in fast-growth companies, then I'll end up owning a higher percentage of turnarounds. If something happens to one of the secondaries to bolster my confidence, then I'll promote it to a primary selection.*

Having read this commentary, here is a few takeaways for me. I should invest in as many ideas as possible provided they pass the stringent rules I have set (including exceeding a 25% compound return hurdle rate). Diversification needs to be done based on consistent quality of ideas, if done so you can perhaps approach the returns of something like the Magellan fund as shown below. It is compared to Berkshire Hathaway on the right, rather, [this study](#) does a good job analysing both records. The article concludes due to Lynches' lack of leverage, open ended structure, and more exposure to bear markets that "It is highly unlikely that the performance records of both investors were due to luck. That said, the probability that Lynch's results were due to luck is far, far smaller than the probability that Buffett's results were due to luck."

5/1977-5/1990	Average Return	Volatility	Sharpe Ratio	Annual Outperformance	Information Ratio
Magellan	20.8%	21.2%	0.98	13.7%	1.78
U.S. Equities	7.1%	16.4%	0.43	-	-

1/1977-5/2016[6]	Average Return	Volatility	Sharpe Ratio	Annual Outperformance	Information Ratio
Berkshire Hathaway	17.6%	23.6%	0.74	10.6%	0.49
U.S. Equities[7]	6.9%	15.5%	0.45	-	-

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

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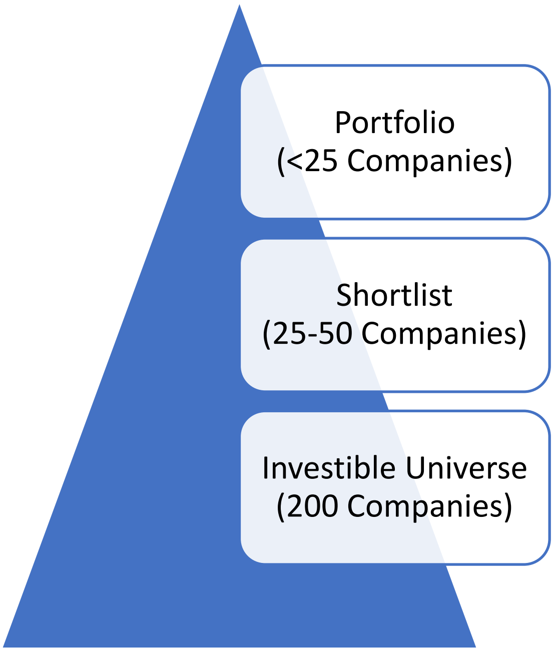
Managing my Investible Universe

As you would expect from the outset of the trust, I have broadly an investible universe of professional and financial services companies worldwide. I have been finding this overwhelming of late to manage the multiple competing ideas, so I have developed a funnel approach as shown, not including my regular activities of monitoring for special situations outside of this investible universe.



Starting from the bottom, the investible universe has been capped at 200 companies at a time. These companies I will monitor passively through receiving announcements via. email, and monitoring multiples using Koyfin. This will allow me to keep abreast of any interesting developments which might warrant elevating this to my shortlist.

The shortlist is the up to 25 companies not in my portfolio that I am most interested in right now. This list is both a research list, and a list of competing ideas where I can look for replacements for things within the portfolio. In addition to monitoring announcements, I am also considering talking to management, attending calls, maintaining more in-depth modelling and research amongst other things.

The portfolio is as you know it, ideas which have met our hurdle rate and other investment standards. I have capped this at 25 names and should there not be enough names in the shortlist to populate this up to 25 companies, I am perfectly fine shrinking the number of companies down to exclusively those where the hurdles are maintained (at purchase). When a portfolio company falls below an expected return of 15%, I look for a replacement in the shortlist or would consider shrinking the number of companies in the portfolio by consolidating the existing portfolio.

Position Sizing

As everyone would know, I am quite transparent about what investments have been made within the trust, however, I think something that I like to keep behind closed doors is the portfolio management side of things. There are many approaches to this, and for quite a long time my own approach to be relatively equally weighted at the 'cost base' level and to let investments run their course. With the addition of external capital, I have taken it upon myself to take this much more seriously, and there is a developing approach to position sizing in my mind which I wanted to briefly discuss.

A hard rule in the Hurdle Rate Unit Trust is that an idea needs to make sense with a 25% discount rate before being worthy of consideration. Beyond that, ideas are largely weighted on perceived reward. I run each idea through a simple valuation process, assuming a 5-year holding period, and look to weight ideas on a % of the Upside SUM. To explain, I can illustrate below what this may look like.

	Current Price	Fair Value	Upside	Proposed weight
Stock 1	1.00	3.00	200%	20.73%
Stock 2	1.00	2.70	170%	17.62%
Stock 3	1.00	2.40	140%	14.51%
Stock 4	1.00	2.20	120%	12.44%
Stock 5	1.00	2.10	110%	11.40%
Stock 6	1.00	2.00	100%	10.36%
Stock 7	1.00	1.75	75%	7.77%
Stock 8	1.00	1.50	50%	5.18%
SUM			**965%**	**100%**

Risk is something I control to the best of my ability, and in some cases I have taken the action to weight things greater than they would otherwise be because of the existence of a highly confident outcome (and vice versa). Thus, variations between my actual weighting and proposed weighting go through a screening process of justification whether the weighting is appropriate or not. My exact weightings right now for example, are largely in line with proposed weighting, although there are a few ideas which have been overridden due to specific reasons, and I did make some changes this month informed by the above rationale.

Importantly, this isn't something I rebalance all the time, I just look at it once a month and see whether anything has changed significantly, if any ideas need to be revalued, if any positions should be added to or trimmed etc. I try to consider all information at my disposal. My larger investible universe is also being gradually researched and valued so I have a shortlist of ideas which are ranked and stacked against my existing holdings should I want to replace anything.

Importantly, most special situations are invested into using 100% debt, so they have no impact on the weighting of the equity and are merely intended to be a boost to returns when they arise. Often these are only held for a few days, purely to take advantage of quick profits such as merger arbitrage, odd-lots, warrants exchanges and so on and so forth. Longer term special situations which would require equity are stacked up against other holdings as according to the process above.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

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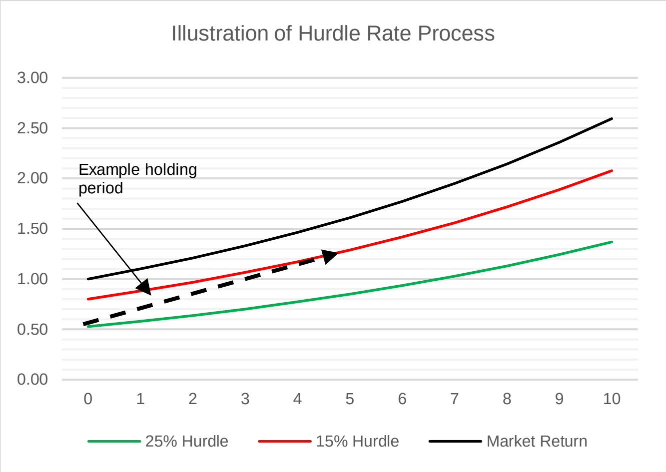
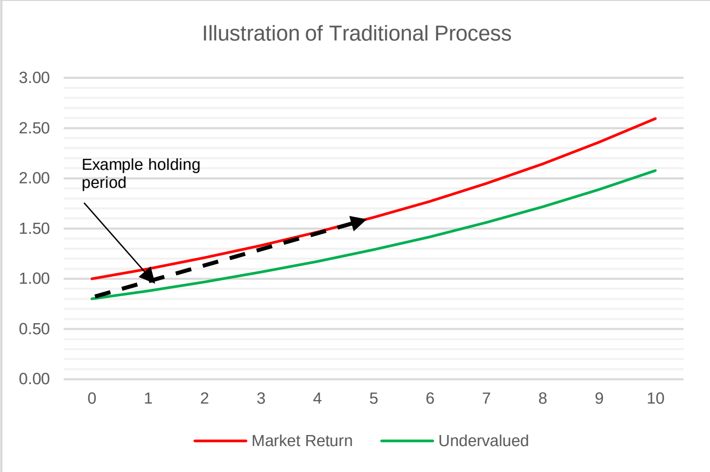
Value Trading

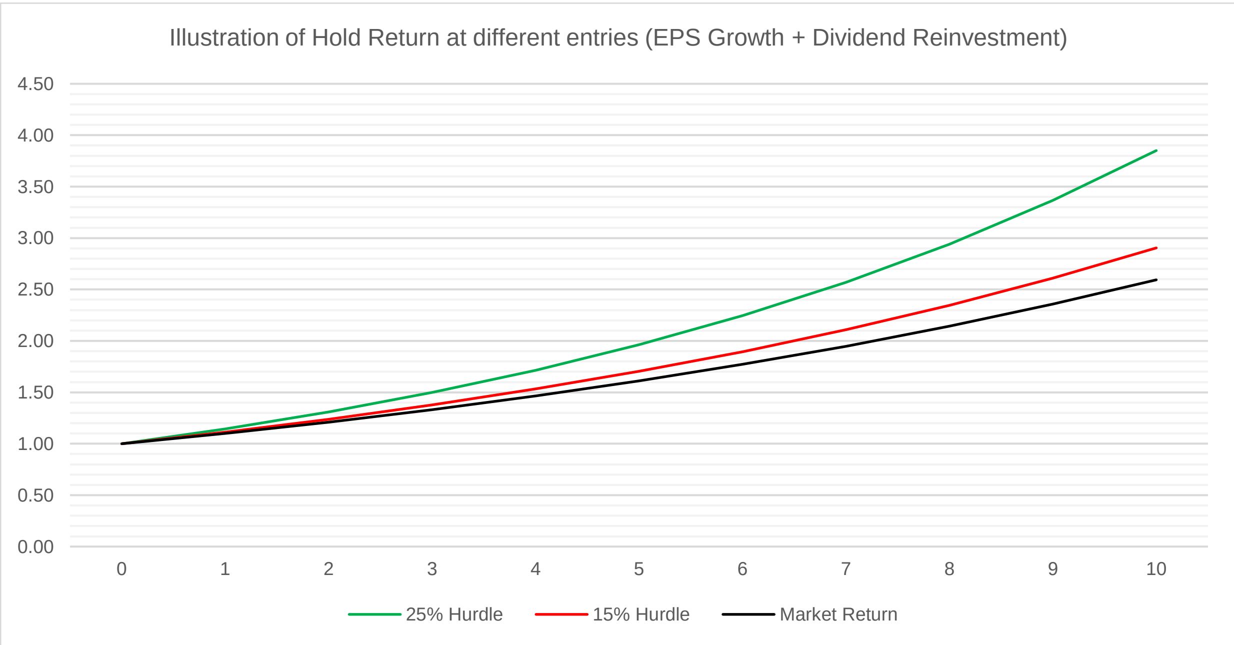
It is unlikely that a business can generate a 25% hurdle without some excitement from the market in the form of multiple expansion. And to maintain high discipline in this area, I haven't talked about this but there is a hurdle to sell as well of 15%. In the event I think potential returns decline below 15% I would be inclined to sell to cash and reallocate into the existing portfolio or new ideas. To illustrate this, I have shown traditional value investment vs the Hurdle Rate approach below.





Hurdle Rate = Purchase a Y+5 $1.50 at $0.50 and get a 3x over the subsequent 5 years if it re-rates to market return (25% CAGR)
Traditional = Purchase a Y+5 $1.50 at $0.75 and get a 2x over the subsequent 5 years if it re-rates to market return (15% CAGR)

So, after looking at these charts, you might be wondering, what exactly is the difference here? Well, first by buying at a deeper margin of safety than other investors, I believe, that the possibility of losing money is drastically decreased, but perhaps the main factor is that we get both a higher free cash flow yield if any. To illustrate this further, we can plot the growth of $1 on various scenarios assuming you purchase a business generating a 10% ROIC and paying out 50% of earnings. The holding return (EPS Growth + Dividend Reinvestment) situations for a 10%, 15% and 25% return look like the following if the gap could close from Hurdle to Market return within a 5-year period.



The difference here is that the black line is reinvesting dividends at 10x earnings, the red is reinvesting at 8x earnings, and the green is reinvesting just above 5x earnings. In these 3 cases the EPS growth is the same, but the dividend yield is 5%, 6.2% and 9.5% respectively. Furthermore, the 5-year multiple expansion CAGR is 0%, 4.8% and 11.5% as well, bridging the gap between the hurdle rates and the hold return.

Herein lies the beauty of the approach. In my hypothesis, both hit rate and slugging percentage are increased by sliding the hurdle rate up, and ideally there is a demonstrable outcome from this approach in the years to come for unitholders.

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Phone: +61 426 026 928

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%

Kelly Partners Group Holdings (ASX:KPG)

An update for the group's strategic review was provided this month. The review continues to assess what combination of strategy, capital structure and governance will maximise long-term shareholder value, with the assistance of financial, legal and tax advisors. As part of this process, the group has established an independent board committee consisting of Stephen Rouvray, Lawrence Cunningham, and Ryan Macnamee to provide oversight of the review. Some general observations were relayed to shareholders, although have been repeated many times before, therefore the announcements felt unnecessary. Perhaps of the most interest was the discussion about the US market and the possibility of a dual listing with the primary shares in the US and use of CHESS depository interests (CDI) on the ASX. Nevertheless, the group has yet to decide. I trimmed our holding quite a bit to reallocate into new and existing holdings in both the previous and current month, but still hold a position in the company.

Diverger (ASX:DVR)

Late in the month Diverger received a counter-offer from COG Financial Services (ASX:COG) for $1.4083 per share (Half cash, half scrip), a business which I have written about before. Oddly enough the group determined this not to be a 'superior' proposal which is frankly ridiculous. The Diverger board is determined on embedding the Count synergies in their recommendation, which to us as shareholders is irrelevant as we would consider each on their own individual merits. The synergies of the acquiring business are irrelevant as there is no guarantee that those synergies can arise, and that COG cannot get synergies of their own for example.

Considering the weakness in support by the board, I took the opportunity in the strong trading on the day to sell our holding off at what was a strong premium to the Count offer, but reasonable discount to the COG offer. **We realised a profit of $20,867 and annualised IRR of +145% ,which contributed +8.6% to the trust' overall return since inception**. I am still actively monitoring the situation; however, I saw it prudent in this case to take my chips off the table as there is the juxtaposition of a board recommending a lower bid, despite an obvious counterbid. If both deals end up failing, then we could see quite a re-trace to where it was prior to any deals. We will be ready should that event occur.

I know it is common to avoid capital gains tax, and in this case, we have recognised a significant capital gain, which is eligible for no concessional treatment. However, if I may clarify, my intent as trustee is to maximise after-tax returns rather than minimising tax. Securing a profit comes far ahead of holding out for the sake of a tax concession. As a reminder, unitholders can withdraw at any stage any amount of their invested capital to pay their taxes or opt to receive distributions in cash rather than reinvesting. I hope that tax planning becomes a constant issue due to excessive profits coming from the Hurdle Rate Unit Trust!

Sequoia Financial Group (ASX:SEQ)

During the month I had the pleasure of attending the Coffee Microcaps Conference, where I was kindly invited to as a VIP to attend to by the founder Mark Tobin. It was a very interesting day and fortunately I had the opportunity to meet and chat with the Sequoia CEO Garry Crole. I had spoken over zoom with Garry before but in the flesh, I was convinced of Garry's genuine demeanour. In this event he presented these slides in which there is a number of interesting points made, many of which were simply reiterating what was said in the 2023 results.

Financially, the group reiterated their 'return on management equity' (ROME) implied valuation approach, but also had some additional colour as to their capital allocation approach. Namely, the following caught my eye:

- Maintain dividend at 90-100% of operating profit after tax whilst maintaining a target cash balance of $20m+.
- Utilise cash on balance sheet to acquire strategic EBITDA on 4-5 multiples of acquisition.
- Buy back when EV is below multiple of 4 that we can acquire growth at.
- Increase normalised dividends by 25% p.a. from 4c in FY 2023.

This is curious as it is implying that Garry can double the earnings of the group with ~$15-20m of capital over 3 years (depending on if dividend is 90% or 100%) given that they currently have $35m.

Orchard Funding Group (LSE:ORCH)

During the month, a new purchase into Orchard Funding was funded with the dividends received during the month. More detail into our rationale for this purchase is detailed here. In essence, Orchard Funding is a lending business which allows for clients to transition their lump-sum insurance premiums, professional services fees, or membership fees into instalment plans. It is a founder-led business trading as a deep net-net and high earnings yield, a good portion of which is paid out to shareholders, yielding high single digits. It is, however, a small business which requires securing larges amount of external funding to trade and operates in what is effectively a duopoly between 2 players larger than themselves.

Financial targets are a staple for the Hurdle Rate Unit Trust, and in this case, it is no different. Targets are set as a 45% payout ratio and 9% ROE. At a valuation of <5x earnings, this would equate to a 10% dividend yield and 5% EPS growth, meeting our hurdle for hold return. It is not farfetched to expect this to trade for 0.9x-1.0x book value at some stage in the short-medium term future. At 0.47x book value this would yield a double from the multiple, which when applied over our targeted 3–5-year average holding period would contribute an additional 15-24% compounded return to the investment. I would like to thank the unitholder which shared this with me.

Fiducian Group (ASX:FID)

Another purchase of Fiducian Group was also made. The full page write up can be read here. This increases our exposure to financial markets significantly, with over 90% of Fiducian's profits coming from variable % of FUMAA based revenue on a fixed cost base. The rationale behind the purchase is that the Australian stock market is reasonably priced generally and investors should generally feel positive about their long-term returns buying the broader market today. Of course, that general view is the extent of the macro for me, but Fiducian has been priced for a bear market in my view, more specifically for a flat market, with net inflows which might just offset cost inflation and no market contribution. We are not paying for FUMAA increase in the form of market performance so I feel relatively confident taking a contrarian view that history will rhyme and Fiducian will continue to perform largely in line with what it has done previously, which when combined with a low valuation generates a return suitable for the Hurdle Rate Unit Trust. Lastly, I was fortunate enough to also listen to Rahul (Subsidiary CEO) at the Coffee Microcaps conference as well, and was impressed with his presentation and professionalism.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

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Sky Network Television (ASX:SKT)

As discussed in this write up, Sky is a short-medium term special situation which I anticipate to have a strong bid premium to it's current price, supported by a strong absolute and relative valuation in the form of a high double digit free cash flow yield and the recent offer for Southern Cross Media (ASX:SXL). I will be waiting for the result of the NBIO process with keen eyes, and without an outcome I would be comfortable to remain a shareholder with strong absolute value. I believe these are strong traits of an appealing 'merger arbitrage' type situation. That is, situations in which you would be comfortable buying the business at the market price without the existence of an offer. As discussed in that write up, this is backed by my own personal line of credit, on-lent to the trust, and is therefore not using trust equity.

Bravura Solutions (ASX:BVS)

As discussed in the write up, Bravura is an Australian software business going through a turnaround process. It has a significant cost base which if alleviated could lead to a mid-teens margin, which given the current valuation, could lead to a very cheap stock this time in 3 years' time. Tomorrow they are releasing a plan at their AGM on their 3-year initiatives which I am keenly interested in.

Peoplein (ASX:PPE)

Peoplein is a heavily sold-off recruitment business where I think that the fears are largely unwarranted relative to the price decline. On FY23 numbers it is equivalent to an EV/EBITA of ~3x which quite frankly, even if they lose much of their earnings still appears attractive. However, I sized this accordingly as I have reservations about my conviction.

Concluding Thoughts

We saw negative performance this month despite the wildly successful Diverger deal, largely due to what I believe is widespread panic (especially in smaller companies), but we still beat the overall ASX300. I know what we own and am excited to take advantage of compelling opportunities as they come up. Diversification will smooth out our results and allow for the benefit of asymmetry. On the contrary, I am prepared to concentrate heavily where it counts.

Some key events for November which unitholders may find of interest are.

- Bravura AGM on the 2nd (Includes 3 Year plan)
- Kelly Partners AGM on the 10th (Possible update on strategic review)
- AF Legal AGM on the 14th (Includes Q1 Results)
- Diverger AGM on the 20th
- Sequoia AGM on the 23rd (Includes results through to October 2023)
- Finexia AGM on the 24th
- Peoplein AGM on the 27th
- Prime AGM on the 30th
- Dow Schofield Watts Half year results.
- Possible outcome of the NBIO due diligence for Sky Network Television
- Possible Orchard Funding Group full year financial results.

As a reminder to all unitholders, please feel free at any time to deposit or withdraw funds. I am also open to negotiating savings plans for a recurring deposit if it suits you better. Additionally, we still have 7 free positions for new unitholders so if anyone is (or you know someone who is) an Australian tax resident and interested in the prospect of investing into the Hurdle Rate Unit Trust, please contact me using my details below.

Yours sincerely,

Tristan Waine

Sole Director of the Trustee of the Hurdle Rate Unit Trust

Phone – +61 426 928 026

Email – Tristan.waine@outlook.com

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October 2023 - Orchard Funding Group (LSE:ORCH)

Orchard is a finance group specialising in insurance premium and professional fee funding in the UK. The listed group was formed in 2015 but it's trading activities date back to 2002. The group has 2 subsidiaries, one being 'Bexhill', an insurance premium funding business which services over 100 brokers across the UK, and the other being 'Orchard', established in 2010 providing fee funding to accounting and law firms amongst others. CEO Rabinder (Ravi) Singh Takhar has been with the business since Bexhill started trading in 2002 and owns more than half of the listed company.

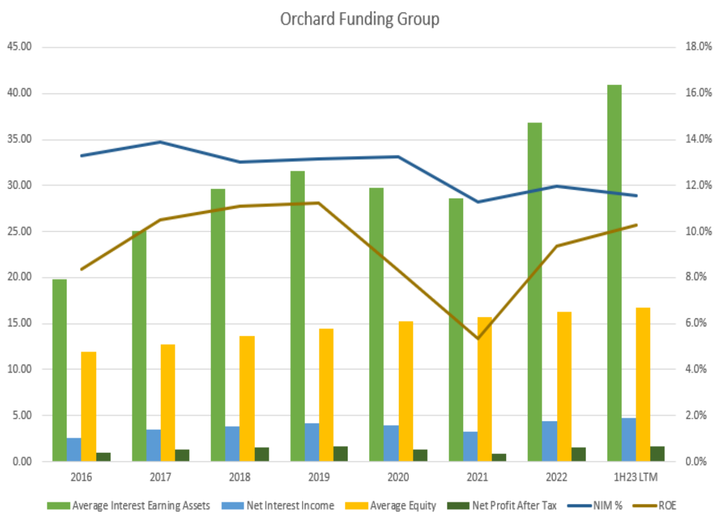
Whilst this video is a few years old now (early 2020), it provides an excellent overview of the business and its future, most of which remains the same despite the introduction of caravan hire purchase lending. Over the years since this video, the group has grown its average loan book from ~£30m in 2020 to ~£46m in half year 2023. This has led to an increased profit, but with the cost of funding increasing significantly, profit has not risen as fast as this loan book as the group has not passed on increases in their funding costs, despite the 12-month tenure of most of their loans allowing for consistent revision of their pricing. This skew to the customer in my view, has allowed them to grow their loan book to where it is today. Nevertheless, I have done my research and find the business to be very conservative in general, with diligent and thoughtful involvement into niche areas of lending.

More specifically, the business model involves providing credit in respect of insurance premiums and professional services fees which allows the customers of these firms to extend their repayment up to one year. More recently, they have extended to providing longer term hire purchase loans (up to seven years) and gap insurance (up to three years). They refer to this business model as a 'hold and collect' model in which financial assets are held to maturity to collect principal and interest, it is a very traditional business model which is widely used. Sales volume is highly dependent on the ability to secure new partners, and to increase business with existing partners, whereas pricing relies on a mix of the cost of funding, the competitive market, and the perceived risk that the borrower is unable to pay. Longer term loans utilise open banking to view banking activity and more accurately assess risk. Orchard's board looks to target more than a 10% net interest margin in any given year. The group's non-interest-bearing costs rank in order from Employment costs, bank fees, advertising, and compliance costs.

Speaking to the risks, the group as explained specialises in insurance premium funding, which in the UK is dominated in a duopoly, with Orchard Funding a distant 3rd player. These top players are Close Premium Finance and Premium Credit, which according to various online resources, control over 90% of the market. In the article linked, Bexhill describes competition in the market, with an interesting barrier to entry being broker commissions paid in advance for exclusive use along with multi-billion dollar spend on integrating themselves into the broker network to make the choice seamless. Bexhill goes on to propose the potential for price fixing with so few competitors. For some context, in 2022 Premium Credit generating a 54.7% pre-tax operating margin, whereas Orchard Funding generated a 33% operating margin. Pressure from the regulator (also here) could bring this disparity more in line, and assist Orchard in gaining more market share, along with a better margin. In my view, the odds are reasonable that Orchard could benefit from a future alleviation in competition, but there is also substantial risk of being dominated by incumbents. In the shorter term, funding costs are likely to put pressure on the group's margin, but with the short-term nature of their loans, should see a relatively quick response in their lending rates.

To combat their uncertain funding position, the business floated the idea of applying for a banking license several years ago but put it on hold going into the pandemic. Recent discussions with management reveal that the banking license would require a cost base of £2-5m per year, which at their current size is not prudent. In saying this, Ravi has written a book titled "How to Build a Bank…" to be released in November this year. It is fresh in his mind, and I think given this that a banking license remains likely in the future as a result. In the meantime, the group has acquired (at NIL cost) a bond finance business and subsequently issued a fixed 6.25% fixed-coupon (bi-annually) bond with a June 2nd, 2027 maturity date. These bonds have traded at and around their par value since listing with very limited movement around par and perceived as low risk as a result. The listed stock trades at a deep discount to book and pays a larger dividend than the coupon on the bond. With the group looking to further grow its loan book and £49.3m on lent to customers on 31 January 2023, there is a noticeable lack of funding capacity (~£52.3m capacity at 31 January 2023) to further expand it this current stage. It appears likely that the group will consider a further bond issuance soon.

When asked about the growth ambitions of the business, it appears that they intend to delve deeper into the leisure industry, specifically static caravans. It is seen that these loans provide long term, safe profits for the group as caravan park operators cover payments to Orchard if they are not paid by residents. The group is working to build relationships with park operators locally and nationally and that the industry is a multi-billion sector which Ravi believes they can safely double the group's balance sheet with these loans.



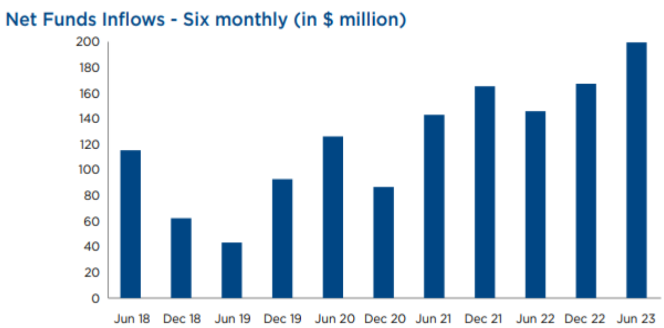
The idea was brought to my attention from one of the unitholders later last year, and I have recently checked back in on its progress. Upon checking I had noticed that the business had fallen over 25% since then and was now trading at ~0.45x book value, despite its average ROE since listing of 9.2%. With a 45% average payout ratio, this means that the group is trading at ~5x earnings as well. Given the fluidity of their loan book, non-discretionary nature, conservative practices and founder, Orchard Funding is an excellent investment case for the trust to have some exposure to. The group should pay us a dividend yield of ~10%, whilst having the ability to compound its book value 5% p.a. This is in line with our hurdle rate at a 15% return, but I think shortfalls to this can be justified given the companies substantial discount to a liquid book value, which sets us up for a more robust margin of safety. Furthermore, with the group at multi-year lows in its interest margin, there is reason to believe that a fundamental improvement in returns on equity is likely as well should rates stabilise. In terms of our hurdle rate, I am expecting a consistent ~10% dividend along with >5% EPS growth (>15% CAGR), and the prospect of the business re-rating to a P/B closer to 1.0x in the next 3-5 years (15-24% CAGR).

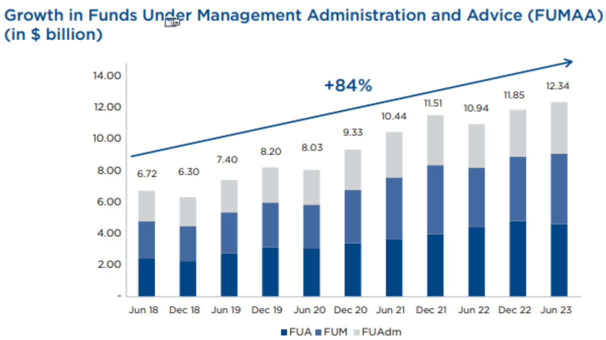
Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

October 2023 – Fiducian Group (ASX:FID)

Fiducian is an Australian financial services business operating since 1996. Like other similar investments made by the trust, it has a diversified set of services predominately centred around the provision of financial advice. It is a founder-led business, of which founder Inderjit (Indy) Singh owns some 28% of the listed company and has done an excellent job since with the group compounding at ~18% p.a. in the past 20 years, and 24% p.a. in the past 10 years.

Since its peak in October 2021, it has suffered a 30% drawdown, despite growing its revenue 19% in the same period. Its earnings have grown 7% in the same period. Importantly, the group is highly correlated with the market, thus it is quite highly dependent on the performance of its funds under management and administration over time. As many may know, an asset management business is an exceptional one on the upside but is catastrophic on the downside, in my view this is the primary risk (and opportunity) with the business. Fiducian does a good job of controlling the controllable with gradual expansion of its distribution network over time allowing for consistently impressive net fund inflows to its asset base. I estimate that over the past 5 years net inflows have accounted for 21% of the increase in funds under management, administration, and advice (FUMAA), thus accounting for some 3% p.a. of the total 13% p.a. compounded increase over the period.





Further, there is some things to be aware of which may impact flows, particularly in their administration business. These include the impending $3m total super balance cap, which will tax those with more than $3m on their super an additional 15% tax, which in and of itself isn't terrible, but the kicker is that this is also calculated on unrealised capital gains, therefore leaving members having to raise cash, through what is likely to lead to more activity between members. Furthermore, other changes include the progressive increase in the employer SGC contribution rate from the current 11% to 12% over the next 2 years and the implementation of the pay-day super reforms although these are unlikely to move the needle. In anticipation of any weakness in super flows, Fiducian has partnered with Generation life (ASX:GDG) to get their funds onto their investment bonds service (next best alternative to super for HNW investors).

In terms of the revenue, the group generates revenue in 3 ways, management fees from their FUM, administration fees from their platform services and fixed fee income from their financial advice. FUM and platform fees (~87% of total segment profits) are based on a fixed % of FUM, are hence variable, are calculated daily and paid monthly in arrears. The remaining revenue is both variable fees related to FUA and one-off performance which are paid as a normal professional service. Thus, we can conclude that >90% of current profit is tied to markets and what would impact revenue is changes in the overall FUMAA through the year (through market performance and/or net flows), and any changes in average % fee because of business mix and/or competitive pressure.

The cost base is the vast majority payments to the group's employees (salaried advisers), responsible entities and franchised advisers. To a lesser extent the group expenses a small amount of operational expenses, but this would only account for some ~15% of the total expenses. In the existence of volatile markets, we could conclude that the cost base is fixed. Additional hires and/or changes in payroll would impact the cost base the most.

Capital allocation has appeared to be quite reasonable over time, but most earnings are paid out with a dividend policy of 60-80% of 'underlying' net profit after tax. The 'underlying' referring to the add back of the client portfolio intangibles which is equivalent to acquired intangibles as it represents the customer attributable value of acquired client books, which is an accounting vagrancy that in my view, does not properly represent an economic reality, and thus the add back is fair. Over the past 5-year period, ~30% of operating cash flow has gone into investment initiatives (26% to acquisitions), ~62% into dividends and paying down debt and the rest piled up on the balance sheet. Considering they compounded FUMAA at 13%, revenue at 9.8% and EPS at 7.4% I would consider this outcome to be reasonably impressive.

The opportunity in my view is that currently, utilising the FY23 UNPAT the PE is about 12x, and there is a little over 1x earnings in cash, thus 11x PE net of cash holdings. The group pays 60-80% of this out, which when franking credits are included is a gross yield of 8.2%, which on a forward basis I expect this to be closer to 9.5-10%. Fiducian has raised the per annum budgeted net flows target to $6m per adviser which when applied over 80 advisers equates to $560m per annum, have doubled revenue targets for salaried advisers to 20% p.a. and launched a platform offering for external advisers called Auxillium. In the existence of market-like returns of ~10% give or take, this gets us to revenue growth just shy of 15%. Not including any capital allocation initiatives, margin expansion or organic growth in adviser count. This and the dividend yield gets us comfortably above hurdle.

Email: Tristan.waine@outlook.com

Phone: +61 426 026 928

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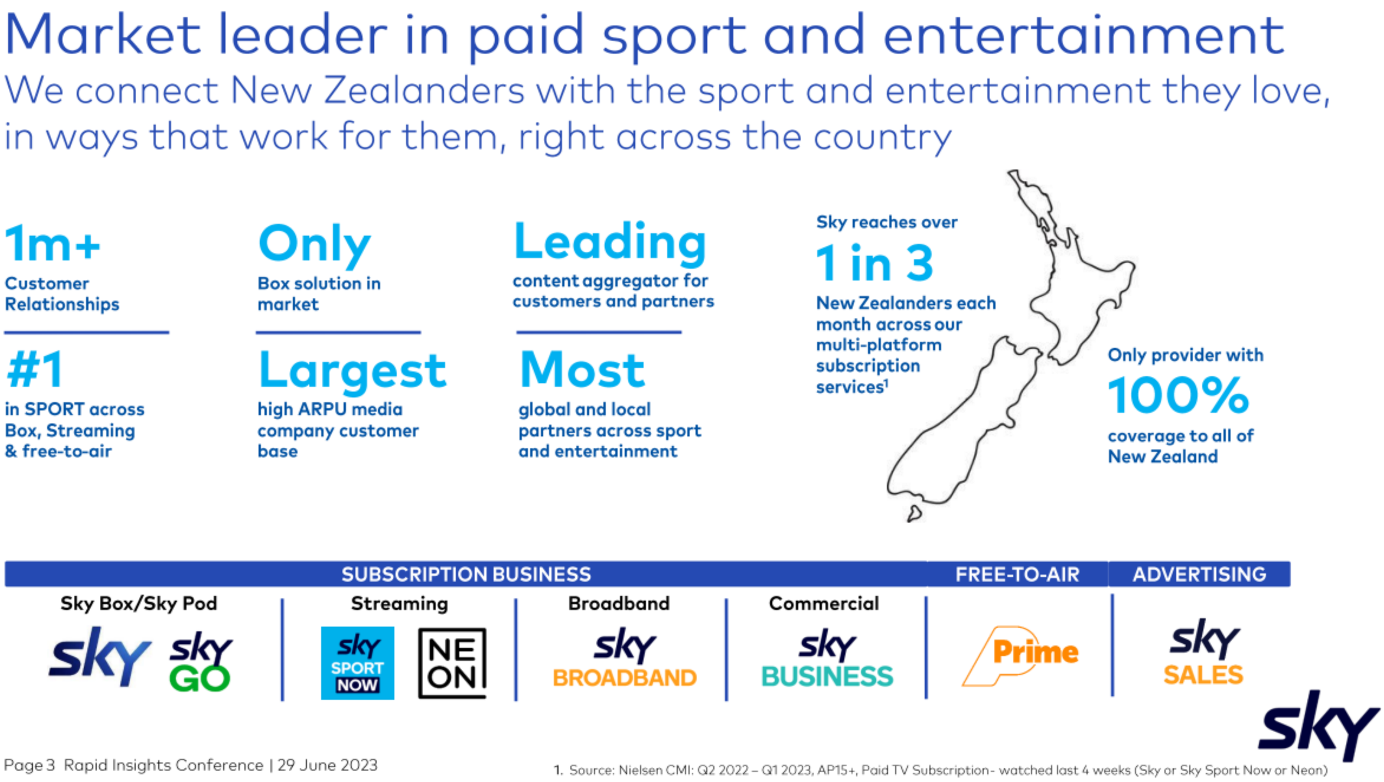
October 2023 – Sky Network Television (ASX:SKT)

Upfront, Sky is a short-medium term special situation initiated by the trust in response to the receipt of a non-binding indicative offer (NBIO) to acquire all the shares in Sky without a price disclosed. This was announced to the market on the 13 of October. On my numbers the group traded at a FCF yield of ~20%. According to local reports, an unnamed overseas private equity firm could be the mystery bidder for the business.

Several days later a reference point valuation was shown with Southern Cross Media (ASX:SXL) receiving a similar offer from Anchorage Capital Partners (ASX:A1N), which contained a price. This is where my interest was drawn as the Sky business generated >$50m of NPAT in 2023 and held >$50m in debt-free cash on the balance sheet (all numbers converted to AUD). On a market cap of $370m this is a valuation of 6.4x earnings. The Southern Cross Media business by comparison generated NPAT of $19m, had net debt of $105m and a market cap of $205m, valuing the business at 16x earnings, a differential of some +-150%. Whilst these aren't identical businesses, the model in my view is quite similar, with them effectively being advertising channels, despite the channels being TV and radio respectively. Importantly, the cost structure would be relatively similar.



Of course, I should provide some background on the business as well as the special situation thesis. In the case of Sky, they are like the likes of Foxtel here in Australia or Comcast in the US, and it is effectively a 'paid subscription', to either a digital TV box or streaming. It also offers broadband, and advertising via. it's free-to-air television service etc. Some 10% of the New Zealand population have a Sky Box which shows their strength. As the graphic above also shows, their overall paid business reaches 1 in 3 New Zealanders each month. It has undergone a significant transition over the past 3 years, stabilising the businesses income streams, decreasing the reliance on Sky Box as it's key division and streamlining costs.

The board are all rather new and, Belinda Rowe, one of the groups' independent directors, also happens to be a non-executive director of ARN Media (ASX:A1N), the company which put out a bid for Southern Cross Media (ASX:SXL). They have more in their executive team than I would like (8 people!), but with 6 of those people joining the executive team within the past 5 years, it appears that at least most of the current executive team were not responsible for the bulk of the lacklustre performance leading and further exacerbated by the pandemic.

To add to the appeal, Sky appears to also be a good value stock for all intents and purposes. It's FY26 targets outline 3-year target revenue, EBITDA and NPAT of +9-12%, +17-31%, and +35%-86% respectively along with a potential doubling of the FY23 dividend. This would equate to a FY26 FCF yield of 22-30% and dividend yield of ~12%. To add to this, the company initiated a share buyback in March 2023 where the board quoted that "Sky's shares are significantly under-priced". If they were unable to secure a transaction in the short term, I am comfortable holding Sky as is, as if the management targets are met, we would benefit from a hold return of >16% p.a. with what I believe to be 'significant' strategic value to a potential acquirer. Of course, it isn't in line with our loose mandate of professional and financial services, but I believe it an easy business to understand and most importantly, is 100% financed by debt, meaning that until this investment is materialised, we will be doing minimal small special situations due to a lack of credit facility to access. On the upside, any contribution to the trust is in effect an unlimited ROI as we are utilising no equity and interest free debt.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

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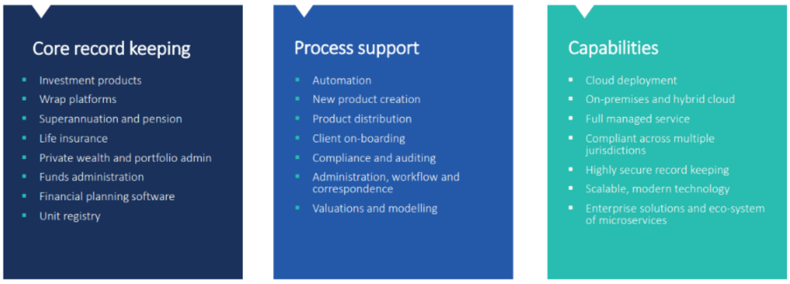
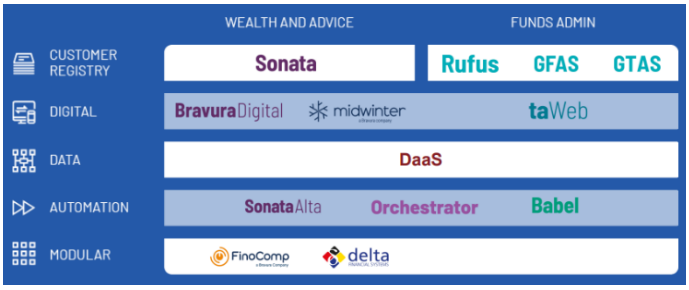
October 2023 – Bravura Solutions (ASX:BVS)

Bravura is an Australian domiciled software business, specialising in providing fund administration & wealth management software in addition to professional consulting services to the financial services industry. It works predominately with larger companies, having 52 customers (44 wealth, 8 Funds Admin) across the globe (Not including Midwinter and Delta SaaS products). The business operates predominately across both Australia and the UK, with minor operations in New Zealand and the rest of the world.



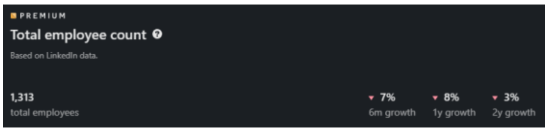
I don't have the space to discuss each individual product under the business as it is what I believe to be a rather complicated business with many high-end software packages. I have shown to the right their core offerings and the functions that they provide for reference. I would also suggest simply browsing their [website](#) one product at a time to understand the breadth of the service here. Its products span multiple global pension systems, reach into niches such as employee pensions and defined benefits, and allows for the administration of investments across asset classes and countries for fund management.



It doesn't take a long-time browsing Bravura's announcement to realise that it's not just me that finds this business complicated, but clearly there is a revolving door of management, who when they arrive demand to be remunerated greatly for their contribution with a remuneration report 'strike' in 2022. Up until EOFY 2019 the group had a relatively stable c-suite, but, from then through to EOFY 2023 the group went through 9 executives (3 CEOs, 3 CFOs, and 3 COOs), with most of that occurring in 2022-23. As you would expect, investors did not take to the stock kindly through this time, with an investor on the 1 July 2019 having just 20% of his invested capital remaining today (including the minor impact from dividends). In the same time, whilst the companies revenue did not decline much at all, the profitability evaporated, with the net margin declining from 'low teens' to 'non-existent' today. As you can imagine the dividend is also gone and the company diluted massively earlier this year to save itself from demise by investing resources into 'organisational change', an endeavour which if managed incorrectly, could destroy further value.

So, all of this doesn't paint a pretty picture, and I wouldn't blame you for thinking so… the business is clearly in drastic need of a turnaround. Enter substantial shareholders Pinetree Capital Management (since October 2022 they have accumulated a stake amounting to 21.6% of the company. Furthermore, Pinetree's Chief Investment Officer Shezad Okhai, jumped ship from Pinetree to Bravura as a newly appointed 'Chief Commercial Officer' (CCO) as of the 15th of August 2023. Shezad previously was Vice President at the Volaris Group, a part of Constellation Software. His duties as CCO involve working with executives to improve the business and engage with customers. It is a fixed term contract which is scheduled to end on the 30 June 2024. Further to this, Damien Leonard, President of Pinetree and son of Mark Leonard of Constellation Software was admitted the board and importantly, to the HR committee as well.

On another note, Andrew Russell was appointed as Group CEO in July, replacing Libby Roy with Andrew having acted as interim CEO last year up until Libby's appointment. I have a history with Andrew as he was the one which was responsible for the sale of my beloved Class Ltd (ASX:CL1 – no longer listed) to Hub24 (ASX:HUB) back in 2021/22 and prior to that a bit of an acquisition spree and in my view 'diworsification' at Class. Nonetheless, he was strongly incentivised to generate a >25% CAGR in TSR over a 3-year period from his 2019 appointment which he delivered through the sale. Either way, I have mixed feelings about Andrew. Prior to class he was an executive of the finance subsidiary at REA Group (ASX:REA).



Before her departure, Libby had raised capital and outlined an operational change program which had targeted $25m in cost reductions (predominately employees) once fully implemented, spread predominately over a 3-year period. This was implemented quite rapidly as can be seen by the LinkedIn employee numbers shown.

The implementation costs have largely been expensed now and the group is planning to announce a new 3-year plan on the 2nd of November, which by the time you read this will likely have been announced. In the FY2023 results they alluded to targeting $40m of cost savings, which in addition to the cost savings already secured, will make Bravura quite a profitable business, and more importantly a reasonable cheap one. I expect them to be able to achieve further margin accretion and am keenly interested in what they can pull together in the plan announced. The group currently has ~$76m in net cash and it is expected that FY24 will incur an additional $30-35m in cash burn, therein leading to a net cash balance of $41-46m in FY24 assuming stable working capital. My crude numbers on the development of the P&L are shown below, bridged from the FY2023 results and based on what has been announced prior to this plan (note I have added back the organisational change expense of $19.5m and ignored the incremental cost in FY2024 they will require). The group has ample tax losses, so will end 2024 at an EV/EBIT of ~13x. I expect that by FY2026 a free cash flow margin of 15%+ is achievable and a return to revenue growth. I have assumed that revenue of >$300m in FY2026 with a drastically improved cost base is achievable and am basing my investment on this target.

	2023	Non-Recurring	1H23 Completed	FY24 Changes	PF FY24 P&L
Revenue	249.6				249.6
Employee Costs	-182.9		23	11	-148.9
D&A	-25			1.5	-23.5
Third Party Costs	-27.4			2.5	-24.9
Other	-58	5.0	19.5		-33.5
Profit before tax	**-43.7**	**5.0**	**42.5**	**15**	**18.8**
Margin	**-17.5%**	**2.0%**	**17.0%**	**6.0%**	**7.5%**

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

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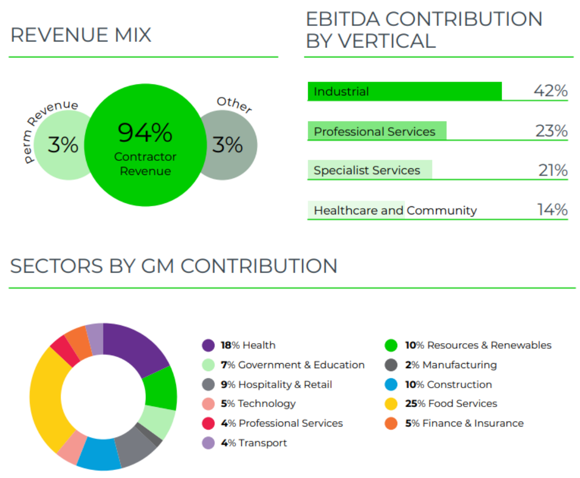
October 2023 – Peoplein (ASX:PPE)

Peoplein provides staffing, business and operational services across Australia including workforce management, recruiting, onboarding, contracting, rostering, timesheet management, payroll, and workplace health and safety. More specifically it predominately provides contract labour to its clients across three key verticals: healthcare and community, professional services, and industrial & specialist services. It employs more than 850 team members who have helped to provide employment to over 34,500 people from a candidate pool more than 55,000 people and 4,200 client businesses.



Long-time readers of the Hurdle Rate Substack would recognise this business from a One Page Stock Pitch I did back in February. At the time the business was more than double the current price. In the time since then the business concluded its strategic review with the conclusion to continue to pursue it's current strategy and Declan Sherman, the group's founder and head of acquisitions had stepped down from the company (It is notable that Declan did own some ~7% of the company up until FY2022 where he transferred out 4m shares to an unknown holder. He remains a shareholder in some 2.1m shares or 2.32% of the outstanding shares. Other shareholders of note include Perennial Value Management with 9.24% and QVG Capital with 5.21%. Acquisition vendors Andrew Brosnan and Mark Reiken also both own 6.14% respectively.

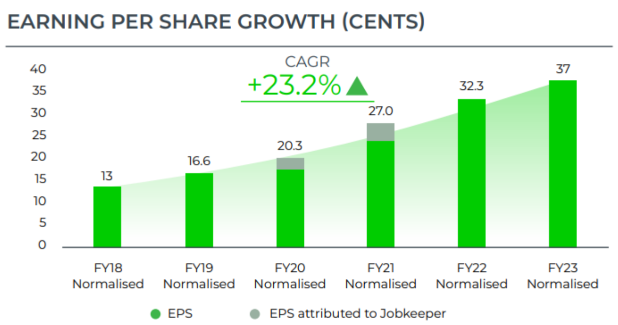
Circling back on the stock pitch I did previously, I did discuss the risk of labour hire being a tailwind for the fundamentals of the business from it's inception in 2015 to date. From August 2014 through to August 2022 the % of labour hire workers working full-time hours increased from 73.9% to 81.2% of all labour hire workers. Looking back at this, I do not think this was a particularly useful statistic to bring to the forefront. Whilst it is true that with more full-time employees in the labour-hire workforce would lead to more billed hours which flow through something like Peoplein, there is much more to it.

Either way, the group generates the vast majority of its revenue through invoicing the firms who are being provided labour, also known as contract hire revenue. There is also a small amount of revenue and profits coming from recruitment in general, being the permanent placement of individuals along with project based managed services. The key variable in the top line growth of the firm is billable hours, much like an accounting or law firm running on a timesheet model as well. This requires an incrementally larger talent pool and utilisation of said talent pool. The group has grown this pool predominately through both acquisition and organic growth in recent years. I feel that in years to come, provided there is no catastrophic change to labour hire, that the group can generate additional revenue through the average wage growth of this pool in addition to any volume growth, making this a somewhat inflation protected revenue stream.

The issue is that the number of businesses seeking labour hire in general would decrease in difficult economic environments given that temp staffing is typically more expensive than permanent. This is certainly the case in recent months with many labour hire companies collapsing due to fierce competition for candidates. This article goes on the discuss that construction, hospitality & retail are showing the greatest signs of distress, which if you refer to the picture above, accounts for some ~44% of the Peoplein business (if we include food services as well). This could very well be what the market is concerned about particularly, but ultimately my uncertainty is quite perplexing with Peoplein as the company themselves appear to be quite optimistic in general, shaking off any looming distress soon.

Across the 3 divisions the billable hours are significantly greater in the industrial division, with it being ~10x the health and community and ~18x the professional services hours. However, the rate and margin at which the latter are realised at significantly greater rates with revenue and EBITDA per billable hour in Industrial & Specialist being $43.63 & $2.10, Health & community being $71.71 & $4.60, and Professional Services being $151.27 & $13.60. Therefore, the areas where Australia are seeing the most impact, also happen to be the lowest rate and margin parts of the Peoplein business.

Same Job, Same Pay laws are also prevalent in labour hire, however, predominately in mining, where there is mass exploitation of contract labour at rates below those of permanent staffing, despite having entitlements to boot including permanency. However, as can be read in this article areas including professional services and carers are typically paid greater rates through an agency than not, therefore is likely to avoid most regulatory drama around labour loop holes and the pending fair work legislation.



All of this points me towards thinking that the share price decline in Peoplein 'feels' overdone. And I know that is a dangerous feeling to have, so I am thinking about this very carefully and have sized this accordingly given my uncertainty. In a best-case scenario, Peoplein sees no real impact, we benefit from a ~13% dividend yield, high teens growth rates in earnings per share and quite a hockey stick in the valuation multiple. I struggle to see much downside, although put a gun to my head and I could envision significant impairments in its food business, losing some ~30% of its profits perhaps and being valued at a high single digit multiple of earnings with perhaps struggles to grow soon. The group has historically grown roughly half/half through organic/inorganic. It would be good to see further focus on resilient areas of labour demand such as the PALM scheme, the FIP business and Halcyon Knight business which all see tailwinds or structural shortage in labour.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

September 2023 - Letter

Dear Unitholders,

This month the Hurdle Rate Unit Trust generated a **Gross return to unitholders of +3.23**%. Including performance fees, the **Net return to unitholders was +2.45%.** The unit price as at month end is **$1.0866**. The full history of performance data can be found on the first page of this document.

DSW Capital (LSE:DSW)

During the month the group announced that it had conducted its first 'breakout' deal, where they are offering teams of 3 or more £50k worth of underwritten drawings for them to start their own business as a new licensee of DSW Capital. The licensee this time is 3 people based in the newly entered Midlands UK, where they acquired license fees from recovery firm Bridgewood just a few weeks ago. Further to this, at the end of the month a new tax advisory partner joined the group.

Of note in these announcements is a quoted tally of 105 fee earners after the deal, down from the 107 they quoted in the results announcement back in July. It would imply at least gross churn of 6 since the start of April. Using LinkedIn data, I have approximated what they have experienced in 1H24. It appears that they have hired ~14 people including the breakout and seen churn of 6 people, an attrition rate of 5.6% in a 6-month window (11.2% annualised). For comparison the group saw full year attrition in FY23 & FY22 of 8.1% and 16.5% respectively. This churn is not outside the normal amount they experience.

The issue here is the rate of hiring, whilst it may be in line with previous years, this is inclusive of the Bridgewood acquisition, which was a lead from a partner rather than recruitment staff. The substantial investment into several recruitment initiatives in FY23/24 have yet to show their worth and I expected to see a step change in the rate of hiring which we have not seen yet. Whilst this is not encouraging data, I am also aware that it has only been a short period of time, and given the shift back towards acquired leads, fee earners may come in group's more often than the past.

Period	Fee Earners	Net Gained	Gained	Lost
1H24(E)	105	8	14	6
FY23	97	9	16	7
FY22	88	12	25	13
FY21	76			

ONS statistics indicate a flat quarter relative to the end of last year, which would suggest very weak revenue per fee earner once more. Furthermore, with an increase in DSW Capital parent company corporate costs, and lack of profit share in the 1st half, it appears likely that 1H results will see a significant drop on the record half of last year, perhaps having licensee income fall upwards of 30% YoY and with an increase in corporate costs, a significant decline in earnings is highly likely. £450k of net profit after tax was made in 2H23, inclusive of some £240k in profit share, which I deem unlikely to recur in the 1H. So, I am expecting around £1.25m in licensee income along with an increase in corporate costs again on the half to ~£1m, thus leading to ~£250k in operating profit, or £187k in net profit after tax, down ~60% on the half year PcP. For this reason, I would not be surprised to see a decline in price once results in November are released.

The positive signs are that the rapid rise in funding costs may be on its last legs, as cited by the BoE governor earlier this month. This is important as uncertain cost of funding impedes M&A activity. As I said last month, I think we bought DSW Capital at a single digit multiple of trough earnings, and my opinion on that remains consistent. We have ample room to increase our position should the price retrace on weak half yearly results.

Just as a side note, you can see here there is a reasonable focus on the macroeconomics for DSW Capital, which some of you may deem unnecessary. The reason why I am discussing it, is that it is highly correlated to the businesses organic business volume, it is crucial to the ability of the investment to succeed. Thus, there is a reasonably high risk that it does not due to sustained weakness in corporate activity, but at least in terms of weighing up the odds, I think that the investment can succeed even in relatively hostile environment, giving us substantial upside in the event of a recovery in volumes due to more certainty coming back into the corporate dealings market.

Diverger (ASX:DVR)

This month, Diverger received a takeover bid from Count (ASX:CUP). The possible payout for Diverger shareholders is:

- $0.367 in cash and 1.38 Count shares per Diverger share. (Default option)
- 2.07 Count shares per Diverger share (Subject to a scale back arrangement)
- $1.10 in cash (Subject to a scale back arrangement)

I am of the view that the offer substantially undervalues the Diverger business, however, given that Hub24 owns 1/3 of Diverger it appears reasonably likely that the deal will go through without a hitch, subject to any counteroffer. Unfortunately, the headline price is not nearly as great as my estimate of intrinsic value, and I hope there is an additional offer or increase in price, if not a refusal by shareholders. I am in active discussion with fellow shareholders as to what can be done here to maximise shareholder value.

The merits of the offer go beyond the headline price, with implied synergies embedded in the scrip proportion of the offer. On the day of the offer, I took to liberty of phone calling both Nathan Jacobsen (CEO of Diverger) & Hugh Humphrey (CEO of Count) to discuss the rationale of the deal and as part of that discussion it was noted that Diverger's CARE business offers substantial synergy potential for Count, the tax training businesses are better suited to Count's accounting business, and that Count has several equity interests like Diverger's. Count themselves have identified $3m in cost synergies (primarily corporate costs – including Nathan's & CFO wage) in addition to this. Which should take the combined EBITA to shareholders from ~$15m to ~$18m in the year or so after the deal. Combined market cap is $94m and Enterprise value of $107m, leading to about a 7.5x EV/EBITA multiple post combination. But our effective price would be closer to 6.5x as we are receiving the $0.37 in cash as well. I have looked extensively in the past at the Count business, and I am not enamoured with it, given their lacklustre discipline on accounting firm KPI's. However, with the introduction of the Diverger businesses, and the ownership of Accurium, I find the combined package reasonably appealing, especially if they can materialise cost and revenue synergies.

In any case, as at this stage I expect to either wait until this deal is in effect in February 2024, Diverger receives a counteroffer, or the deal is turned down by shareholders. Most likely, I will consider taking scrip and only reevaluate after we have both hit the required holding period for the CGT discount and are in the 2025 financial year as I view the combined entity as cheap as well. Either way, it has become more apparent that our purchase was indeed substantially undervalued at the time of purchase which I find pleasing. With this catalyst, I took the opportunity to trim some other holdings and average up into Diverger at the end of the month, as I view the possibility of an increased bid as likely, and the closure of the offer as very likely. The default offer is still a 13% premium to the most expensive purchase, which if it closes in late February would equate to a mid-30s CAGR on that purchase.

Getbusy (LSE:GETB)

Getbusy reported its 1st half results to the market in early September. The results were reasonable, in the context of their discussion to the market. First, the ARR in constant currency terms was up 7.8% on 31 December (16.2% annualised), but with a 2.6% FX headwind. Furthermore, the group ended the 2022 year with 56.85m diluted shares, which has increased slightly on the year end to 57.63m diluted shares, dilution of 1.4% in the 2023 year to date. Cash was down from just shy of 3m to 1.7m in the half year in addition to this. The group continues its long-term incentive plan share issuance, which I was forgetting when initially setting the targets. As such I changed to ARR/Share compounding at >15% p.a.

Financial Targets for Getbusy

	Dec-22	Jun-23	Actual	Target
LTM ARR/Share	0.34	0.35	6.4%	> 15%
Net Debt	-2.97	-1.7		< 0

These results certainly don't look too good when compared to our targets, but perhaps to provide some context, regarding ARR the group took initiatives to change up its sales and marketing methodology in the Smartvault business unit, delaying growth in this division. US revenues grew by just 1.4% in the half year (negatively impacted by a strong performing GBP relative to the USD), despite its significant investment. Ironically the UK was the standout with 8.7% growth in the half year. It is important to understand that particularly in the Smartvault product, the group has adjusted it's pricing plans, such as introducing minimum account sizes, and increased average sale price, shaking out the lower value customers which bring in both lower sales price and higher churn rates. The board's view is that the churn is worthwhile to them in the short term to remove engagements which do not have attractive unit economics to them (lower sale price but similar attention demands).

Half Yearly Growth in Revenue by Geography

	1H20	2H20	1H21	2H21	1H22	2H22	1H23
Total	6.97	7.21	7.49	7.96	9.07	10.22	10.52
Growth (HoH)		*3.44%*	*3.88%*	*6.28%*	*13.94%*	*12.68%*	*2.94%*
Growth (YoY)			*7.46%*	*10.40%*	*21.09%*	*28.39%*	*15.99%*
US	2.74	2.73	3.03	3.45	4.56	5.35	5.43
Growth (HoH)		*-0.36%*	*10.99%*	*13.86%*	*32.17%*	*17.32%*	*1.50%*
Growth (YoY)			*10.58%*	*26.37%*	*50.50%*	*55.07%*	*19.08%*
UK	3.23	3.47	3.46	3.48	3.48	3.77	4.1
Growth (HoH)		*7.43%*	*-0.29%*	*0.58%*	*0.00%*	*8.33%*	*8.75%*
Growth (YoY)			*7.12%*	*0.29%*	*0.58%*	*8.33%*	*17.82%*
AUS/NZ	1	1.01	1	1.02	1.03	1.1	1
Growth (HoH)		*1.0%*	*-1.0%*	*2.0%*	*1.0%*	*6.8%*	*-9.1%*
Growth (YoY)			*0.0%*	*1.0%*	*3.0%*	*7.8%*	*-2.9%*

Targets remain feasible given the group is intending to double its sales team in the US and has introduced Right Networks as its 1st US partnership, which is a sales channel they don't need to pay for, has low correlation in userbase, and 1.2x the userbase of the entire Smartvault userbase currently. All signs point to strong Smartvault growth in Q4 as the group goes into the months leading up to the 2023/24 tax season. Workiro also has 20 partnerships now which should also lead to some positive momentum. Net debt is down on the half, but the group receives most of its annual prepayments in the latter half of the year, which given the prospects for Q4, may result in a very strong half year cash inflow for the 2H period.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

Hurdle Rate Unit Trust

**Last Updated – 1 November 2023*

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<u>Dividends, Franking Credits & Priority in the Source of Returns</u>

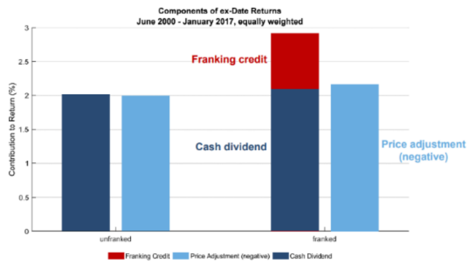
This month we received our first round of material dividend income, which has put the trust into a realised gain position for the first time. For transparency, income is taxable at the end of each financial year as normal, but I process distributions monthly. This is to ensure that each unitholder is entitled to their fair share of income, and to prevent new unitholders being taxed for income from previous months or old unitholders from dodging tax which would have been attributable to them prior to their sale. Importantly, this does not shield new unitholders from unrealised capital gains, however.

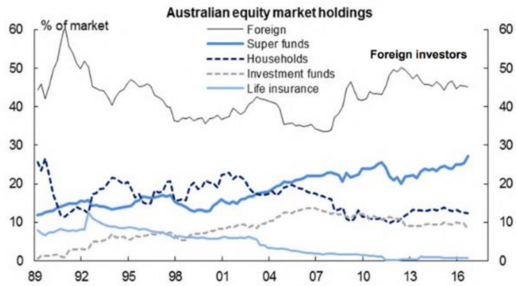
Speaking of this income, I have included the grossed-up value of these dividends in our performance, this is because franking credits represent equivalent value to $1 of cash, as they are what is called a tax offset, rather than a tax deduction. Franking credits are a tax credit paid alongside dividends for company tax that has already been paid by an Australian company. From the investor's point of view, they can use that credit to pay tax they would otherwise pay, and any excess is an allowable cash refund from the tax office (For receiving companies it is a credit to their own franking account). To date we have received franking credits of $4,268, or $0.0146 per unit.

Having established this, an excellent [presentation](#) from the Plato Income Maximiser LIC (ASX:PL8) talks about how when a dividend paying company passes it's ex-dividend date, unfranked dividends are understandably represented in a price decline equivalent to the dividend payout. But interestingly the price adjustment does not have the same 1:1 adjustment for franked dividends. The effect is shown in the charts to the right, only a mild value is ascribed to franking credits, which is largely due to the large foreign shareholding in Australian shares. Furthermore, many funds are [not managing their performance on an after-tax basis](#), meaning that to display strong performance, funds often opt away from high franked dividends, and particularly large special dividends or off-market buybacks.

All of this is strong evidence towards explaining why we might have a non-negligible contribution from this effect over time to our performance. This doesn't mean I will go out of my way to chase fully franked dividend payout companies, but just that it will be a minor consideration when comparing alternatives.

Franking credits are not priced





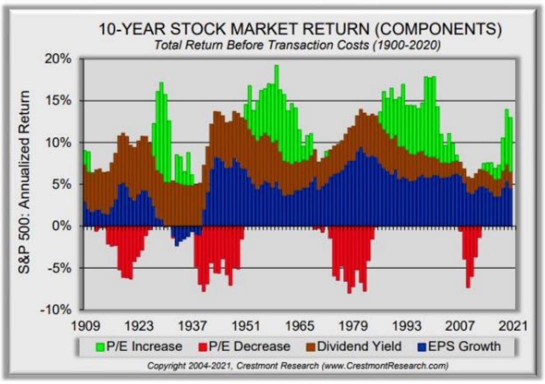
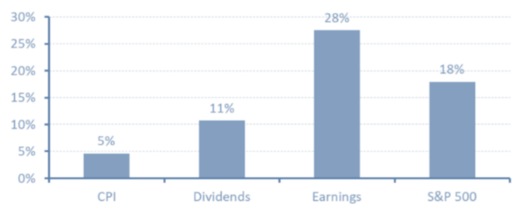


Figure 2: Standard deviation of growth rates (25-year periods)



Source: Robert J. Shiller market data, Aaron Brask Capital

The discussion on franking credits and comparing alternatives has prompted me to think about weighting different sources of return. TSR is driven by intrinsic value growth, dividends, and multiple expansion/contraction, but perhaps it is worth it to think about the drivers of that equation, and what appears to be more favourable. In my view, a capital return is the most predictable and favourable of all returns, but in lieu of franking credits, is typically taxed the most, so there is much investment research speaking about the impact of compounding a deferred tax balance, which of no surprise Buffett also talks about in his [1989 letter](#). As an Australian trust, with all beneficiaries able to benefit from franking credits, this consideration holds less weight, but ignoring taxes for the time being, investments based on capital returns tend to be significantly more predictable over the long-term (shown with charts to the left), which when combined with the nullification (via franking credits) of the double-taxation issue that international investors may have, I tend to view a higher Australian sourced dividend as preferable to other sources of return.

This doesn't put me in a camp of 'dividend investing' or anything like that, it is merely a structural advantage that would weigh in its favour. As evidenced through our holdings of non-dividend paying companies such as Getbusy and AF Legal along with double-taxed dividends from DSW Capital, consideration is to be given to what the total return would look like from multiple competing factors which includes but is not limited to confidence of future organic revenue and earnings growth, the capital efficiency of the underlying business, the capability of management to reinvest profits, potential catalysts, market valuation, and the tax impact on the HRUT unitholders. Ultimately, our aim is to maximise after-tax rate of return as consistently as possible.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

Concluding Thoughts

Last month, I touched on special situations and noted that we spent a small amount of trust capital on a subscription to Special Situation Investments. I am happy to report that we have made the first investment because of that subscription and have recovered the subscription and then some. Importantly, this was done using interest free debt instead of trust equity. You can read more about our investment into Direct Digital Warrants later in the document.

Similarly, I have decided to utilise a small portion of the trust ($595 or ~0.2% of NAV) for a Koyfin Plus subscription. This platform I have been using the free version of for some time and find it to be an excellent companion tool to my research process. The Plus subscription will allow for things such as an increase from 2 years to 10 years of financial data, access to filings and transcripts within the platform, earnings calendar, stock and transcript key word/phrase search, and significantly customisable stock screener's and watchlists which can also be exported to excel. If you are a unitholder and would like to use this, please reach out to me as I am happy to share the login details.

My comments last month about incorporating an opportunistic tail have evolved into simply removing all constraints on position sizing, instead opting to let it 'evolve' over time, with an allowance to be more diversified so long as hurdle rates are maintained, as this will smooth our results, whilst still allowing for excellent returns. Similarly, if an outcome appears very confident, I will consider quite high levels of concentration. Portfolio turnover is the price of progress, in periods of abundant opportunity it makes sense to trade much more, although it is a delicate balance.

As noted last month, my discussion with James Goodwin on the Firm Discussions series about Sequoia Financial Group (ASX:SEQ) was uploaded. You can listen to it here. Furthermore, a live discussion on X spaces also discussed has now come and gone, it was an excellent experience. Early in the month, my application to join the revered MicroCapClub was accepted, and I have had a very interesting time browsing the website for ideas and commentary from many investors much more experienced than I. Membership is voted on by peers, and my short pitch on DSW Capital (LSE:DSW) received 71% approval by those that voted, earning me just enough (>70%) to reach the line and be approved. This sounds low, but historically only 18% of applicants gain approval, and once declined you must wait 90 days to try again. Considering this was my 1st application, I was pleasantly surprised to receive entry without having to re-submit.

As a reminder to all unitholders, please feel free at any time to deposit or withdraw funds. I am also open to negotiating savings plans for a recurring deposit if it suits you better. Additionally, we still have 7 free positions for new unitholders so if anyone is (or you know someone who is) an Australian tax resident and interested in the prospect of investing into the Hurdle Rate Unit Trust, please contact me using my details below.

Yours sincerely,

Tristan Waine

Sole Director of the Trustee of the Hurdle Rate Unit Trust

Phone – +61 426 928 026

Email – Tristan.waine@outlook.com

September 2023 - Direct Digital Holdings (NASDAQ:DRCTW)

This special situation was made aware to us courtesy of the Special Situation Investments weekly subscription we had paid for last month. In the email a quick pitch was provided as shown in italics below:

> *This is a quick note on a fresh and very timely situation that will likely fade away over the next week or so. Liquidity is fairly limited with the last two days' trading volume ranging from $60k to $130k. The situation is also not actionable to European investors, who won't be able to buy this security due to certain regulations related to KID (key information document).*
>
> *A tiny digital advertisement platform provider Direct Digital Holdings intends to completely eliminate its public IPO warrants DRCTW and is offering to buy them out at $1.20 per each warrant. The warrants now trade at $1.07-$1.11/share for a seemingly low risk 8%-11% upside in one month. The tender expires on September 26.*
>
> *A minimum tender condition is that at least 50% of the warrants must participate in the exchange. The tender is very likely to succeed, as the offered premium to the pre-announcement price is significant, at around 100%. The redemption price of the remaining untendered warrants will be set to $0.35.*
>
> *The tender is also unlikely to be cancelled. DRCT wants to eliminate the warrant overhang in order to "provide potential investors with greater certainty as to the Company's capital structure". There are currently 3.2m warrants outstanding, which, if exercised (at a strike price of $5.50), would double the number of public class A common shares and dilute the total number of shares outstanding by 22%. DRCT had $5.7m in cash as of June and intends to finance the offer with a combination of cash on hand and a credit facility. Three other warrant exchange situations with similar strategic rationale have been covered on SSI before: ATCXW, LFACW and BIOX. All of these closed successfully.*
>
> *The spread is partially explained by very limited coverage of the company/stock, low liquidity of warrants and visually high downside.*
>
> *DRCT is a busted IPO (not a SPAC) that is now totally under the radar for most investors. The company went public in February 2022 at the lower limit of its initial price range of $5.50 - $7.50 per share, raising only $15.4m of its intended $40m. The common stock fell to $3.25/share on its first trading day and has remained at those levels ever since (currently at $2.80/share). The warrants have been trading at around $0.60 in the meantime. Despite this troubled background and difficult-to-understand product/business, DRCT's financials are actually quite impressive. The company is growing incredibly fast - 206% revenue growth in 2021, 134% in 2022 and 74% in H1'23. Most importantly, despite its size, DRCT is profitable, generates cash, and seems pretty cheap on both last year's earnings ($4.2m net income) and Q2'23 run-rate ($4.8m). Management owns 80% of shares (mostly through non-tradeable class B stock).*

Long story short, as expected the situation was timely and largely faded away and we were unable to purchase at the spread the email is referring to. By the time I had received the email, the warrants were trading at $1.18 (1.1% upside). Knowing this, I still decided to go ahead with it as this upside was still enough to generate a dollar return high enough to almost offset our subscription cost giving me the peace of mind that I have not wasted unitholder capital, and we are effectively getting another 47 Special Situation Investment emails for almost free. The purchase was funded by my own personal line of credit and NIL trust equity.

August 2023 - Letter

Dear Unitholders,

This month the NAV of the Hurdle Rate Unit Trust **increased in value by 1.73**% to a unit price of **$1.0669**. Including performance fees, the **Net return during the month was an increase of 1.38%.** The full history of performance data can be found on the first page of the letter, along with charts detailing the contribution from each of our investments. The below commentary will be long with 6 reports to discuss and the introduction of some new ideas.

This month marks the first month using the Investment thesis tracker. This section is to house a set of 1-page succinct investment theses and a summarised table at the top to indicate generally if it is on track with expectations. The financial targets are set at the start and fixed so as not to change part-way, unless the investment transforms in some drastic way, which will be detailed if, and when I believe that has occurred. The aim of all of this is to ensure that we hit our hold and total return targets, so of course I will be looking to report on this information as well.

For most of my investments, it is my intention to target a specific return on incremental capital and payout ratio combination that would allow for both a hold return (yield + growth) of >15% and total return (includes multiple expansion) of >25%. This is done so using a matrix with implied PE by ROIC and growth. Some investments are lacking in capital and/or profitability, for which I intend to track alternative measures such as non-dilutive ARR growth for Getbusy or a combination of margin expansion and flat working capital turns for AF Legal, at least until they can also be tracked using PE, ROIC and growth. Warren Buffett has highlighted the importance of incremental ROIC. In his annual letter to Berkshire Hathaway shareholders in 1992, he said,

"Leaving the question of price aside, the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return."

I look at what LTM earnings and the last reported equity and invested capital numbers are. What I am chiefly concerned with is earnings growth, and the amount of capital required to get the earnings growth. So, I am attributing an exit multiple that is implied by those 2 figures and a 25% hurdle rate, the lower the assumptions needed the better.

Take for example, our investment in Diverger was done so when LTM NPATA was just $3.8m, Equity is $37.8m and invested capital is $39.7m whereas the market cap and enterprise value were $30.1m and $32.1m respectively. Assuming a mid-point range of managements 40-60% payout ratio we get a dividend yield of 9%. To reach a 25% return we need growth of 6.5%, which is the other 50% of earnings retained at a ROIIC of 13%. So, from here you can refer to the matrix linked above and imply that a business generating 6.5% EPS growth at 13% ROIC is worth 14.3x earnings. With the multiple being 8.4x earnings, it's about a 70% upside from the multiple, which over a 5-year holding period annualises at 11% p.a. The total return resulting is 9% dividend + 6.5% EPS growth + 11% multiple expansion or +26.5% p.a. Now I think a 13% ROIIC is more than achievable. This approach is merely embedding the minimum assumptions required to meet a 5-year 25% IRR.

Our investment in DSW Capital is an example of the requirement to generate a 15% return from earnings growth and dividends alone, with a dividend yield of 6%, and thus required EPS growth of 9%. Although with a payout ratio of 70%, this would imply ROIIC of 30%, which the matrix implies is worth a sky-high multiple of 70x earnings. With our entry multiple this implies potential multiple expansion of +840%, an annualised rate of 57% p.a. over a 5-year holding period. Obviously, this is such an outlier I just tend to think the multiple will take care of itself when we are only paying 7.4x '23 earnings for it, over a 5-year holding period we only need an exit PE of 12x.

With this tracker in place, I am happy that the core is being appropriately managed, however, I now shift my focus on to formalising the research process. Whilst I have put a lot of work into research with 130 posts now on my Substack written over the span of the past ~4 years, I would like to keep incremental research under wraps for the most part, with shared ideas only discussed in direct discussion with unitholders or specific investors. This is as to recognise the highly illiquid nature of these investments, and by taking ideas into the arena we potentially risk premature price discovery and/or a tainted perspective about an investment. By avoiding excessive social interaction before an investment is made and implementing financial targets (pre-mortem) as an investment is made, external influence is minimised. With this said, if you are a unitholder, I am open to sharing my active research pipeline.

Delving further, I have a watchlist of now 208 companies (including the 8 we own) that are all being actively monitored and progressively researched. Many of these have been the topics of the so-called "one page stock pitches" on the Substack, but most of them are completely unresearched. All of them, however, have announcements being emailed directly to my email address as they occur, allowing me to be pivot my research pipeline appropriately as companies develop in real time. In my view, it does not make much sense to spend a lot of time and effort researching a company at a point in time, only for that business to change (such as have its management change, a transformational asset acquired/divested or drastic capital allocation changes occur). It is best to keep your ear to the ground as good companies may become bad companies, and vice versa. What matters is how things change in the future, not how they have played out in the past. And I am always looking to expand this list further. So, if you know companies that may be of interest to me including not only professional and financial services businesses, but also businesses that service these as suppliers such as software, IT, recruitment, or training among others, please let me know.

Lastly, I have recorded a special podcast discussion with James Goodwin from Firm Returns where we spoke at length about Sequoia Financial Group (ASX:SEQ). You can listen to it and more in this playlist once it is released.

Furthermore, on the 16th of September at 7PM AEST I will be on a live discussion on X spaces joined by a few Asia-pacific heavy hitters including:

- Michael Fritzell from Asian Century Stocks,
- Jamie Halse, Fund manager for Platinum AM's Japan Fund,
- Ben Tan, an individual investor from Singapore.

The discussion is co-hosted by 2 Austrian investors which you can find here and here. It will be an open discussion and opportunity to asking questions to all of us so I would be happy to see any of you listen in.

Hurdle Rate Unit Trust

**Last Updated – 1 October 2023*

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Kelly Partners (ASX:KPG)

Our newest position reported their FY23 annual results on the 11th of August which I found were broadly in line with what I had expected. Margins were slightly lower than anticipated yet lockup (Cash conversion) was slightly higher. Organic and acquired growth along with the net debt balance were within expectations. Perhaps one of the biggest disappointments was the amount they spent at the parent entity (11.9% of revenue) over and above the 9% services fee, albeit this was not entirely unexpected with the 1H parent spend being 12.3%. During my 1H results review I had said the following:

"It's in my view that this (parent spend) could continue for a few years yet as they scale up overseas services teams which would have substantial cost relative to their actual services provided until they reach some reasonable level of scale. So that's one thing that puts weight on those high value near term cash flows and is given the commentary in the earnings call, is likely to result in a cut dividend."

By the way, I did mention the dividend cut here, but I really had no idea of their intentions with the strategic review just announced along with the full year results. I had seen Brett before making scattered comments about the potential for a US listing, but Brett had always denied criticism on the dividend policy up until now with the rationale that both internal and external partners deserve consistent cash flow. Also, the prospect of a privatisation came completely out of left field, and quite frankly would be very surprised to see them act on that in particular, and they received a very significant number of dishevelled questions on the privatisation in their earnings call.

Our tracking to the right includes the organic and acquired growth for the 2H in isolation where the business grew +0.8% organically and +10.1% via. M&A. Annualising of these numbers reveals growth lower than anticipated. Furthermore, the additional $2.5m in capital during the half came through with a $1.2m decline in NPATA, (primarily due to elevated corporate costs, increased interest rates and debt and a decline in both established and new firm margins) leading to a negative ROIIC. Dividends as discussed above are currently in consideration via. the strategic review, which I await keenly on news about with a preference for no-dividend compounding.

Financial Targets for Kelly Partners

	Dec-22	Jun-23	Actual	Target
LTM Revenue	78.0	86.5	21.8%	>25%
Equity	19.9	20.6	0.7	
Net Debt	1.1	2.8	1.7	
Capital	21.0	23.4	2.5	
LTM NPATA	6.6	5.4	-1.2	
ROIC	31.4%	23.1%	-49.0%	> 25%
Payout		3.3	61%	0%

At the end of the month, I decided to trim KPG to a smaller size in favour of an alternative and opportunistic investment opportunity.

Reckon (ASX:RKN)

Reckon released its 1H 2023 results on the 15th of August which I found satisfactory. Continuing Revenue and EPS increased by 4% & 13% YoY respectively with the latter benefiting from a prior year R&D tax amendment. If it had not received that, NPAT would be down 2-3%, largely driven by increased amortisation due to capitalised R&D spend having grown faster than revenue in recent years. The balance sheet has further improved, with just $0.3m in net debt down from $2.8m in December, partly due to the group's strong cash conversion with operating cash flow after adding back capitalised R&D, taxes, and interest at 107% of reported EBITDA.

The legal group grew its subscription revenue by +19%, but total legal revenue by +12% due to upfront and service revenue declining by 39%, but this is now just 7% of legal revenue, down by 14% last year. EBITDA was slightly in the positive but perhaps more importantly, NPBT improved by 14%, with strong operational gearing due to a near capacity cost base. All these figures can be reduced by 6% to reflect positive USD exchange rate movement. The business group fared less favourable, with it's still excellent NPBT margin on an LTM basis (due to seasonality) declining from +30% in December in to +28% in June. However, this was partially offset by revenue growing 3% over the year. Pleasingly, they are making progress on swaying prospective clients into higher ARPU subscriptions with a big step in the cancellation of the free single touch payroll mobile app.

With the 1H result, based on modest growth in 2H revenues like the first, and seasonality typical of each division, I am expecting ~$5.2-5.8m in full year net profit after tax attributable to owners of the parent, with further optionality if they lodge an R&D claim for 2023 (Current half was an amendment of prior year). This could be upwards of $0.7m for a total of $5.9-6.5m. Given today's market capitalisation of it would equate to an earnings multiple of ~10x. Without the legal group, Reckon, as a standalone business could trade at ~7x earnings. Lastly, the group indicated that it would move to an annual dividend payout and has declared a fully franked dividend of $0.025 per share, equating to a 4.8% and 6.9% net and gross yield respectively.

On the group's 1H earnings call, Sam and Chris detailed their plans to transition the remaining Desktop subscription revenue to the cloud, which currently is a hybrid model where their 'Reckon Accounts' product is both offered to customers via. an executable desktop file along with the same thing, hosted in a Reckon server. This server (referred to as 'hosted') is a temporary step for clients to move into the cloud whilst they develop an accounts solution in the Reckon One infrastructure, as opposed to the Intuit Quickbooks infrastructure they own a license to as the old Quickbooks reseller here in Australia. It is conveyed that the existence of revenue on this infrastructure creates a barrier for potential takeover offers due to limited development potential under that infrastructure. This transition is expected to take <5 years, of which I suspect that the business group could well be 'in-play' for acquirers once transitioned.

Financial Targets for Reckon

	Dec-22	Jun-23	Actual	Target
Equity	17.15	21.18	4.03	
Net Debt	2.80	0.30	-2.50	
Capital	19.95	21.48	1.53	
LTM NPAT	4.55	5.04	0.49	
ROIC	22.8%	23.5%	32.0%	> 23%
Payout		2.83	56%	60%

Our financial targets are all tracking to plan, with what looks like impressive incremental NPAT margins and ROIIC, but it includes an R&D tax amendment from prior years of $0.7m. Without this, the NPAT would be down 4.6%, with incremental margins and ROIC of -17.9% and -13.7% respectively, largely due to a large increase in amortisation, however, as reported for all intents and purposes we have exceeded targets. Lastly, the dividend is an annual payment going forward, and Reckon is historically 1H weighted so will hit targets with a small amount of 2H NPAT.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

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Getbusy (LSE:GETB)

Getbusy reports its half year results early next month, but just to establish financial targets, I am looking for recurring revenue growth more than our 15% hurdle rate using its own cash generation, free of debt or capital issuance.

Financial Targets for Getbusy

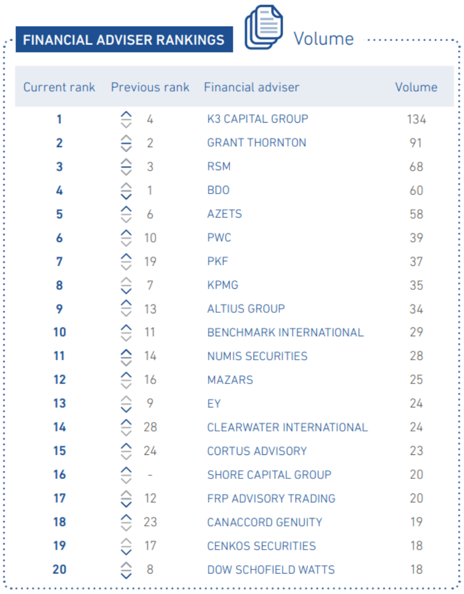
	Mar-23	Jun-23	Actual	Target
LTM ARR	20.5			> 15%
Diluted Shares	56.96			0%
Net Debt	-2.7			< 0

DSW Capital (LSE:DSW)

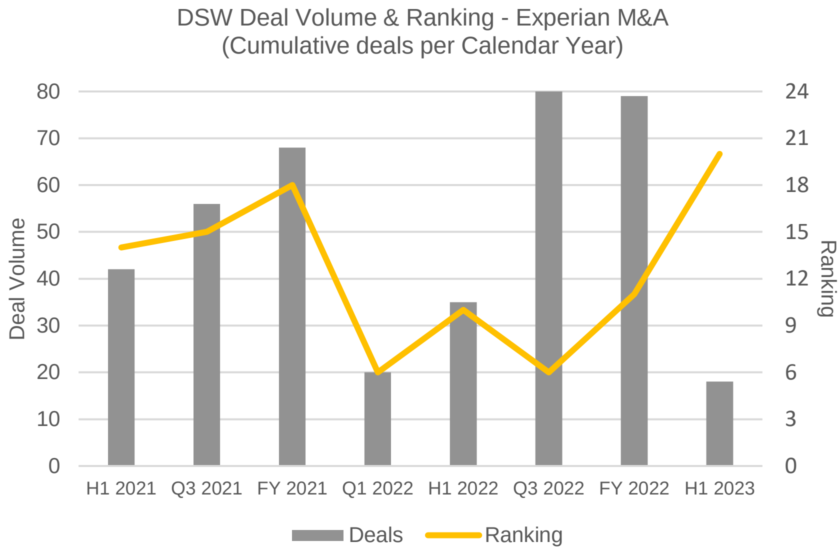
Whilst DSW Capital reported it's result last month and there has been no subsequent announcements this month, I wanted to touch base on the Experian 1H23 M&A report which is highly important for the DSW business.

"The 2,863 transactions during the first six months of the year represented the lowest half-yearly total we've recorded during the last decade." ~ Experian MarketIQ UK & Ireland M&A Review 1H 2023

As you can see below, DSW has fallen from the overall #8 ranking to the #20 ranking over the half year, with 18 deals advised on relative to 35 in the prior half comparable period. In terms of where those deals came from, 7 were from the Northwest (20 in H122), whereas it failed to rank in previous podium positions with <4 in Scotland (7 in H122) and <4 in Southwest (5 in H122). Overall, this is a decline of 48.6% in terms of deal volume, however, we are missing the value of these deals, so only get half the story. Despite a steady headcount in the M&A service lines, DSW has seen its ranking fall from a peak of 6 in the 1st and 3rd quarters of 2022 to 20 in the 1st half of 2023.


FINANCIAL ADVISER RANKINGS Volume

Current rank	Previous rank	Financial adviser	Volume
1	4	K3 CAPITAL GROUP	134
2	2	GRANT THORNTON	91
3	3	RSM	68
4	1	BDO	60
5	6	AZETS	58
6	10	PWC	39
7	19	PKF	37
8	7	KPMG	35
9	13	ALTIUS GROUP	34
10	11	BENCHMARK INTERNATIONAL	29
11	14	NUMIS SECURITIES	28
12	16	MAZARS	25
13	9	EY	24
14	28	CLEARWATER INTERNATIONAL	24
15	24	CORTUS ADVISORY	23
16	-	SHORE CAPITAL GROUP	20
17	12	FRP ADVISORY TRADING	20
18	23	CANACCORD GENUITY	19
19	17	CENKOS SECURITIES	18
20	8	DOW SCHOFIELD WATTS	18



Whether this is a lasting trend or not, it's hard to tell off the back of the financial results, but the 2H of FY2023 for DSW has been their worst in the past 3 years at the very least, and given their 2H revenue per fee earner as alluded to last month also being the worst in the past 10 years, it appears to me unlikely that things could get much worse for DSW than a 30% NPAT margin (~5-6% of network revenue). Given our purchase price of £8.4m enterprise value and a 2H network and parent revenue of £8.5m & £1.5m respectively, it would imply trough earnings of £1m, therefore we purchased at a high single digit PE multiple in what appears to be a clear cyclical low given industry deal volumes being their worst in 10 years and the addition of a drastic fall in 1H market share to a ranking they have not seen in years.

The other thing I wanted to touch on is in reference to the updated Investment thesis tracker. In the table I have stated financial objectives for DSW of >70% payout ratio and a ROIIC (Return on Incremental Invested Capital) of >30%. This is to approximate >6% dividend yield on our base earnings along with >9% EPS growth (30%*(1-70%)) and meet our hurdle rate of >15% return from EPS and dividends.

Notably, I have added back the SBP (Net of 19% tax rate) related to the Legacy/growth shares as they were pre-IPO and non-dilutive post listing. With this being the case, I reached a LTM NPAT of £1.12m & £0.86m for 2H23 & 1H23 respectively along with invested capital of £3.32 and £3.27. The business generated an additional £0.26m in NPAT with £0.05m in capital, a ROIIC of 520%.

Financial Targets for DSW Capital

	Sep-22	Mar-23	Actual	Target
Equity	7.99	7.9	-0.09	
Net Debt	-4.72	-4.58	0.14	
Capital	3.27	3.32	0.05	
LTM NPAT	0.86	1.12	0.26	
ROIC	26%	34%	520%	> 30%
Payout		0.81	72%	> 70%

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

Hurdle Rate Unit Trust

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Prime Financial Group (ASX:PFG)

Prime reported results of +28% revenue (+19% Organic) & +15% EPS for FY2023. This is broken down in 1H & 2H growth rates in revenue of +31% (24% Organic) & +26% (15% Organic) along with EPS of +33% and +6% for each respective half year period. The drastic variance in 1H/2H EPS growth rates is due to the derecognition of an ROU asset relating to a Melbourne sublease. Underlying EBITDA growth of +11% for the full year with a decline in margins from 30% to 26%

Capital efficiency was particularly disappointing with cash conversion days further increasing from 60 in 2022 to 77 in 2023, which led to a subsequently poor ROIC relative to the growth in earnings with +7% ROIIC in LTM NPATA from 1H23 to 2H23. Luckily, this was accompanied by a top of the range dividend payout ratio, making things more stomach able. Debt is very slightly above target, but with slower dividend growth anticipated for FY2024, we should see the group pay this down to comfortably within target range in lieu of a new acquisition.

Financial Targets for Prime Financial

	Dec-22	Jun-23	Actual	Target
Equity	46.87	48.7	1.83	
Net Debt	9.13	9.47	0.34	
Capital	56.00	58.17	2.17	
LTM NPATA	4.79	4.94	0.15	
ROIC	8.6%	8.5%	7.0%	> 13%
Payout		2.99	61%	50%

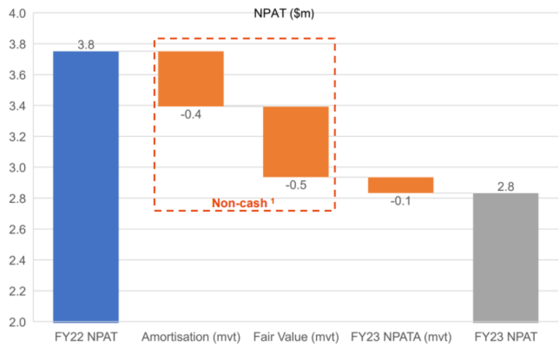
During the year Prime introduced 2 new service lines (both in the ABA & Capital division) in the form of Debt advisory and ESG consulting, with the debt advisory business being the result of the purchase of businesses assets including its business name and products. This purchase was for a total of $350k and generated $400k in revenue in the first 13 weeks alone. The acquisition and integration of Intello was also particularly successful, having contributed $500k in profit before tax in the first 9 months, implying full-year run-rate of $667k, inclusive of estimated purchase price amortisation of ~$360k, indicating that Intello would be generating EBITDA more than $1m, or $700k after tax. Considering the purchase was for a total of $4m, an earnings yield of ~17.5% for a negative working capital business is an excellent acquisition.

Interestingly, the group has introduced the intention to implement another 3–5-year plan of $100m of revenue by 2028-2030, 2 years prior to the current one being due. This points to significant confidence that they will achieve their current, which still requires 50% more revenue than they have now in the next 2-year period. The plan's existence may well extend our potential holding period if the group remains of a reasonable valuation, but I would certainly like to see them achieve this growth at a higher ROIC than we have seen in our first half year period, that is, with stable cash conversion days. If we maintain the current ROIC we couldn't reasonably expect any multiple expansion, whereas my target of 13% implied potential multiple expansion of up to 50% on our purchase multiple of ~10x earnings. In any case with a dividend yield of ~10% on our purchase price, even 7% ROIC still gets us to our 15% hold return (EPS Growth + Dividend Yield) hurdle.

Diverger (ASX:DVR)

Diverger reported Net Revenue +19% (9% organic) & underlying EBITA -2% (-11% organic). We refer to an underlying figure here as the bulk of the 21% decline in statutory profits relates to M&A accounting, which is non-cash in nature, shown on the right. Pleasingly, the group declared a 3.5c fully franked final dividend, bringing the full year dividend to 5.5c or 7.86c grossed up, which when compared to our cost basis of 80c, is just shy of a 10% dividend yield for on an LTM basis.

Lower FY23 NPAT primarily attributed to non-cash M&A accounting impacts



The company also took the liberty of highlighting the forward run-rate of acquired earnings, resulting in what they expect to be FY24 impacts of +15% Net Revenue (all acquired) and +19% (9% organic) underlying EBITA.

Cash conversion was highlighted by the company to be strong on a pre-tax basis, however, the group's pre-paid it's 2023 income tax opposed to a carry-forward balance in the prior year, resulting in an estimated cash conversion of 55% on a post-tax basis (FCF/NPATA).

On a more granular level, the group saw most of its organic growth come from the CARE managed portfolio's business, with FUM up 21% YoY, with roughly 50/50 contributions from net inflows and market returns. This number being above the 13% revenue growth CARE has seen in FY23 gives good visibility for further strong growth in FY24 of at least 8% + any increase from further net inflows or market returns. In wealth, the number of full-ARs was also flat YoY, but a [massive increase in the ASIC adviser levy](#) cost (passed on to advisers) saw this disbursement drive net revenues substantially. Accounting saw mild volume growth of 2% YoY, but a margin decline saw accounting profits down 9%, due predominately to higher wages. There is upside potential of ~12% should accounting margins return to their historic 40%.

In terms of financial targets, I have set targets as discussed earlier in this letter with the assumption of a 50% payout ratio of NPATA (mid-point of managements stated range) and 13% ROIIC for 6.5% EPS growth. During the 2H the group reduced its debt more than it increased its equity, leading to a reduction in capital whereas 2H23 earnings were higher than 2H22, increasing LTM earnings. This negative return on capital, by default is exceeding our target ROIIC, as Warren Buffett has [quoted](#) *"Growth is most positive when it takes no capital at all"*. The dividend was slightly below expected but not an issue.

Financial Targets for Diverger

	Dec-22	Jun-23	Actual	Target
Equity	37.76	38.70	0.94	
Net Debt	1.97	0.72	-1.25	
Capital	39.73	39.42	-0.31	
LTM NPATA	3.83	4.70	0.87	
ROIC	9.7%	11.9%	-279%	> 13%
Payout		2.07	44%	50%

Overall, results were broadly in line with my expectations, but beyond our targeted returns with LTM NPATA growing 22.7% vs the 1H of 2023 with reduced invested capital, along with a declared dividend 3.6% of our cost base. With run-rate EPS of 13.2c Diverger trades at 6.5x our cost base.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

AF Legal (ASX:AFL)

On the final day of the month, AF Legal reported their results for the full year, which given the change in management in the 1H, really was a tale of 2 halves. This is particularly noticeable when you look at the financial results. Revenue for the full year was $18.9m, with 53% coming in the 2nd half, whereas net profit before tax was $0.16m, with $0.62m in the 2nd half and ($0.46m) in the 1st half.

Financial Targets for AF Legal

	Dec-22	Jun-23	Actual	Target
LTM Revenue	17.2	18.9	9.8%	> 0%
LTM NPBT	-0.8	0.2		
Margin	-4.7%	0.8%	0.8%	15%
Lockup Days	75	86	86	< 75

Regarding our financial targets, my thesis lies almost entirely on the group reaching what I believe to be feasible profit margins, without sacrificing revenue or working capital efficiency to do so. Growth is but a bonus to the thesis, and I was pleased to see 9.8% of growth on the year, most of which however is attributable to the 51% owned Darwin based Withnalls Lawyers, so it is dilutive to possible profit margins to shareholders. Withnalls also carries more WIP through the courts, and henceforth also is dilutive to working capital. Nevertheless, the growth in the period in my view is enough to offset the decline in lockup efficiency.

The management has also provided an outlook with a focus on continued organic growth, increasing profit margins and robust cash collection. All things which align with what I would like to see, so am a happy shareholder. Our target of a 15% margin is being rapidly approached, with the group collecting a 4.3% margin in Q3 FY23, stepping up to an 8.2% margin in Q4 FY23, of the back of unprofitable 1H figures. On a unit level, employees appear to be returning to historical levels of utilisation, with gross margins showing a noticeable reversal in the 2nd half as shown to the right. Historically the group has operated in the high 40s so it would be nice to see some stability and/or further improvement in employee utilisation.

	1H22	2H22	1H23	2H23
Revenue	8.5	8.5	8.8	10.1
Employees	-4.5	-5.0	-5.5	-5.8
Gross Profit	4.0	3.5	3.4	4.2
GP %	47.5%	41.4%	38.3%	42.0%
Net Profit Before Tax	1.3	-0.4	-0.5	0.6
NPBT %	15.8%	-4.8%	-5.3%	6.2%

Given our profits to date, it seems prudent to reiterate that I remain of the view that the AF Legal business is substantially undervalued, and that at a price of 20c, and enterprise value of 17.5c, simply annualising the Q4 profitability of the group would equate to an earnings yield of 9%, but I still see the prospect of near doubled profit margins in the short to medium term. I remain comfortable in our holding and seek no compulsion to replace it any time soon.

Sequioa Financial Group (ASX:SEQ)

Early in the month, given the weakness in the share price I chose to trim Prime slightly in favour for adding to Sequoia. This decision was done based on a perceived gap in potential IRR from each investment with Prime at ~10x PE and Sequoia at what I deemed to be ~4x PE (Both on an Enterprise Value basis) and weightings which I felt were too similar given this disparity in valuation.

The group reported on the final day of the month, and to be frank the operating results were not good at all. However, they did receive the final tranche of the Morrison Securities divestment, closing that door at the very least. Now with $40m in cash on a $73m market cap, the market is valuing the continuing business at $33m. To approximate the economic earnings power of this business, we can do some adjustments to the financial results (shown to the right). Working back and ignoring certain management normalisations such as the decline in structured products, I approximate NPATA of $3.7m for the year, which would equate to 9x EV/NPATA.

Continuing business

Description	FY23
Loss before tax	-2.5
Argent Insurance Brokers Consideration	1.5
Impairment of Intangibles	1.7
Amortisation	2.2
Share Portfolio Unrealised	0.7
Payment of Insurance Remediation	1.6
Adjusted NPBTA	5.2
Statutory Tax (30%)	-1.6
Adjusted NPATA	**3.7**
FY2022 NPATA (Exc. Morrison)	**5.4**
YoY Change	**-32%**

Furthermore, during the year due to the decline in structured products revenue (which receives cash up front, and revenue is recognised over time), there was a significant working capital outflow. If the structured products revenue grows once more, there should be a rather substantial working capital inflow, so the cash flow statement looks atrocious this year, but it is largely due to that.

Financial Targets for Sequoia Financial

	Dec-22	Jun-23	Actual	Target
Equity	47.2	43.0	-4.2	
Net Debt	-15.2	-16.0	-0.8	
Capital	32.00	27.0	-5.0	
LTM NPATA	5.30	3.9	-1.4	
ROIC	16.5%	14.0%		> 12%
Payout		2.2	56%	>70%

Regarding our financial targets, I have removed the insurance remediation from the above, but added back $1.3m for the Discontinued profit of Morrisons to reach full year NPATA of $3.9m. Due to the loss for the year, and the various non-cash effects, both the equity and the profitability are down, the net effect of which is dilutive to ROIC, leading to a miss of our target return. The group didn't declare a final dividend, leaving the payout ratio less than we would of hoped as well. But given the intent of a special dividend that is 11% of our cost base later this year, and the board has reinforced FY24 budget NPATA of $7m and that the special dividend is consistent with an ordinary go forward dividend.

Of all reports this month, Sequoia would have to be the most frustrating given the home run that was the Morrison sale. Thankfully, the stock still looks cheap even on my adjusted and the companies' budgeted earnings, I am hopeful of a rather strong recovery and good capital allocation in the year to come.

Email: Tristan.waine@outlook.com

Phone: +61 426 026 928

Hurdle Rate Unit Trust

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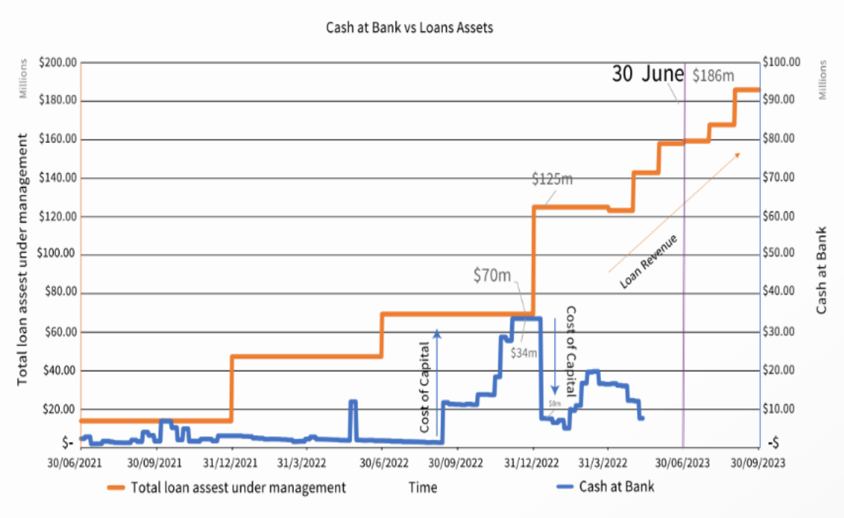
Finexia Financial Group (ASX:FNX)

Finexia is a new purchase this month, of which you can read a single page thesis of here. Assuming you've read that thesis I will spare you the details. Finexia reported this month with +35.4% revenue and -16.7% earnings per share, largely driven by a rights issue made during the year from which we have a part-year of income along with the favourable recognition of tax losses in the prior year which are now exhausted. On a profit before tax basis, the group grew +12.1% from the prior period. Interestingly, Finexia announced its inaugural dividend as $0.02 per share, 25% of the year's net profit after tax, but 6.7% of our cost basis and 8.9% including franking credits. Perhaps even more interesting is that the group generated $0.08 in EPS for the year, whereas the valuation we purchased the business on was a market price of $0.30 and enterprise value per share of $0.16, or about 4x and 2x EPS respectively. With a valuation like this you'd expect the business to be a chronic value destroyer, but in recent years the group has generated returns on its equity of 25%, 47% and 29% in each of the last 3 years. The dividend policy for me was the tipping point.



In saying that, in line with our trust requirements of >15% hold return (EPS Growth + dividend yield), we are demanding 5% EPS growth from a 2/3 retention rate, or a ROIIC of >7% p.a. This appears to be more than achievable given returns in recent years and the prospect for further increased dividends due to majority of the AUM growth in the FY23 year occurring in the final months of the period (as shown to the right), embedding a lot of implied net interest margin into the FY24 year, which in simple terms should lead to a very strong FY24 growth rate as well. With these targets in place, and its miniscule valuation multiple, I view the hurdle rate is easily achievable should the business maintain its current performance and growth trajectory.

Finexia Financial Targets

	Jun-23	Target
Equity	16.7	
Net Debt	-6.8	
Capital	9.9	
LTM NPAT	3.2	
ROIC	32.5%	> 7%
Payout		> 30%

Special Situations

During the month I participated in 2 unique investment opportunities outside of the trust. Whilst 100% of my investable equity is inside the trust, I retain empty brokerage accounts outside of the trust. With emergency savings and an interest free credit card facility, I funded both a tender offer from Trinet (NYSE:TNET) and split-off between Johnson & Johnson (NYSE:JNJ) and Kenvue (NYSE:KVUE) of which I bought an odd-lot sized position in both. These generated returns of +3.7% (+78% IRR) and +9.7% (+1,588% IRR) respectively. I have put single page theses for both in the thesis section of the document.

These are appealing as they provide a unique opportunity for smaller investors due to the preferential treatment of odd-lot holdings and provide a known timeframe, making them particularly appealing to conduct with credit cards, as I have a 55-day interest free period, leading to the retention of both interest-bearing assets and exploit of non-interest-bearing liabilities, an ideal way to juice household income in my view. The reason I'm mentioning this is not to boast, but to talk about the prospect of incorporating this into the trust, without having to sell our core holdings. The idea came across from this Substack post where the author mentions:

> *"While this idea won't make anyone wealthy, we appreciate these opportunities as a chance for EPC to offset some or all of our clients' management fees and trading costs, depending on the account size."*

I really liked this perspective, as a way of offsetting the trust's minimal operating costs and part of the performance fees it may be worthwhile investigating forms of low/no-cost finance in order to generate consistent cash flows from special situations in addition to those generated by our core holdings, ideally with the grand goal of offsetting part if not all of our fees (an odd-lot in both of these opportunities alone would of contributed +1.03% to our opening NAV for the month), although that would be more difficult as we scaled in size, requiring not only increased financing facility, but also additional accounts to purchase multiple odd-lot sized positions for example.

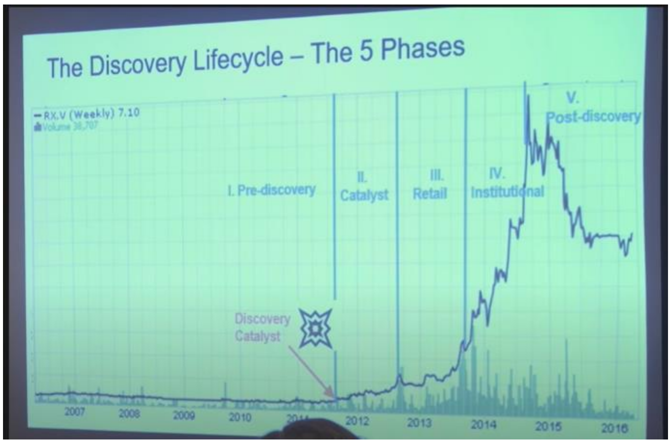
To enable consistent flow of ideas in this area, I have purchased an annual subscription in Special Situation Investments (SSI) (0.05% of NAV), a website dedicated to sharing special situation ideas. The cost has been paid by me and will be reimbursed with part of next month's cash dividends. Rest assured I am fully expecting this investment to pay itself off multiple times over, and I will be loaning my own money into the trust to do so for the time being (until we find the trust's own finance). We are looking for consistently low risk ideas so it is unlikely that I would take speculative options, but every and all odd-lot tender offer or split-off ideas are fair game, and any particularly appealing liquidations, merger arbitrage or option strategies. Basically, anything that a) has a defined time span and b) is low risk, utilising derivatives wherever it makes sense to do so.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

Opportunistic Tail

The idea of incorporating a tail end weighting of the trust has also been floating around in my mind, whereby I maintain a core of 6-8 positions at ~80% of the trust and a longer tail end of up to 10 ideas accounting for the final ~20% of the trust. Such things that would suit this are multi-month special situations that could not be financed as discussed above or unique ideas in my circle of competence which may not carry the conviction of a core position and could eventually be elevated to the core.

Furthermore, by having additional positions, it would allow us to access more leverage on Interactive brokers if we would want to use it for special situations. If I was to implement this, I would do so via. allocating incremental cash dividends and inflows rather than crystallising our investments to avoid unnecessary CGT.



Along these lines, after listening to the X spaces with successful micro-cap investor Paul Andreola this month I am thinking much more about the prospect of incremental 'discovery' in my portfolio and would like to plant some seeds on the earlier spectrum of discovery (Shown to the right) that have some early but fundamental strength in their business.

The largest returns are available at the pre-discovery and catalyst stage of the process. Given its sky-high multiple I have decided to trim Kelly Partners down to a smaller sized position (~5%) in favour of much cheaper undiscovered businesses. I still maintain a strong belief in its future success, but I believe that I captured the best possible returns in my 2019-2022 holding period where it was executing not only fundamentally but saw itself go from pre-discovery to institutional shareholding in its largest shareholder.

Yours sincerely,

Tristan Waine

Sole Director of the Trustee of the Hurdle Rate Unit Trust

Phone – +61 426 928 026

Email – Tristan.waine@outlook.com

Hurdle Rate Unit Trust

**Last Updated – 1 October 2023*

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August 2023 - Finexia Financial Group (ASX:FNX)

Finexia Financial Group is a diversified financial services business in Australia. It operates in 3 key service lines, Private Credit, Equity Capital Markets, and Funds management. The business was founded in 2014 by its current CEO Neil Sheather before conducting a reverse takeover arrangement with Natural Fuels in 2015 to list its business on the ASX. From here it acquired the Hong Kong listed Mejority Securities, who subsequently sold its HK service line and obtained an Australian financial services licence (AFSL) to provide a variety of financial services to retail and wholesale investors. Since this time, the group has conducted several bolt-on acquisitions in equity markets and professional services, before a transformational acquisition in 2020 of Creative Capital & another of StayCo in 2022 through a rights-issue.

I have been reading announcements from this business for about 14 months now, with the first being the group's announcement of its [2022 financial guidance](#). Within this release I saw a rather impressive FY2022 guidance of $3.8m EBIT, which at the time would be equivalent to a pre-tax yield of about 40% of its market capitalisation. Today the price is the same, but the group just booked $4.3m of PBT for the FY2023 year, despite a delay in some loan settlements pushed into the FY2024 year. But perhaps, of the most interest to me, and why I only took a position now, was the implementation of a dividend policy for the group of ~1/3 of its net profit after tax along with the recruitment of the Sequoia financial group founder Scott Beeton to charge distribution to dealer groups. I view these 2 factors as hugely beneficial for the investment case and think that with this and the growth in private credit will lead to rapidly growing earnings and its loan book in the near future.

To speak further on the group's service lines, it draws the lion's share of its current profitability from the Equity Capital Markets division, which is the legacy business, helping businesses with equity finance, stockbroking etc. There is also a small component of SMSF administration in this service line. Predominately, this business is high margin and accounting profit is closely aligned to cash flow however, it is heavily exposed to the level of activity it experiences in both share trading volume and corporate advisory activity.

Private Credit represents its creative capital acquisition done in 2020. This business is in essence a lending business, with expertise across various forms of alternative financing, but with some 50% of their financing being exposed to residential development and a further 30% to Industrial property. This no doubt sounds quite risky, however, as per the group's FY2023 guidance the LVR of this division is 45%, and typically these loans have a term of just 12-24 months. Per its most recent figures this division has a $28m loan book with 11.17% borrower rate. The group generates a net interest margin on this of consistently above 5% p.a. The primary risk for Finexia in my view is that the bulk of it's lending activities across private credit and funds management are unlisted in nature, thereby not requiring frequent valuations. Whilst their current LVR's are low of 45-60%, it is possible that with the revaluation of the underlying assets that these LVR's are lower than initially intended and that fund investors, could see their capital impaired if they seek short term redemptions.

Family Income	Current CCS%	New CCS % from July 2023
$70,000	85.0%	90.0%
$80,000	82.5%	90.0%
$90,000	79.2%	88.0%
$100,000	75.8%	86.0%
$120,000	69.2%	82.0%
$140,000	62.5%	78.0%
$160,000	55.8%	74.0%
$180,000	50.0%	70.0%
$200,000	50.0%	66.0%
$220,000	50.0%	62.0%
$240,000	50.0%	58.0%
$260,000	48.9%	54.0%
$280,000	42.3%	50.0%
$300,000	35.6%	46.0%
$350,000	20.0%	36.0%
$400,000	0.0%	26.0%
$450,000	0.0%	16.0%
$500,000	0.0%	6.0%
$530,000	0.0%	0.0%

Last but certainly not least, the groups funds management arm is by far the most important part, with the group acquiring the Stay Company Income Fund late last year, launching the Finexia Childcare income fund and the Prime Asset Backed Lending. This division has seen the size of the loan book dramatically grow in recent times, with the Childcare Loan book in particular growing from $11.5m in March 2023 to a forecast of $69m in September 2023. Given its borrowing rate of 13.9% and its monthly distributions, the group has seen strong interest from investors seeking yield. There are several articles on their flagship Childcare fund which point to [strong structural tailwinds in the childcare sector](#).. Furthermore, of the listed childcare centre operators, they have predominately been highly leveraged vehicles, which may support the banks hesitancy to lend, and detract from the Childcare lending thesis that Finexia is relying on. Finexia needs to ensure that these loans are properly secured by real assets and strong cash flow generating potential. Thankfully, there is strong government support in this sector including the [cheaper child care bill](#) which just passed senate, which is aimed at subsidising child care fees for families and allowing discounts for staff, which indirectly will support volume to generate enough revenue to cover fixed costs and lending expenses.

The Stay Company Income fund (StayCo) operates several properties across southeast Queensland. This business is interesting as StayCo purchases rights to operating the letting business of individual rooms under its own brand, of which have a weighted average term of 19.5 years. These properties include some of the largest apartment blocks on the gold coast including Bel Air & Ivory Palms among others. Importantly, StacyCo does not hold material ownership in any of the properties in its portfolio. This strategic decision allows the company to control a portfolio of quality real estate assets with relatively low upfront and ongoing capital commitments. StayCo seeks to enhance its management interest in properties by strategically acquiring freehold ownership in certain areas (such as lobbies, restaurants, conference rooms). AUM has grown significantly since it's launch in the group generating FY23 revenue of $12.2m and is [expected to generate >$16m in FY24](#).

My investment into Finexia is the first of several smaller sized opportunistic allocations which aims to focus on opportunities which may not qualify for a primary sized position, and with reservations around Finexia's service lines, I felt that small sizing was appropriate, however, at a FY2023 Price/Earnings ratio of just 4.5x (2.4x including net cash), a fully franked gross dividend yield of 9.5%, and what appears to be a lot of embedded net interest margin (evident by the massively increased loan book in the 2H), Finexia appears to fundamentally represent a metaphorical home run should risks not materialise.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

Hurdle Rate Unit Trust

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August 2023 - Trinet Group (NYSE:TNET)

(This was not an investment made by the Hurdle Rate Unit Trust, please refer to the August 2023 Letter for more information)

On the 31 July 2023 Trinet announced its intention to launch a $1 billion fixed price tender offer at $107 per share in cash. As Trinet is on my watchlist of >200 companies I received this news via. email and was instantly interested in it.

Within this announcement the group included a priority allocation for "odd lot" holders of <100 shares, by and large ensuring that they would not be subject to proration on the implementation of the offer, or in other words, they would receive consideration for 100% of their holding. Furthermore, the offer document highlighted the key dates as being an August 28, 2023, expiration date and a September 13, 2023 repurchase date.

The primary risk was that the offer was dependent on the receipt of financing which I was highly confident they would be able to achieve and it was announced on the 17 August, 2023 that the financing condition was to be waived and henceforth the Tender Offer was amended to remove this as shown below. This all but guaranteed the implementation of the repurchase agreement.

Moving on to the trade itself, I did not undertake this within the Hurdle Rate Unit Trust, but did so using interest-free credit card debt (Using the Citi Payall feature which effectively allows for a free cash advance) and my personal brokerage account. However, it was discussed in the August letter that I intend to do more of this in the Hurdle Rate Unit Trust going forward. Fortunately, my initial purchase was on the 10 August 2023 at $104.70 before subsequently selling at $106.42 on the 14 August 2023 to do the JNJ/KVUE Split-off (More on this below) transaction. Once completed I repurchased Trinet on the 25 August 2023 (one day before offer expiry) at a price of $105.71. This double dip made my effective purchase price $103.99 per share, resulting in a +2.9%, or AUD +3.7% / $586.30 in profit per odd-lot holding (You can purchase odd-lots in multiple accounts for additional profits) for a 24-day holding period, an annualised return of +54.3% p.a.

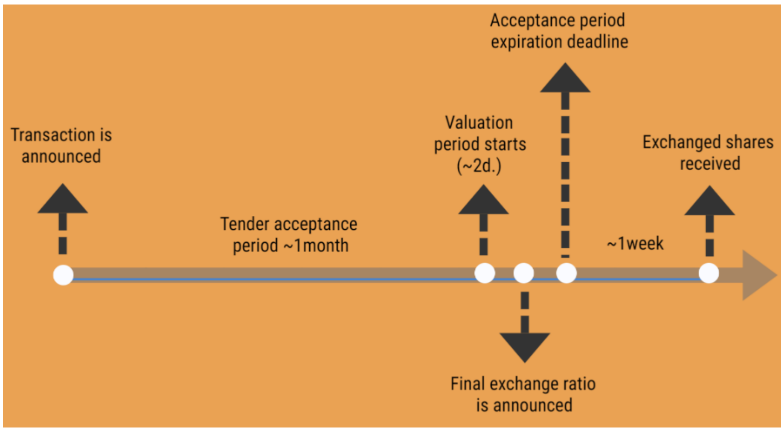
August 2023 - Johnson & Johnson (NYSE:JNJ)

(This was not an investment made by the Hurdle Rate Unit Trust, please refer to the August 2023 Letter for more information)

This investment was made aware to me by this Substack post by Eagle Point Capital, which provided a great overview of the thesis in and of itself so I suggest giving that a read.

On July 24 2024 Johnson & Johnson (J&J) launched an exchange offer for its Kenvue (NYSE:KVUE) holding, of which it had held 100% of the company up until it's decision to spin it off in an IPO in May 2023 where it sold 10% of it's shareholding. This exchange offer represents an additional 80% of the Kenvue business being sold in consideration for a large scale repurchase of its own common stock.

The specifics of a deal were an initial implied value of $107.53 per $100 worth of J&J shares held by the shareholder with once again, an 'odd lot' priority provision which allowed us to purchase 99 shares without the highly likely chance of proration occurring. However, this was subject to a maximum 'exchange ratio' of 8.0549 shares of Kenvue per J&J share, making it riskier the earlier you bought before the finalisation of the exchange ratio. Thankfully, the final exchange ratio was 8.0215, below the upper limit, affording us the best possible outcome. The process is shown below.



So, the primary risks to the investment were related to the price movement of both J&J and Kenvue along with the movement of the AUDUSD. However, there was a further factor which was working in our favour, the imminent inclusion of Kenvue in the S&P500 on the closure of the exchange offer. According to Barron's, approximately 300 million Kenvue shares (~15% of the float) could be purchased by S&P 500 index funds required to hold all the index's constituents in short order. This and some ~93m shares in Kenvue short interest to take advantage of the arbitrage opportunity that was the exchange offer gave me strong confidence that it was unlikely Kenvue shares would fall further after being allotted. Low and behold on the finalisation of the exchange offer on the 24 August 2023, Kenvue shares had 370 million trading volume and saw it's share price close slightly higher in the day, allowing me to sell at a favourable share price.

So, in summary, I ended up purchasing my J&J shares at $173.22 per share and selling my Kenvue shares at $23.20 per share, plus being eligible for the payment of a $0.20 Kenvue dividend, a profit of +8.51% in a 12-day holding period, made sweeter by favourable AUDUSD exchange rate movement which resulted in a base currency return of +9.74% / AUD $2,570.49 per odd-lot, an annualised return of 1,599% p.a.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

Hurdle Rate Unit Trust

**Last Updated – 1 October 2023*

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July 2023 - Letter

Dear Unitholders,

This month the NAV of the Hurdle Rate Unit Trust **increased in value by 2.75**% to a unit price of **$1.0487**. Including performance fees, the **Net return during the month was an increase of 2.07%.** An additional $75,000 was also received from 4 new unitholders this month. Thank you for partnering with the Hurdle Rate Unit Trust.

Something important to note is that the Hurdle Rate Unit Trust is NOT a managed investment scheme and rather is classified as a '[small scale offering]' (SSO), as a result is not required to issue a product disclosure statement to prospective investors. To retain this freedom, our trust is not allowed to have >19 Unitholders with >$2m cumulative investment in any rolling 12-month period. For regulatory purposes, an investor that counts towards the count also includes 'beneficial owners' such as beneficiaries of a trust or shareholders of a company. These are counted as several unitholders; such is the case for some of you with family trusts and SMSF's. Given this threshold, it is appropriate to disclose now and ongoing that we have 12 used (Not including myself as trustee) and 7 free slots for prospective unitholders along with $1,805,000 remaining of the $2,000,000 threshold. It is my intention that once we reach the cap, further unitholders will have to materially out-invest the smallest beneficial owners of the trust to be admitted as a replacement unitholder. Furthermore, I believe that we are not allowed to have >19 Unitholders apply in total, so we will not be able to replace until the first unitholders have been within the unit trust for 12-months. Caps will be reported on the left to ensure ongoing compliance.

Something else I wanted to touch on was the specifics of how the Trust's performance fees work. As specified previously, the fees are levied when the Trust generates an ROI of 6% on an annual basis. To administer this, it is applied monthly as is the cycle of applications and withdrawals. This means the rate is converted to a daily rate and then applied based on the days in the month.

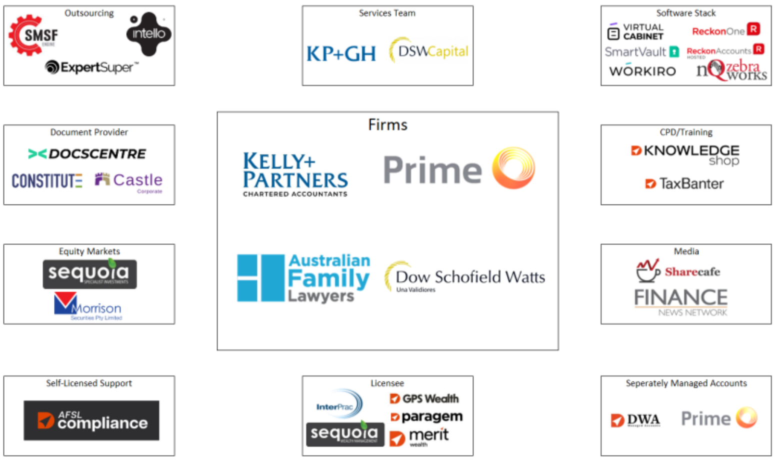
To illustrate this at the end of June someone who has invested an initial $10,000 as of 31 May 2023 has a threshold of $10,048.01 which is $10,000 compounded at 0.01597% (rounded to 5 Dec) for 30 days. Compounding at this rate for 365 days will get you to $10,600, which is a return of 6%, consistent with the trust's fee threshold.

The value of a $10,000 investment made on 31 May 2023 excluding the impact of performance fees on June 30, 2023, is $10,207.45. This is $159.44 above the $10,048.01 calculated above. As such 25% of $159.44 is the accrued incentive fee, or $39.86. Lastly, this is then converted to units using the month closing price of $1.0207, which resulted in a transfer of 39.0503 units from the unitholder to the trustee. This is repeated monthly.

I have also simplified the Hurdle Rate Substack. I have ceased the weekly one-page stock pitch and monthly deep dive in favour for a variable schedule of deep dives with an executive summary. Lastly, I have also combined the portfolio update with these letters, so I will be writing more about portfolio positions within these letters as a result. As noted in the previous month, the hurdle rate for the trust is an aspirational return of >25% before fees for each investment made. Furthermore, we want >15% from Dividends and EPS Growth alone, leaving 10% or less from market factors. Given this goal, I wanted a way to report this so I will be dedicating a table for this going forward, shown below the performance table.

You'll see quite a strong contribution from EPS Growth this month, which is worth touching on. The metric I'm using for this is statutory EPS. In many cases there are factors impacting EPS, which in this month includes predominately DSW Capital's lack of IPO costs, causing them to jump into statutory profitability. I intend to maintain consistency by using the accounting earnings per share for each business. The average statutory multiple of EPS we have paid to date is ~24x PE, but on an earnings power basis I am estimating more like ~10x PE, which should lead to elevated statutory results as the earnings normalise, but over time it should smooth out any anomalies in year-to-year EPS.

Portfolio Diversity by Area



To demonstrate my commitment to remaining firmly within a circle of competency that involves professional services firms and their respective suppliers, I have compiled the below chart to show each individual service offering of all our companies. There is no doubt some overlap which is predominately contained to licensee services with little overlap elsewhere. This doesn't necessarily matter too much as you will see below licensees aren't driving much of our results.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

In terms of profit-pools, on a portfolio basis in terms of Net profit after tax (NPAT) margin I estimate a weighted (Using market value to account for differences in valuation multiples) margin of 13.1% portfolio wide with the following ranking in contribution:

1. 27.7% of NPAT = Firms
2. 27.5% of NPAT = Software
3. 13.0% of NPAT = Services
4. 7.4% of NPAT = Separately Managed Accounts
5. 6.1% of NPAT = Licensees
6. 5.6% of NPAT = CPD/Training
7. 5.6% of NPAT = SMSF Outsourcing
8. 2.7% of NPAT = Legal Documents
9. 2.7% of NPAT = Equity Markets
10. 1.0% of NPAT = Financial Media
11. 0.7% of NPAT = Self-Licensing

So clearly, a few key takeaways for me are that the most lucrative areas in terms of quality of earnings are without a doubt software, training, SMAs and services with the least being licensees and equity markets which rely heavily on volume.

Diverger (ASX:DVR)

Diverger started out the month with an announcement detailing a new partial vertical acquisition into a financial advice firm (ASPW) for $2.37m. For this, Diverger is expecting a first year EBITA contribution of $0.33m, an EV/EBITA multiple of 7.2x. ASPW is a firm under the Paragem AFSL, which consists only of unrestricted financial advisers. Founded originally by Steve Atkinson in 1993, this transaction looks to supersede Steve with long-time employee David Saynor, who originally purchased a partial stake in the firm in 2017. David not only can provide financial advice, but also is accredited by the SMSF association of Australia allowing SMSF related advice. Beyond David, there appears to be 2 paraplanners and 2 admin staff in the firm.

More broadly, it was specifically noted that they are making strong progress in their M&A endeavours and have acquired more than $1.3m EBITA in the past 12 months. My own analysis indicates that they paid an average EV/EBITA of ~6x using initially announced EBITA of $1.53m, however it appears that they are using a lower EBITA number in the most recent announcement. Their FY25 target is to acquire $1.5-2.1m of EBITA, meaning they are just short of the lower band 1 year in. They also provided reaffirmation of a highly improved 2H for FY23, consistent with comments made on release of 1H results stating that there would be a 2H earnings skew and flat underlying earnings relative to FY22. This would be an impressive result given that the 2H requires 62% higher EBITA and 93% higher EPS just to get a breakeven result for the full year.

Sequoia Financial Group (ASX:SEQ)

Sequoia announced the acquisition of Castle Corporate and Castle Legal. Castle Corporate, like several other subsidiaries Sequoia owns assists accountants, financial advisers, and lawyers with entity formation. Castle Legal partners with the corporate business to ensure documents are up to date with regulations and provide more nuanced commercial advice with regards to business structuring. The Castle business has been operating for 31 years under the direction of its founder, Jenny Hamley, who will join the professional services division on closure of the deal. Consideration is up to a total of $3.15m, with $1.8m paid in cash upfront along with the issuance of 200,000 SEQ shares. The balance is paid in cash via 2 tranches after 12- and 24-month milestones, contingent on undisclosed performance hurdles. With $0.8m in EBITDA, this values Castle at an appealing upfront multiple of just 2.4x EBITDA upfront with a further 1.6x EBITDA on contingent terms for a total of 4x EBITDA.

Speaking of Diverger and Sequoia, having spoken to Garry previously, In light of the divestment I asked a very relevant question:

Q: *If you had unlimited capital- what initiatives would you take on that you are currently not able to?*

A: *Buy Diverger and Countplus*

Given that we own both these Sequoia and Diverger, I had thought about what the outcome could potentially look like. In my view shareholders wouldn't vote through a deal unless it was at a 'material' premium to the offer price. If I was to entertain an offer price of $1.20 per share, paid all in cash, it would equate to a +50% capital gain on our DVR cost basis, but we would benefit from what I potentially believe to be as a greater combined dividend policy, given DVR intention to pay 50% as opposed to SEQ 70%+. Therefore, we would benefit from freeing up ~25% of our account for reinvestment and only a minor impact to our total dividends. For purely illustrative purposes, were I to reinvest the proceeds into Sequoia shares, Our Portfolio Dividends would increase from an estimated $18,119 to $29,233, a change in yield from 5.8% to 9.4% of NAV.

Kelly Partners (ASX:KPG)

For those unaware, I up until recently (December 2022) was an accountant in the Kelly Partners Wollongong office over a time span of 2 years, and furthermore was a shareholder from October 2019 through to December 2022 (Which you will note was longer than my employment). I feel that Kelly Partners is the single business which I feel qualified to say I have an informational edge on because of relationships and experience formed across my employment. Despite its optically expensive valuation. The primary reasoning was hidden in one of the group's recurring dividend announcements where they quote:

"*The company notes that the current dividend policy will be subject to review in the next 6-12 months as the company considers moving to a no dividend policy as part of a process of determining it's optimal capital allocation".*

This was music to my ears as the primary reasoning for me selling last year was due to its demanding valuation and international intentions. With what is likely to be $110m in revenue and $11m in net profit in FY2024, with an enterprise value of $240m, the group is valued at ~22x 2024E earnings. But cutting the dividend, and the M&A pricing unit economics outlined in this post, should afford the group the ability to grow their earnings at sustained high rates (>25%) for some time to come. Given the lack of dividends returns will be better to most of you net of tax, as such the group hits our hurdles from earnings growth and deserves at least some capital.

AF Legal (ASX:AFL)

AF Legal put up its 2nd month of significant contribution to our results in terms of share price increase. More importantly, the group announced a swathe of senior executive movements which in my view, further improves the quality of the management team. The most important changes are that Chris McFadden has moved into a group CEO role (from CFO/COO), Stace Boardman has been clutched back from a prior notice of resignation to be retained as CFO/COO, and Grant Dearlove is remaining on, but taking an important step back from operations.

DSW Capital (LSE:DSW)

DSW Capital released its full year audited report. As we know from May's trading update, Network revenue is flat at £18.3m and adjusted pre-tax profit (Company defined) is down 30% to £1.4m. On the bright side, cash conversion was strong with licensee lockup days falling to 27 days from 30 days (appealing Q4 comparative), fee earners grew to 97 (+10%), and they announced the acquisition of license fees from a 10 Fee earner Insolvency firm called 'Bridgewood' in a new geography. This is an excellent move as it runs contrary to the economically exposed corporate finance business, counterbalancing revenue.

Primarily, the decline in profits is from a reduction in Revenue/Fee earner down to £193k from £227k (-15%), which given the flat parent revenue and 10% growth in headcount, must have therefore come from licensees with a lower than average % revenue share to boost the average rate of realisation, which is the legacy corporate finance business. As a result of a change in business mix the average share of revenue moved from 16.9% (13.8% License fee + 3.1% Profit share) the year before to 16.6% (14.0% License fee + 2.6% Profit share). What's important to note here is that the group remained profitable in 2H with ~£450k in net profits in the 2H (After adding back the growth share expense), despite Revenue/FE in the 2H amounting to ~£78k, which at consistent license fees indicates that the group could operate profitably with >30% NPAT margins even at the lowest levels of Revenue/FE they have seen in the past decade of ~£156k per fee earner. In an ordinary year I would expect them to generate ~50% profit margins on the license fee and profit share income, equivalent to ~8-10% of Network Revenue.

Regarding cost growth, DSW has invested heavily in its corporate team, not too dissimilar to the additional investments that Kelly Partners makes in its corporate team, having hired a Talent and Resource Manager, a Strategic Projects Director, marketing executive and office administrator. In the current year a senior IT resource has also joined the central office. Furthermore, it was flagged that a potential £0.144m License fee could be lost in from December 2024 due to PHD acquiring the trademark from DSW Capital for £1. Given this is in relation to a trademark, presumably this drops directly to the bottom line and hence will also highly impact net profits.

The Insolvency firm mentioned earlier is structured as a license fee acquisition, which unlike a merger, does not result in a change in control. Rather what DSW is doing is providing an interest bearing and repayable loan of £880k to 2 existing younger partners to buy out the succeeding founders equity, in addition to which the business has agreed to sign a term of agreement for DSW to provide centralised support services in return for a license fee. Lastly, a minimum return has been guaranteed of £130k per annum for the next 3 years, which given the interest on the loan, tailwinds to insolvency and the 10 fee earners joining the DSW network, appears to be a low amount and should easily be outperformed.

With M&A activity remaining supressed going into the start of the FY2024, the group remains cautious about its expectations for FY24 results, but that does not stop their strong recruitment drive, having signed two new licensed businesses since the year end. The trust's first dividend was declared with the ex-dividend date being the 14 September 2023 and the amount of 2p per share will convert to A$978 at today's foreign exchange rate (3.3% of our DSW cost basis). I remain highly confident about DSW Capital's prospects for the medium to long term.

Later in the month I spoke to James Dow (Founder) which was insightful with some revealing answers such as avoiding network contagion due to the variability of license fees, James' succession plan, Bridgewood and international expansion.

Conclusion and Final remarks

Our performance has been pleasing to say the least, but what is humorous is that the best performer was the lowest conviction holding and worst performer the highest conviction. Given that AF Legal is our lowest conviction holding, it is entirely possibly, that if it should continue to be forced up by market participants, that it may reach or exceed our estimate of intrinsic value and we will consider selling in favour of alternatives. To be fair, there is still a large gap between the market price and our estimate, so I have no immediate pressure to do anything. Sequoia Financial as our highest conviction holding will be reporting results in August. Given the imminent receipt of the final tranche of the Morrison divestment, I am very much looking forward to what they intend to declare as a dividend, along with and if any intentions for the cash balance they now have.

This brings the July letter to a close, which I apologise if it was too long. I suspect with 6/8 of our portfolio companies reporting next month in ASX reporting season, that there will be a lot to talk about next month as well. Pleasingly, I am having a lot of fun and have passion for the hunt of attractive investment opportunities, it is my hope that this continues to translate into brilliant long-term return for the unitholders of the Hurdle Rate Unit Trust. As a reminder, you can apply for more units at any time.

Yours sincerely,

Tristan Waine

Sole Director of the Trustee of the Hurdle Rate Unit Trust

Phone – +61 426 928 026

Email – Tristan.waine@outlook.com

Hurdle Rate Unit Trust

**Last Updated – 1 October 2023*
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July 2023 - Kelly Partners Group Holdings (ASX: KPG)

Kelly Partners Group Holdings is a listed parent company which owns a majority stake (Typically 51%) in many accounting firms across the east coast of Australia. These accounting firms predominately engage their small and medium business clients with accounting services on an ongoing basis. This includes compliance with both federal and state tax obligations along with managing permanent documentation as corporate messenger. In addition to this core function, complimentary service lines are offered to clientele such as wholesale wealth services, insurance/mortgage broking and even wholesale investment.

This operation was founded in 2006 by none other than current CEO and significant shareholder Brett Kelly. Brett was born in Sydney in 1974, who after high school went on to complete a bachelor in business and masters in tax, as well as being admitted as a CA. His employment commenced at PWC for 5 years before a brief role in corporate finance at Schroders before starting Kelly Partners in 2006 with 2 other partners. From here the business has grown its top line from $1.2m in the first year to what it is today. As of 30 June 2023, the group generated $86.5m in LTM revenue and has 32 offices with 78 Equity partners (Those with a minority stake in the underlying partnerships) servicing c.19,000 client groups.

For added complexity, the group engages in frequent acquisitions to grow with a stellar track record in making them work, uncharacteristic of the many companies that have attempted similar consolidation with no success. What makes Kelly Partners different is a focused approach, exercising caution on people, structure, and price. Deals are structured utilising a partnership agreement, isolating risk to the parent by using a wholly owned special purpose vehicle to hold the equity interest in that partnership (otherwise called 'ring-fencing'). From here, the partnership takes on any necessary debt and loans it to the equity partners for them to repay, keeping default risk isolated to that partnership. If you read that carefully, I am implying that the listed parent entity utilises no equity to enact any acquisitions, instead paying off its share of the partnership debt using incremental partnership distributions from the newly created partnership. Another benefit of using a partnership structure is that it is not a separate legal entity that benefits from the so-called veil of incorporation. Therefore, partners have unlimited liability and are all liable for each other's share of the debt that is within the partnership, this has the benefit of partners that take on an equity loan working extremely hard to at least pay off the loan, which benefits the parent entity significantly. Before we can discuss M&A metrics, we need to understand firm unit economics and capital intensity.

Revenue	100%
Fee Earner Wages	(35%)
Admin Wages	(5%)
Other Overheads	(10%)
Premises Cost	(10%)
Capital Expenditure	(1%)
Services Fee	(9%)
EBIT Margin	30%

To the left is my estimate of a firm's margin profile. Underlying Firm margins typically adhere to the mantra of 1/3 direct costs, 1/3 overheads and 1/3 profit with EBIT margins of ~30% in any given year. Firms tend to run on a time-sheet billing model where hours are accrued in a practice management system when working on a client job, admin related tasks are not billed. Whilst we have assumed admin is 1/8 of total wages, admin staff are paid less and there is likely to be 1 admin head per 5 fee earners. Overhead expenses are any non-parent covered costs (relating to IT, HR, marketing, finance), stationary costs, software subscriptions, and travel in addition to the minimal capital expenditure required by a firm. The services fee is in return for the HR, marketing, finance, IT, and strategic functions performed by the parent entity.

From here any subsidiary level interest is paid before partnership distributions are made. In the event of a firm having paid off its partner loans, the parent entity would take pre-tax profits of ~15%. In an ordinary year this is unencumbered barring statutory tax, but often the parent entity expenses are slightly more than the 9% services fee, causing the parent to dip into partnership profits, In the consolidated financial statements this often confuses investors. Assuming this does not happen, the group pays 30% statutory tax and ends up with a net profit after tax margin of ~10%.

Regarding capital intensity, professional services firms carry just accounts receivable and employee creditors only. Given my prior comment on timesheets, typically unbilled timesheets are carried on the balance sheet as so called "Work-in-Progress" and billed timesheets are accounts receivable as normal. You must be careful with Work-in-Progress as it is possible that large portions of it can expire worthless as a disingenuous recording of time, resulting in a bad debts expense, this is much the same as a retailer having to write down the value of its inventory for various reasons. The sum-total of accounts receivable and work-in-progress is referred to as "Lockup", and often capital intensity of a firm is solely reflected by the number of days it takes lockup to turn, calculated as fee income divided by the average balance of lockup through the period. In this sense, Kelly Partners has excellent focus on minimising lockup, with an internal target of <55 days, relative to peers often carrying closer to 100 days or more.

With unit economics established we can engineer M&A metrics (Shown to the right). To set the stage, Kelly Partners conducts several inorganic growth strategies including greenfield (new office, existing partner), tuck-ins (new partner, existing office) and marquee acquisitions (new partner, new office). These have varying appeal such as greenfield having the lowest start-up cost but needs to be bootstrapped, tuck-ins having shared operational gearing and marquee bringing new geographies and office space. Pricing is typically either based on revenue or EBIT with multiples ranging from 0.8-1.2x revenue or 3.5-4.5x EBIT, with average industry EBIT margins of ~17% and typically a 20-30% retention portion based on earnings being 'maintained'.

	Low Price	High Price
Price/Sales	0.8x	1.2x
KP EBIT %	30.0%	30.0%
Price/EBIT	2.7x	4.0x
Price/NPAT	3.8x	5.7x
Earnings Yield	26.3%	17.5%
Organic Growth	5.0%	5.0%
Working Capital	-0.5%	-0.5%
Unlevered ROIC	30.8%	22.0%

The primary risks associated with the investment in my eyes are clearly that it is more dependant than most on the Founder and CEO Brett Kelly. Should something happen to Brett it would be a significant cause for concern, despite how much mitigation he has done to date. Furthermore, their intention to grow internationally is a massive undertaking and requires multiple moving parts to work in harmony, including funding partners, structuring, and expanding the services team to accommodate entirely different geographies, cultural differences, regulations, resources and so on. As the group scales, it is also dependent on if they can enforce metrics on a partnership level as well as they have to date, deterioration in margins and/or lockup for the average firm is entirely possible when Brett has 150 offices under him as opposed to the current 28.

To wrap things up, with the possible elimination of the existing dividend policy (50-70% payout ratio), there is an opportunity to benefit in full from the extremely compelling M&A economics at play here, with focused management and a lot of white space given international expansion plans, even at an enterprise value of ~22x run-rate earnings ($4.80 Cost) it seems feasible that they can double the size of their business every ~3 years (>25% CAGR) without diluting shareholders for the foreseeable future, therefore meeting our total hurdle rate from earnings growth alone.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

June 2023 - Letter

Dear Unitholders,

Before we begin, I would like to advise you that there is **no distribution coming in respect of FY23**. No realised income has been received yet and we have only paid a minor expense of $220 for the BGL accounting software subscription to date which will be carried forward to offset future income. Besides this, I have covered all the initial setup costs of $1,460 out of pocket, which are not brought to account within the trust given they are not deductible since the trust is not a small business entity.

I managed to allocate all the raised capital from the prior month, and we have closed the financial year with a full portfolio. We have new positions in **Diverger (ASX:DVR), DSW Capital (LSE:DSW), Getbusy (LSE:GETB), Reckon (ASX:RKN)** and **AF Legal (ASX:AFL)**. All these businesses have been covered in detail on the Hurdle Rate Substack, which you should all have complimentary access to by now. If you do not, please contact me and I will sort it out for you. Investments have been made with an implicit “Hurdle Rate” in mind. This is a core tenet of the trust, and it effectively means to swing at only the best priced opportunities and nothing else. For me, it means I must realistically see a pathway to 25% returns annually (before the impact of performance fees).

We also received another vote of confidence with an additional $20,000 from a new unitholder. I would like to welcome you all again and thank you deeply for your commitment to the trust. This month the NAV of the Hurdle Rate Unit Trust **increased in value by 3.61**% to a unit price of **$1.0207**. Including performance fees, the **increase during the month was 3.20%.**

I would like to note that when applicable performance fees are levied by a transfer of units between the unitholder and myself, this is to ensure that each unitholder is treated fairly as a cash withdrawal would impact those unitholders which may have not seem the same performance (based on the timing of their purchase). For tax purposes, it will be treated as an adjustment to your cost base. I will be sending out updated unitholder statements whenever a transfer occurs.

During June there was some pressure on most of our Australian holdings to the notion of ‘tax loss selling’, where investors crystallise companies with a capital loss to offset against capital gains. Our international holdings were free from this tax loss effect with, however a decline in the conversion rate of the AUD/GBP have negatively impacted these in AUD terms. I stress that the variability in performance for our positions will be significant and is the price of admission. Performance ranged from +25% performance from the likes of DSW Capital and AF Legal to -8% performance from Sequoia Financial and Prime Financial, all of which announced nothing to the market. The primary benefit of this volatility is that it will create opportunities to add to and remove from our constituent positions over time. If a strict focus on fundamental value is maintained, I fully expect that the market will reward us over time for good valuation work.

Now that we have a full portfolio, I can outline how I am viewing potential returns for our names based on their cost basis. These are merely estimations of their future trajectory, and the key is to maintain diligence on sourcing high potential opportunities for the trust, if we fall short on any of these we still end up with an excellent result. For further reference the 25% hurdle rate I would like to have >15% from Dividends and EPS Growth alone as valuation is a lot less predictable given the variability in investor sentiment as noted before.

Company	Dividend	EPS Growth	Valuation	Total CAGR
Sequoia Financial Group	9%	20%	9%	38%
Diverger	11%	18%	8%	37%
Prime Financial Group	10%	20%	7%	37%
DSW Capital	6%	9%	10%	25%
Getbusy	0%	15%	10%	25%
Reckon	6%	5%	12%	23%
AF Legal	0%	15%	7%	22%
Portfolio Attributable	**7%**	**16%**	**9%**	**32%**
Weighting	**22%**	**50%**	**28%**	

Historically, through to the end of 2022 my own portfolio has returned a compounded +29% with a ~55% weighting to EPS Growth, ~10% to dividends and ~35% to market pricing net of currency movements. As you can see from the estimates for our current positions above, I am attributing future returns with a much larger skew to dividends, because the yield is much higher than the past investments I have made. As an individual with deeper expertise in these company industries than most, with what I believe to be a top 5% understanding of these businesses I expect my broad estimates to be much more accurate than the average market participant, and that is what gives me the confidence to estimate returns like this.

In the coming weeks going into July there’s a few things I’m looking forward to for the trust including Audited full year results for **DSW Capital (LSE:DSW)** on the 13th of July. August will also be an important month with our ASX companies reporting their full year results. Lastly, **Getbusy (LSE:GETB)** has announced it will release its half-year results on the 5th of September. Rest assured I will provide ample context to my expectations vs what we get in the coming months in these reports and on the Substack.

Yours sincerely,

Tristan Waine

Sole Director of the Trustee of the Hurdle Rate Unit Trust

Phone – +61 426 928 026

Email – Tristan.waine@outlook.com

June 2023 - DSW Capital (LSE:DSW)

DSW Capital is the listed parent company servicing a small UK-listed network of accounting firms, predominately in corporate finance, but also various other service lines including insolvency and business planning etc. The business was established in 2002 by three ex-KPMG partners, James Dow, John Schofield, and Mark Watts who collectively own 37% of the company today. When you include immediate family and business partners that figure is closer to 78%. James is the CEO of the parent, Mark is active in corporate finance, and Jon is acting as a non-executive.

The rationale behind DSW was to disrupt the status quo oligopoly of the big 4 accounting firms by allowing senior staff in those firms the opportunity to leave and start their own business under the DSW brand. With the myriad of corporate failures under the oversight of these firms, there has been countless calls for the firms to restructure, particularly by separation of consulting related service lines from audit services. The co-existence of audit and consulting creates a conflict of interest that starkly contradicts an auditor's requirement to show independence. An example of this includes the KPMG UK restructuring practice being sold to Interpath Advisory where KPMG stated that "an increasing number of conflicts of interest had become too complex and was 'likely limiting' the growth of the firm's restructuring business".

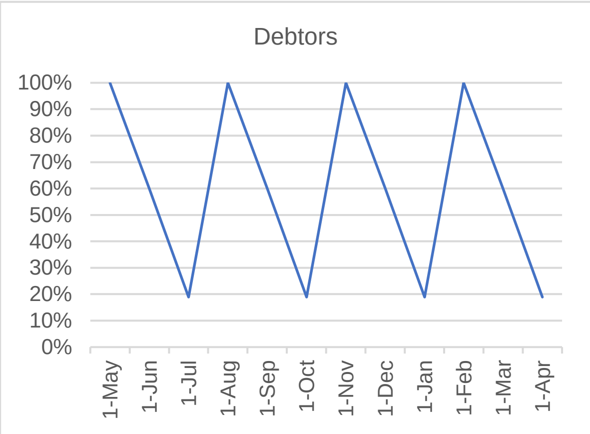
The parent company enters into licensing agreements whereby each licensee business will split a % of their revenues with DSW in return for HR, marketing, finance, and IT. DSW typically enters their license arrangements through lateral hires (individual or teams) by enticing them with funding initial partner drawings of up to £50,000. Additional benefits to being part of the group include both a 5% introduced service line incentive and 10% referral fee commission in addition to the use of an established brand which is now in the UK's top 50 accounting firms. The group's global M&A network "Pandea Global" also provides a good platform for inbound M&A search from global sources.

	5y Average	2023	2022	2021	2020	2019
License Fees	**13.6%**	13.9%	13.8%	14.6%	12.6%	11.9%
Profit Share	**0.7%**	0.9%	0.8%	0.7%	0.4%	0.7%
Associate Share	**1.1%**	1.6%	1.7%	0.7%	0.5%	0.6%
JV Share	**0.3%**	0.1%	0.6%	0.1%	0.2%	0.3%
Total Revenue Share	**15.7%**	**16.5%**	**16.9%**	**16.0%**	**13.8%**	**13.5%**
Parent Wages (Admin)	**(3.4%)**	(4.9%)	(4.3%)	(2.4%)	(2.3%)	(1.7%)
Parent Wages (Directors)	**(2.3%)**	(2.9%)	(2.6%)	(1.9%)	(2.3%)	(1.7%)
SBP (PSP Awards)	**(0.1%)**	(0.4%)	(0.0%)	0.0%	0.0%	0.0%
SBP (FY Bonus)	**(0.0%)**	0.0%	(0.2%)	0.0%	0.0%	0.0%
Depreciation & Amortisation	**(0.6%)**	(1.0%)	(0.7%)	(0.5%)	(0.4%)	(0.4%)
Expected Credit Losses	**(1.0%)**	(0.4%)	(0.7%)	(1.1%)	(1.4%)	(2.1%)
Audit Fees	**(0.2%)**	(0.3%)	(0.3%)	(0.3%)	0.0%	0.0%
EBIT	**7.9%**	**6.6%**	**8.1%**	**9.8%**	**7.4%**	**7.6%**

Financially, the licensing model is a share of revenue rather than an acquired ownership in that business. In some cases, an equity stake is also taken in their underlying network firms, meaning that they also receive some profit share, but it is not consolidated as it accounted for as either an associate (50%>20% ownership) or an investment (<20% ownership). This means that the parent company is highly capital light since it can service the network with 1/10 of the employees required in the underlying network. So, where the underlying firm may spend 50% of its revenue on its fee-earning staff, for DSW it may be closer to 5% of the underlying firm's revenue. In addition to this, the cost base of the parent includes directors' wages, compliance costs and a single office. Credit losses pertain primarily to start-up loans.

A few takeaways from the development of their income statement are that the parent company has historically been under resourced, indicated by the 3x growth in admin wages as a % of revenue. Furthermore, additional directors with the listing have caused these wages to increase along with associated share-based payment plans. Interestingly, credit losses have reduced significantly, reflecting more organic recruitment and marquee acquisitions in recent years as opposed to licensee loans.

Licensees are 100% equity owners of their respective businesses, meaning that they pay themselves out of partnership profits and are incentivised to collect as a result. Unlike their listed peer Keystone Law, DSW does not collect client revenue before paying it to the partner, so there is a debtor raised specifically for license fees due to DSW on a quarterly basis. Similarly, there is one for profit share due as well. Lastly, it is treated as a debtor in the accounts, but startup loans will ebb and flow with recruitment efforts.



On the topic of future growth, the group has identified multiple avenues for potential recruitment including organic recruitment by existing partners, start-up loans to lateral hires, and acquired license fees. Their initiatives on these fronts include engaging a recruitment consultant in recent months to drive organic recruitment and lateral hires along with the introduction of the £50,000 'breakout' incentive mentioned earlier. Speaking with James, it appears that acquiring license fees (such as Bridgewood) was a primary driver of seeking the listing, as they believe given market dynamics with the Big 4 afforded them to garner more scale and presence to take advantage of market conditions.

In its current state, the group generates more than 2/3 of its revenue from the cyclical corporate finance related service lines. With sustained weakness in the economy, this will continue to be a significant drag on parent level margins. During 1H23 revenue generated per M&A fee earner was ~£19k whereas in 2H23 it was ~£11k, with a cost to service of ~£8k per half, it is easy to see the impact that this can have on parent profitability with a 1H EBIT margin of 58% relative to 29% for the 2H. This can be seen as a strength of the model as well however, as 2H represented the weakest revenue per fee earner DSW has seen in over a decade yet still generated PBT margins of 37%. Furthermore, their flexible license fee whilst appealing, could cause problems with network contagion in the future if partners have issues with varying revenue share.

DSW Capital trades at an enterprise valuation of just £8.4m (£0.60 per share cost) despite generating normalised NPAT of £1.1m in FY2023 where their main activity of corporate finance was suffering significant declines in volume. With a payout ratio of 70%, the shares offer a 6% dividend on top of a model which affords significant organic recruitment potential. Capital allocation has historically shown to be successful with a highly flexible negotiation model, price discipline, and genuine revenue synergies due to their range of service lines and incentive fees. To hit our 15% hurdle for EPS growth + dividends, the group needs to generate a 30% ROIC on the capital it retains, which it has done so in all the past 5 years. For our total hurdle of >25%, the business trades at <8x earnings whereas the closest peer Keystone Law has had an average PE of >30x since it's IPO. Over a 5-year holding period we would only require DSW to reach a PE of 13x for us to meet a hurdle rate of 25%.

June 2023 - Diverger (ASX:DVR)

Diverger provides services to circa 3,000 accounting practices, 150 financial planning firms and 600 licensed advisers. These services include licensing, back office, equity investment and managed portfolio services for financial advice firms along with CPD and help-desk support to accounting firms.

Historically the business was known as Easton Investments and is only relevant from the start of the 2014 financial year onwards when Kevin White (Founder of WHK Group/Crowe Howarth) who subsequently went on to acquire the Knowledge Shop training business along with the Merit Wealth AFSL, and some great talent as part of that deal in Greg Hayes and Lisa Armstrong. From here the group made leaps and bounds in terms of improvement in profitability with a misstep buying AFSL licensee GPS wealth in 2017 shortly before the royal commission into misconduct in the banking, super and financial services industry, however, despite this drastic industry event, the group-maintained profitability throughout and has successfully shifted their business model. Kevin White served as CEO for part of 2014 before Greg Hayes was appointed CEO from 2014 to 2020 before current CEO Nathan Jacobsen joined as part of the acquisition of Paragem.

Financially, the group has several service lines with vastly different margin profiles. Firstly, the accounting solutions division inclusive of Knowledge Shop and TaxBanter accounts for 49% of the revenue but 58% of the profitability of the group. This division has a 40% EBITA margin with its primary cost being direct wages accounting for 51% of its revenue, leaving a mere 8% to other expenses. The wealth division is inclusive of both the licensee business and the managed portfolio business. It is difficult to put a number on just how much profit is being driven by each side, but I do know that managed portfolio's has a significantly higher margin than licensee services, which is unsurprising as we might assume the average adviser does ~$450k in revenue and Diverger is bringing all of that in to their accounts before forwarding the advisers share, debiting $37k of that as net licensee revenue, therefore it would be more fair to consider wealth margins on the basis of revenue share being a mere disbursement to underlying firms rather than revenue, In this case, wealth has EBITA margins of c.25-30%.

Cash conversion is exceptional in all cases, with the training business having 2 billing models, with ~40% coming from recurring subscription revenue billed monthly in advance and the remaining 60% coming from on-demand training, often billed well in advance of the training date as well. Wealth consists of the licensee business which controls the flow of adviser cash, receiving directly from clients before forwarding to advisers, the CARE business bills management fees at a rate of 0.297% p.a. of which is apportioned monthly.

Shown below is the development of free cash flow and cash returns on equity and capital over the past 10 years.

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Free Cash Flow	-1.1	-1.3	2.3	2.2	1.8	0.9	2.9	2.2	5.7	4.4
Shares	11.5	21.3	27.4	27.5	28.4	33.9	34.8	34.5	35.7	37.6
FCF/Share	-0.09	-0.06	0.08	0.08	0.06	0.03	0.08	0.06	0.16	0.12
Net Debt	-0.6	-1.8	-0.8	-3.9	-2.6	6.7	8.4	5.1	-2.3	-2.5
Equity	9.1	18.4	19.7	19.2	20.7	30.6	32.0	32.2	35.4	37.8
Invested Capital	8.5	16.6	18.9	15.3	18.1	37.3	40.4	37.3	33.1	35.3
Cash ROE		-9%	12%	11%	9%	3%	9%	7%	17%	12%
Cash ROIC		-10%	13%	13%	11%	3%	7%	6%	16%	13%

**Millions except per share*

Over this period the group has accumulated an incremental $26.7m of capital and grown its free cash flow by $5.5m, an incremental return on its capital of 21% p.a. Furthermore, when including dividends declared an investor would've seen an additional 4% p.a. dividend yield. Despite this, capital growth in the share price was a paltry 7% p.a. for a total return of 11% p.a. As you would surmise from this, the valuation multiple demanded by the company hasn't kept up with the pace of business growth with a 3.3x increase in free cash flow per share occurring whilst it is now trading at 0.9x it's 2013 enterprise value per share. Therefore, the group has suffered 14% annualised multiple contraction since 2013…brutal.

Going forward, the management team are enacting on a strategic plan and capital management policy detailed below.

$m	FY22	FY25 Targets
Net Revenue (NR)	$30.15m	$40m - $45m (10% - 13% CAGR)
Underlying EBITA margin (%)	23%	24% - 28%
Underlying EBITA[1]	$7.06m	$10.5m - $12.5m (15% - 21% CAGR)
Adjusted EPS (NPATA/SOI)[2]	12.25 cps	18 -22 cps

Board approved Capital Management Policy

- Strategy to balance growth and shareholder returns
- Investments into operations funded from free cashflow and debt at accretive ROIC (Return on Invested Capital)
- NPATA used to remove the distortion of amortisation of investments with strong alignment to FCF
- **Stable Dividend payout ratio:** 40% - 60% of NPATA[2]
- **Conservative capital structure**: target range of 1.0 - 1.5 times Net debt / EBITA
- Board to retain flexibility outside of these guidelines based on value accretive opportunities

Positively, the group now is valued at an enterprise value of just $32m ($0.80 cost) whilst generating free cash flow more than $4.5m, an EV/FCF multiple of 7.1x which when considering the above mentioned strategic goals and the 40-60% fully franked payout ratio that would provide a yield of 8-12% for investors, and implied incremental returns on their capital of 25%-50% (based on a low case of 15% EBITA CAGR / 60% retention rate OR high case of 21% EBITA CAGR / 40% retention rate). Further to this, management is incentivised with performance rights that straight line vest based on (1) EPS CAGR of 13.5% to 18% and (2) TSR CAGR of 12.5% to 20% with a baseline EPS and share price of $0.1225 and $0.94 respectively. Nevertheless, Diverger represents what I believe to be a high-quality business at a low valuation.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

Hurdle Rate Unit Trust

**Last Updated – 1 October 2023*

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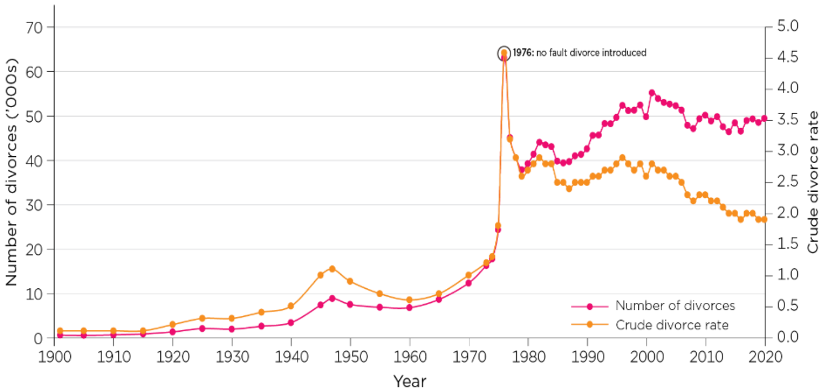
June 2023 - AF Legal (ASX:AFL)

AF Legal is the publicly listed parent company of a group of law firms specialising in family and relationship law. More specifically the group provides advice to clients in respect of divorce, separation, property, and children's matters together with related and ancillary services such as litigation, most of which are settled via. mediation as opposed to long-winded court processes. AF Legal is the largest of its kind in Australia.



Family dispute resolution is akin in stability to industries such funeral providers and tax preparation, representing a high-quality recurring workflow. In the past 47 years since the no fault divorce was introduced, divorces have slowly but steadily climbed at a rate of about 0.6% p.a. as opposed to population growth of 1.3% p.a. leading to a decline in divorces per 1,000 residents from the ~2.5 people in the late 1970s to ~1.9 today., driven mainly by a decline in marriages as opposed to more robust marriages. However, what really moves the needle for family lawyers is the growth in household wealth in conjunction with the median age of divorce having grown from ~35 in the late 70s to ~45 today, meaning that the average divorced couple has substantially more 'real' wealth today than they had in the past.

With this backdrop, you'd expect the family law business to be a great one, with most cases settled by mediation along with ample asset pools to pay in trust leading to potentially brilliant cash conversion. Federal legislation allows for geographic expansion and sharing of resources and the lack of required overheads. However, AF Legal has seen anything but success as a listed company having been founded in 2015 and subsequently listed in 2019 through a reverse takeover of Navigator Resources, since listing at $0.20 in June 2019, it reached a peak of $0.66 in May 2021 before falling to as low as $0.10 in February 2023. Today it trades back at its IPO price of $0.20. So, what happened?

Primarily, this can be traced back to the actions of past management, who were nothing short of predatory in the extraction of what otherwise should have been excellent shareholder value creation. First, the key management remuneration including share-based payments over the period 2020-2022 was an average 15% of group revenue, as opposed to peers with similar margin profiles such as Diverger & Prime financial at 7%. At the corporate level, total expenses were an average 21% of revenue (excl. disbursements) as opposed to the peers with 9% and 11%. It's clearly hard to argue that management weren't taking shareholders for a ride. AF Legal has a similar margin profile to Prime Financial (Slightly lower gross margins), so theoretically it should be able to generate margins of ~10% on a net profit after tax basis, yet it averaged closer to NIL due to what was explained above.

Australian Financial Review
https://www.afr.com › rear-window › af-legal-divorces-it...
AF Legal divorces itself from reality
22 Nov 2022 — **AF Legal's** Grant Dearlove. The firm's update in April 2020 brimmed at the prospect that "self-isolation policies and loss of income will ...

Australian Financial Review
https://www.afr.com › rear-window
radioactive law firm nukes merger
24 Nov 2022 — As detailed in this column on Wednesday and Thursday, the proposed merger between **AF Legal** and GTC Legal Group, which runs GoToCourt.com.au, has ...

Australian Financial Review
https://www.afr.com › rear-window › rick-dennis-af-lega...
Rick Dennis' AF Legal circus comes to town
23 Nov 2022 — Chief financial officer Pratyush Jagdishwala resigned suddenly without explanation, days before **AF Legal** said it had wrongly printed in the ...

This leads us into where AF Legal is today, since the fallout of management during the fiasco that surrounded the unsuccessful GTC Legal merger where internal arrangements were leaked to the AFR and substantial shareholders that led to management resignations and shareholder activism, the management team has been highly streamlined and a cost-conscious CEO that led a very successful turnaround at Ashley Services Group (ASX:ASH) has been appointed in Chris McFadden. In Q3 FY2023 the group reported a consolidated NPBT margin of 10% & 7% before and after non-controlling interest, despite only being the first quarter not inhibited by prior management, alluding to strong potential for the group to streamline their operations and perhaps start to generate shareholder value that attests to the favourable setup of the industry.

AF Legal when the Hurdle Rate Unit Trust purchased it was trading at an enterprise value of $10m despite generating LTM Revenue of $17.9m. If we think the business is capable of ~10% NPAT margins less minority interest, this will equate to a normalised NPAT of $1.58m, a potential post margin improvement PE of 6.3x. Given the improvements they have made in a short time span, I don't see why this should not be the case. Furthermore, Chris McFadden's is incentivised to generate $2.35m of NPBT attributable to the parent in FY2024, which at the current revenue is equivalent to a 13% NPBT margin, which would align closely with a 10% NPAT margin. In the event of this profit being achieved, we have an earnings yield of 15.8% which meets our hold return hurdle rate and should be fully capable of some organic revenue growth via. recruitment and rate expansion and/or multiple expansion to get us to a hurdle rate of >25% p.a.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

June 2023 - Reckon (ASX:RKN)

Reckon is an ASX-listed software holding company that currently operates across two divisions targeting Australian small businesses and accounting firms with its suite of Reckon branded solutions along with Global (particular the US) legal firms with its majority owned Zebraworks business. It currently services over 115k users in Australia and close to 500 legal firms with many of the world's largest legal firms as clients.

Historically, the group was founded in 1987 by current substantial shareholder Greg Wilkinson and operated for a long time as an Intuit Quickbooks reseller here in Australia before an IPO in 1999 and moving into practice management software in 2004. In 2014 the reseller arrangement ceased, and the group begun to offer their own small business software using that as a foundation, shortly after Reckon Accounts and Reckon One were brought to the market. Prior to this, in 2012 Reckon had purchased the UK based Lidenhouse Software business and begun offering it's Virtual Cabinet document management solution to it's Australian customers, subsequently purchasing the similar US based Smartvault business in 2016 before spinning off the two document management business as the now UK-listed Getbusy (LSE:GETB) in 2017. Shortly after this Reckon was approached by MYOB with an offer to purchase its practice management division for $180m which failed to go through, 5 years later Access Group approached Reckon with another offer to purchase this division for $100m which closed for investors. This division was struggling with a cloud-transition and the sale was done at a valuation of 4.6x revenue and 8.4x EBITDA, but with burgeoning cloud development costs was closer to 20-25x NPAT. Lastly, the group acquired a majority stake in US legal outfit Zebraworks in 2020 and increased their stake early this year.

Shareholder Return Bands	Cash Distribution – CEO	Cash Distribution - CFO
Under $150,000,000	No cash distribution (Award is forfeited)	No cash distribution (Award is forfeited)
$150,000,000 and up to $200,000,000	$770,000	$180,000
$200,000,000 and up to $250,000,000	$1,300,000	$300,000
$250,000,000 and up to $300,000,000	$2,600,000	$600,000
$300,000,000 or more	$5,700,000	$1,200,000

With the backstory out of the way, the group is currently managed by CEO Sam Allert, appointed in the group CEO role in 2018, but has a long history within the Reckon business originally joining in 1999, moving through various senior subsidiary management roles in the interim.

Sam does not own a particularly large stake of the company with 1.3% ownership but has reasonably aggressive 'Cash distribution incentive plan' which offers upwards of 1.2x – 9x his base salary dependent on 'shareholder return' bands. This plan was only introduced this year and is a replication of a similar plan recently introduced in the Getbusy listing on the LSE as well, given much of the board of directors is shared between the 2 businesses. This plan entitles Sam to receive a cash distribution contingent on the following conditions.

- Sam remaining as an employee until the 31 December 2029
- Cumulative payments to Reckon shareholders of at least $150m between 24 May 2023 and 31 December 2029 in the form of dividends, distributions, or takeovers, appropriately adjusted for any LTIP expense and capital raised.

Notably, there is also another scheme which was introduced at the time Reckon took an increased stake in the Legal group earlier this year which similarly. Which afford non-controlling interest shareholders of the Legal group to have some of Reckon's ownership transferred to them in the case of a disposal of USD $200m>$100m>$70m. Disposal proceeds of between USD $70m - $100m will offset dilutionary impacts of the raising earlier this year and amounts between USD $100-200m will allow for a further pro-rata transfer of up to USD $7.5m in shares. For reference, Reckon's current shareholding is 76% of the business. This plan was introduced due to the underperformance of the legal group since acquiring in 2020 and the capital raised earlier this year should allow for several years of funding.

Financially, the business mix of the 2 divisions and the existence of the incentive plans creates an extremely interesting proposition. First, segment profitability is shown on the right (not including corporate costs). The group generates a NPBT of $5.2m after corporate costs, a margin of just above 10%, although is the result of a highly profitable business group mixed with a highly unprofitable legal group. In the event the legal group is excluded, pre-corporate cost NPBT margins would elevate from 16% to 30%, which if you assume consistent corporate costs as a % of revenue and a 25% corporate tax rate, would equate to an NPAT margin of 18% as opposed to the current margin of 7.6%, more than double the current.

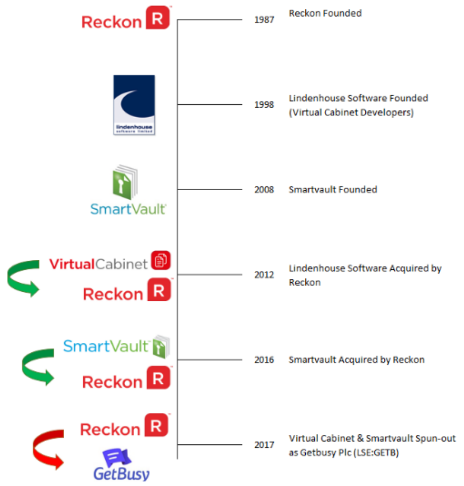
	Business Group $'000	Practice Management Legal Group $'000
2022		
Operating revenue	40,799	10,429
Segment results		
EBITDA[1]	**21,036**	**222**
Depreciation and amortisation	(8,692)	(4,441)
Segment profit before tax	12,344	(4,219)

Not to mention that the Business Group is currently facing a masking of its double-digit cloud growth via. the flat or declining desktop-based revenue and perpetual licensing. This is made even further appealing knowing that the business group's ARPU is significantly below any peers in the Australian market with the average cloud user paying just ~$16 per month as opposed to the average Xero user paying more than double at $34 per month. As a result, it would not be unfair to assume Reckon has some degree of untapped pricing power in their client base.

Knowing this, Reckon, at our cost basis of $0.53 trades at an enterprise value of $63m and generated a normalised NPAT of $4m in the FY2022 year, which by itself does not sound particularly appealing as a multiple of 15.6x. But, with optionality surrounding the incentive plans and the underlying profitability of the Business Group approximating a PE of 8.6x with untapped pricing power, there is many ways to throw shareholders a bone in terms of capital appreciation. It should also be noted that the group maintains a 60% fully franked dividend, equating to a 6% dividend yield on our cost basis at the current level of earnings. Hurdle Rate Unit Trust is an excited shareholder of Reckon for the reasons stated above.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

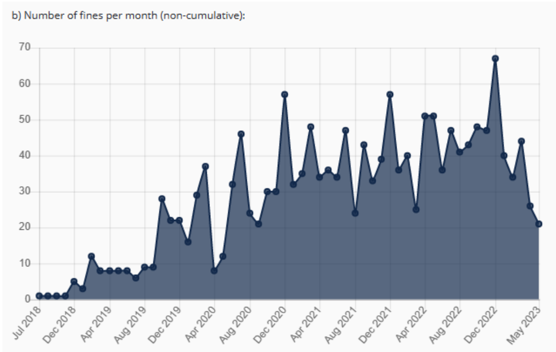
June 2023 - Getbusy (LSE:GETB)



Getbusy is an LSE-listed software holding company that currently owns several Document management software products geared towards accounting firms. It was the result of a spin-off from the ASX-listed Reckon (ASX:RKN) in 2017 and has been on the AIM exchange since.

Its primary products include Virtual Cabinet which is provided to mid-large accounting firms in the UK and Australia in addition to Smartvault, provided to small accounting firms in the US. There are also several emerging products including Workiro, a Netsuite app aimed at plugging the poor Document management functionality inside Netsuite and Certified Vault, a Smartvault add-on which aims to allow for the provision, storage, and distribution of so-called e-document contracts.

The group's current executive team consists of Daniel Rabie (CEO) and Paul Haworth (CFO) along with 4 members of the Board including Daniel's father Clive Rabie, both of whom came over directly from Reckon at the time of the spin-off. Clive and Daniel own a collective 20.4% of the company, whereas the Reckon founder Greg Wilkinson also owns an additional 7.4% of the company. All up, members of the Reckon and Getbusy board and executive team own around 30% of the company.



On a macro level, all Getbusy's services will benefit greatly from the data privacy driven GDPR style legislation that is permeating throughout the world, particularly so as state legislation is plotted across the US will Smartvault see continued growth in its customer base. As of May 2023, there is just 9 states in the US with signed bills that have passed through government, with 41 states having no such GDPR style legislation.

The number of non-compliance fines issued in the enforcement of the EU legislation has continuously risen since the introduction of the act, which is an incentive to further increase the penalty for a breach, in turn driving businesses to take data privacy seriously as a result.

Financially, Getbusy operates as a SaaS business model where they receive cash in the form of monthly and annual subscription payments. Given the reasonably large discounting available for annual cycles, it is unsurprising to hear that some 70% of Getbusy revenue is received annually in advance. That means that cash revenue is consistently higher than reported revenue as a result, and the more growth they report, the wider that the gap should be ordinarily.

The cost base is managed so as to report an accounting profit of close to NIL as possible, with 24% of revenue invested into it's customer acquisition associated sales and marketing expenses in order to grow it's customer base. Furthermore, the group has historically invested some 10% of it's revenue into non-revenue generating software, namely Workiro. I would consider these investments as a capital allocation decision and the group's claim that it could reach >30% EBITDA margins on a group basis at maturity to be feasible as a result. In fact, Virtual cabinet is already generating NPBT margins of ~50% on a standalone basis (pre-corporate costs)

2021	**SmartVault £'000**	**Virtual Cabinet £'000**	**Workiro £'000**	**Corporate & central £'000**
Recurring revenue	6,439	7,881	31	(8)
Non-recurring revenue	379	726	-	-
Revenue from contracts with customers	**6,818**	**8,607**	**31**	**(8)**
Cost of sales	(1,082)	(161)	(60)	8
Gross profit	**5,736**	**8,446**	**(29)**	**-**
Sales, general and admin costs	(4,987)	(3,292)	(774)	(2,535)
Development costs	(1,769)	(784)	(1,234)	-
Adjusted profit / (loss) before tax	**(1,020)**	**4,370**	**(2,037)**	**(2,535)**

Shareholder Return Bands	Cash Distribution- CEO	Cash Distribution - CFO
Under £70,000,000	Existing Plans (£5,000,000)	Existing Plans (£1,750,000)
£70,000,000 to £120,000,000	Linear increase from 7.0% to 15.0% Share	Linear increase from 2.5% to 10.0% Share
£120,000,000 to £150,000,000	15.0% Share	10.0% Share
>£150,000,000	No additional	No Additional

Like Reckon, Getbusy has recently introduced a 'Cash Distribution Incentive Plan' which for management is much more appealing here than it is at Reckon, making the incentive particularly strong in comparison.

In the event each of these thresholds is met, net of incentives shareholders would see £57m, £95m and £121m respectively. Importantly, the plan is in place for 7 years and does not specifically state that it cannot just be a partial sale, therefore any individual part is up for grabs.

Knowing this, Getbusy, at our cost basis of £0.67 trades at an enterprise value of £30m and generates ARR of $21.3m, a multiple of 1.4x ARR on a non-diluted basis. Getbusy may trade on a normalised EV/EBITDA of just 4.7x with the believable prospect of >30% EBITDA margins at a steady state. Furthermore, with management targeting £30m in ARR by 2026, the compounded rate creates a hold-return that exceeds the hurdle rate set by the trust. Optionality exists with the CDP incentive as well with a minimum CAGR of 9% in the event the business is sold for just £70m (assuming it takes them 7 years to do so, and they are at the lowest band). Either way, the odds look bright, and incentives are strong to the point that it is difficult to envision a scenario where the Hurdle Rate Unit Trust did NOT make money on this investment.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

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May 2023 - Letter

Dear Unitholders,

First, thank you all sincerely for placing your trust in me as trustee of the unit trust. Managing outside capital has been a dream job since catching the investing 'bug' over half a decade ago now and to finally have the chance to do it, even as a humble sized trust, makes me delighted. Some of the mechanisms I've decided to adopt may need an additional explanation.

First, the most important thing to get right at the outset of starting a business, is the business model, as it is the foundation to build on for the future. Not to say that it can't be allowed to change over time but I there is some things that are hard to change if not implemented at the outset. The unique traits I have put in place include:

1. Myself as manager have realised all my outside investments and purchased 100,000 units in the trust as the initial unitholder. This humbly represents all my investable funds at this stage in my life, and any additional investments made will be filtered through this trust to ensure full alignment with my fellow unitholders.

2. Unitholder's who choose to add or withdraw money will have their units issued or cancelled at the end of each month, in fact, all administrative functions including incentive fee allotment, distributions and reporting will always be done at month close. This also means that units also get valued monthly and circulated to investors via this exact report.

3. Unit purchases will have a 0.25% premium applied to the unit price to reflect the spread of the underlying holdings, and conversely unit sales will have a 0.50% discount applied to the unit price. The skew is intended to dis-incentivise selling to ensure that existing unitholders are not adversely exposed to any un-intended tax consequences.

4. Incentive Fees are calculated using a 0/6/25 fee structure that was popularised by Warren Buffett which he had used in his partnership ran during the 1950s and 1960s. This means that until the trust earns a 6% return on its capital (~0.49% per month), the trustee gets no remuneration. Amounts above a 6% returned are split in a ratio of 3:1 with the manager receiving a quarter of profits made above the hurdle. To stress is that fees are only re-adjusted if the portfolio value ends the month above both the previous peak (High watermark) and the incentive threshold. But don't take it from me, here is Warren's long-time business partner and Berkshire Hathaway Chairman "Charlie Munger" to provide testimony

5. As a budding Accountant myself who is also trying to scale a taxation offering, I have introduced an incentive for unitholders where 10% of incentive fees can be reimbursed through a credit applied to any invoice for taxation services provided by yours truly. It is my hope that this creates cross-pollination between the two businesses.

   Take for example, an investor puts $100,000 of capital into the unit trust, and I manage to generate a $10,000 return in the first year. The incentive fee attached to that would be $1,000 (1/4 of the amount > $6,000). In line with this policy, the unitholder would be eligible for a $100 credit to apply to their invoice.

6. Lastly, Unitholders become automatically eligible for a life-time subscription to the Hurdle Rate Substack (RRP $10 per month). Through this I post frequently the following:
   - Weekly One Page Stock Pitch (Available to free subscribers)
   - Monthly Deep Dive
   - Monthly Portfolio Update
   - Occasional Management meetings and other ad-hoc blog posts.

   Importantly, these posts will differ to the content conveyed in these updates with no dollar figures conveyed, intended to just be position by position commentary. Information discussed in the Substack may find its way here, but never the other way around.

In terms of investments, opening the various investment and bank accounts took some time, and I placed my first trades on the last day of the month. Note that a single trade can move these investments several % up or down so that is the reason for our slight decline for the month. Volatility will be par for the course going forward.

Following month end, on the 1st of June 2023 more was invested into DSW Capital (LSE:DSW) and there are multiple orders in place to allocate the remaining capital by the end of June.

That concludes the first monthly report for the unitholders of the Hurdle Rate Unit Trust. If you would like to contact me with any questions, suggestions or simply to chat you can reach me through my contact details below.

Yours sincerely,

Tristan Waine

Sole Director of the Trustee of the Hurdle Rate Unit Trust

Phone – +61 426 928 026

Email – Tristan.waine@outlook.com

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May 2023 - Sequoia Financial Group (ASX:SEQ)

Sequoia Financial Group is a professional services business providing a variety of services to accountants and financial advisers across Australia. These service lines include acting as an AFSL licensee, provision of legal documents, SMSF administration, insurance broking, financial media and wholesale investment opportunities. The business has drastically changed over time, particularly with the reverse takeover of Sequoia Financial Group in 2015 and the acquisitions of InterPrac & Morrison Securities in 2017.

Today the group is spearheaded by Executive Chairman Garry Crole (59 years old), who came onto the board in the 2017 financial year and into the executive team during the following year. Garry has an extensive career, but perhaps most notably were the 2 businesses he founded in Money Planners in 1988 before having it conjoin with ASX-listed Deakin Financial Services where Garry was CEO from 1990 to 2000 before founding InterPrac in 2003. All these businesses relate heavily to what Sequoia looks like today. Other notable appointments include CFO Lizzie Tan and the various heads of each division such as William Slack (Head of Equity Markets), Alex Fabbri (Head of Corporate Finance), Brent Jones (Head of Professional Services), Raika Afzali (Head of SMSF). Just announced as well were 3 senior appointments in Martin Morris as COO, Justin Harding as Head of Legal and Risk and Mark Hutchinson as Senior compliance manager. Directors alone own 11.4% of the shares, with significantly more owned by subsidiary heads which many of which are past acquisition vendors.

Division	EBITDA	Margin	Growth	Activities
Licensee Services	$5.5m	8.6%	(11%)	Dealer Groups, Corporate Finance, Broking
Professional Services	$2.9m	26.5%	38%	Legal Documents & SMSF Administration
Equity Markets	$6.3m	9.0%	7%	Institutional Trading, Structured Products
Direct Investment	$1.0m	37.6%	63%	Media, Retail Trading

Sequoia is a difficult business to explain financially as there is a long list of different billing models throughout their various subsidiaries. When looking at the financial statements, unlike other more focused businesses, additional revenue is more likely to be either highly dilutive or highly accretive to margins in this case, depending on the business mix within the group. Margins for each division are shown to the left in addition to the growth for the FY2022 income year.

Below the EBITDA line, we have genuine depreciation and lease expenses of $1.4m along with acquired intangible amortisation of $2.1m before a tax expense of $3m. Given customer list intangibles are like amortising goodwill, it would not be unfair to look at this business based on NPATA, for which we have $7.1m for the 2022 year. During the 1H of 2023, the group saw significantly contracted profitability, which I will touch on further below, but for the time being, we should now get the general idea of the income statement.

The majority of the Sequoia's subsidiaries benefit from a point-in-time revenue recognition barring Sequoia's specialist investments division which markets structured products where it offers leveraged instruments known as 'deferred purchase agreements' to SMSF's (which are otherwise not allowed to take on margin debt). These instruments demand all interest to be paid upfront along with an application fee, and often this results in multiple years of interest received upfront. The group's negative tangible invested capital after subtracting net cash is a testament to its negative cash conversion profile.

Capital allocation has shown to be reasonable since Garry was adorned as executive chair in 2018 with an average EBIT multiple paid of 4.2x over the past 5 years. With a tax rate of 30% this would be equivalent to an upfront PE of 5.9x and earnings yield of 16%. With a cumulative investment of $18.2m the group has acquired EBIT of $4.3m, 2018 operating profit was $4.3m and 2022 was $12.4m, meaning that the group generated organic EBIT of $3.8m. This equates to an organic CAGR of 14% + Inorganic CAGR of 16% for a total of 30% between 2018 and 2022. However, during this time, the share count has also compounded at 7% predominately due to acquisitions, as a result the real Inorganic CAGR is closer to 9%. This is also ignoring the movement in their net cash position from $11.6m to $14.9m. Over this period 20% of the cumulative NPATA was paid out as dividends, as a result returns on incremental capital are approximately 25%. If you consider that all incremental capital was used for acquisitions (given the negative working capital cycle), inorganic returns on capital are just 11%, leading me to believe that perhaps an aggressive dividend policy along with a special dividend of the existing cash on hand is the best possible course of action.

Business	EBIT Multiple
Libertas	3.1
YBR Wealth	4.2
Phillip Capital	2.5
Total Cover	3.0
Panther Corp	2.7
Multiple Adviser Books	3.0
Macro Investor	3.0
Tag Brokers	4.6
Informed Investor	12.8
Castle Group	4.0
Average	**4.2**

The Sequoia business has had a very interesting FY2023 year, with sharply declining profitability juxtaposed with a highly successful divesture of Morrison Securities. With the share price down just 8% it's clear the market is slightly outweighing Sequoia's current year profit decline as opposed to the receipt of some 60% of its market cap in cash proceeds, in other words the market thinks that Sequoia has lost >60% of it's earnings power in a year, a sentiment that to me sounds absurd given it's growing adviser network and largely unchanged headcount over the past 12 months. It is unlikely to see advice remediation costs every year with the current standards of adviser education requirements. Sequoia is not without risks with the primary risk in my view being the misallocation of their newfound cash proceeds, but also elevated and recurring client remediation, any future mishaps with ASIC regarding financial services or products, adviser attrition, vendor attrition and so on.

With the run-rate of the media business, and the acquisition of both Euree and Castle group, lost earnings of Morrissons have been replaced with just 1/10 of the sale proceeds. Should Sequoia generate similar NPATA in FY2024 as it did in FY2022, the group will be trading at an enterprise value of ~4x NPATA. Given their intentions to move to a payout ratio of >70% and abundance of franking credits, the opportunity screams mispriced even without any growth. This is all ignoring the previously announced 7-year business plan with targets of $30m in EBITDA by FY2026, 2.5x what it was in 2022, representing a 25% CAGR. Given their track record of acquiring, they should be able to acquire $10-12m of EBITDA with their cash balance alone, leaving another $6-8m to be sourced from any incremental retained earnings and organic growth.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928

May 2023 - Prime Financial Group (ASX:PFG)

Prime Financial Group is an ASX-listed professional services business operating along the east coast of Australia which offers several different service lines including financial advice, corporate advisory, accounting services and SMSF administration. The Prime business was founded by father and son duo Peter and Simon Madder. The original company was the Prime Development Fund (PDF) which went on to form an AFSL holding entity which took minority stakes in a distribution network of accounting firms to disseminate its financial advice services.

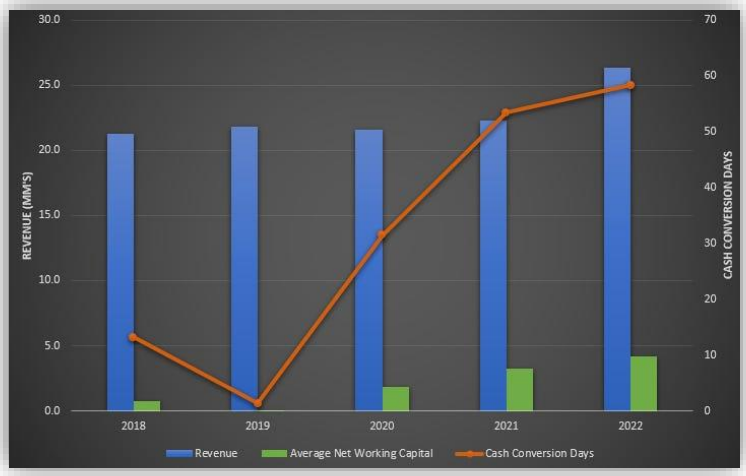
The business has had a mixed track record as a listed company with an initial reverse takeover in 2007 by the then named AVFM Ltd. In the following 3 years it suffered due to significant exposure to equity markets and saw it's NPAT vary significantly as a result. In the period of 2010-2015 the group went through a period of divesting its funds management business and further diversifying into increasing stakes of accounting firms before eventually taking a controlling position in a fast-growing accounting firm 'MPR' in 2016. From here the business has made several key acquisitions and senior hire's which have diversified the Prime business model and generated meaningful value for shareholders in the past 7 years. As of 31 December 2022, the group generated LTM Revenue of $30.2m and employs >150 team members.

Ownership is very important at Prime, with 45% of the company owned by staff and associate shareholders, with performance rights being a recurring theme in rewarding staff. Ordinarily this may be seen as negative and dilutive to shareholders but the incentives to be granted these rights are reasonably intensive in nature, requiring a 3-year compounded growth rate in parent attributable EBITDA of 8% p.a. and share price of 20% p.a. Obviously the EBITDA target is not ideal (ignores per share metrics and interest cost), but my belief is that insider ownership is so material that abuse of dilution and debt is unlikely. Furthermore, these targets are merely on capital growth, and are not inclusive of the fully franked dividend payout ratio of 40-60%. Therefore, if the group does not dilute, incremental ROE targets are in the mid-teens in effect (8% growth / 50% payout).

	Wealth/SMSF	ABA/Capital	Corporate	Total
Revenue	43.1%	56.9%		100.0%
EBITDA	**16.7%**	**20.7%**	**-5.7%**	**31.7%**
Leases (AASB16)	-0.8%	-1.5%	-2.5%	-4.8%
P&E Depreciation			-0.2%	-0.2%
Software Amortisation			-0.9%	-0.9%
Customer List Amortisation			-2.3%	-2.3%
EBIT				**23.5%**
Finance Costs			-1.2%	-1.2%
NPBT				**22.3%**
Tax Expense			-5.4%	-5.4%
NPAT (Consolidated)				**16.9%**
Non-Controlling Interest				-2.4%
NPAT (Parent)				**14.5%**

Speaking of financials, accounting services billing model centralises around timesheets, wealth is a mix between fixed fees and % of AUM fees on SMA's, corporate advisory is transactional and SMSF is fixed fee. The cost base is quite similar between them however, with the primary resource being fee earners, and minor variances in other costs. EBITDA Margins are all in the realm of 25-35%. The group distils it's four major service lines into two reporting segments, 'Wealth & SMSF' and 'ABA & Capital' in their financial reports. 2022 segment profile is shown to the left as a % of total revenue.

Working capital has been fast increasing in recent years, largely due to the increasing working capital profile of the ABA/Capital division, which accounts for just shy of 60% of revenue but 100% of the lockup given that wealth and SMSF revenue is largely point-in-time. The accounting service line generally has 30-day credit terms but when conducting R&D tax incentive services the firm does not get paid until the claim is successful, the matter of which is subject to multiple successive ATO reviews typically (we all know how fast government turn-around is…). This is mentioned in the trade receivables note starting in the FY2020 year so presumably it is the primary driver of all the working capital in the group.



Going forward, I would like to think that working capital would remain relatively consistent and that most of the group's increase in cash conversion days is behind them, with internal lockup targets of ~90 days quoted by Simon during the FY2022 results presentation.

Speaking to the future of Prime Financial, the group has a strategic plan to reach $50m in revenue by 2025 with implicit EBITDA margins of 30%, without diluting shareholders (beyond performance rights) and using strictly debt in a stated range of 0.5x – 1.0x Net Debt / EBITDA. From the 2022 income year this would represent a CAGR of 25%. Through 1-1 discussions with Simon myself, it seems they intend to get there with growth being 2/3 organic and 1/3 inorganic. With the acquisition of Intello we have a general idea of their price discipline with a multiple of ~5x EBITDA, 3.3x upfront and 1.7x subject to 12-month performance. Intello however has a website asset and if we assume similar premises cost to the group, NPAT margins would approximate 15% as a result, a PE of 10x. For the purposes of figuring out how much they need to deploy, they paid 1.5x revenue for Intello, which at that valuation they would need to deploy another $7.5m to get to the inorganic target. Over the 3-year period, it would equate to deploying $13m into M&A + $5m into working capital with NPATA increasing $4m, a ROIIC of ~22% for shareholders.

Prime trades an enterprise value of $52m and is likely to generate ~$6m in run-rate NPATA, a valuation of <9x earnings. With a 40-60% payout ratio and franking credits Prime will pay a dividend of 8-12% whilst growing it's earnings at a rate of 20%+ p.a. with c. $8m in retained earnings it is estimated Prime will have to take on an additional ~$10m in debt to fund it's growth strategy, meaning that in 2025 Prime would have $10m in NPATA on an EV of $62m, a valuation of 6.2x earnings, whilst paying a fully franked dividend yield of 9-14% on the enterprise value. Either way, Prime's valuation appears quite frankly, undemanding and an investment has been made at a cost basis of $0.21 per share.

Email: Tristan.waine@outlook.com
Phone: +61 426 026 928