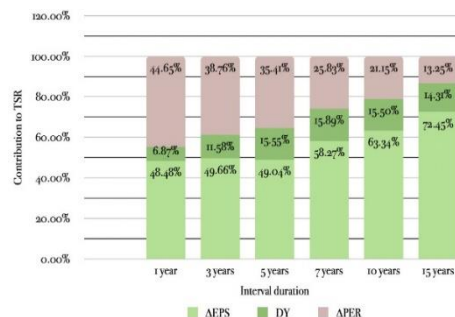


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Hurdle Rate Unit Trust

February 2024 - Musings on the attribution of Total Shareholder Returns (TSR)

There is a great post I read this month by Conservalue called "[Market returns redux](#)" which I found informative. I would commend him and suggest others to read this. In that it is considered that the formula for total shareholder return is $(1 + \Delta EPS) * (1 + \Delta PER) * (1 + \Delta FX) + DY$, where ΔEPS represents the increase in per-share earnings, ΔPER the variation in the earnings multiple, ΔFX the currency fluctuations and DY the dividend yield. The problem here is that it eschews any look-through change of the capital required to generate that growth. Thus, I propose a new formula as $(\Delta NPAT / (\Delta Equity + \Delta Net Debt)) * (1 - Dividend Payout Ratio) * (1 + \Delta PER) * (1 + \Delta FX) + DY$. The issue with mine is that it won't be able to be used for a business that doesn't need capital, if capital goes backwards the formula will break, but at that stage you can simply use a dividend discount model. Another interesting part from this post was the contribution to overall market returns (S&P500) since 2000, which clearly shows an increasing contribution from dividends and earnings over time as shown to the right.



Lastly, I wanted to touch on my own fundamental development of the portfolio and how I view trust returns in the future. I have constructed a look-through table showing the current makeup of some of the key metrics I am paying attention to. Note that anything besides 'LTM' is all my own forecast and is not indicative of actual results. This also excludes any event-driven investments and cash holdings which is the bridge between 'market capitalisation' and our net asset value.

	LTM	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	\$585,963	\$607,158	\$727,881	\$884,589	\$970,213	\$1,062,866
Revenue Growth		3.6%	19.9%	21.5%	9.7%	9.5%
NPAT	\$49,245	\$55,233	\$68,665	\$81,546	\$93,726	\$106,812
NPAT Growth		12.2%	24.3%	18.8%	14.9%	14.0%
NPAT Margin	8.4%	9.1%	9.4%	9.2%	9.7%	10.0%
Payout Ratio		46.5%	46.0%	47.8%	45.7%	44.0%
Dividends		\$25,696	\$31,612	\$38,967	\$42,791	\$47,049
Franking Credits		\$5,962	\$7,988	\$10,741	\$11,938	\$13,273
Enterprise Value	\$407,341	\$614,440	\$831,126	\$1,043,019	\$1,254,911	\$1,466,803
Net Debt	-\$28,782	-\$20,211	-\$8,480	\$833	-\$12,774	-\$31,900
Market Capitalisation	\$436,123	\$634,651	\$839,606	\$1,042,186	\$1,267,685	\$1,498,703
Equity	\$380,437	\$409,974	\$447,027	\$489,606	\$540,540	\$600,303
FCF Yield	12.1%	9.0%	8.3%	7.8%	7.5%	7.3%
Dividend Yield		5.0%	4.7%	4.8%	4.3%	4.0%
Return on Equity		14.0%	16.0%	17.4%	18.2%	18.7%
Return on Capital		14.9%	16.6%	17.6%	18.4%	19.5%
Return on Incremental Capital		15.7%	27.5%	24.8%	32.6%	32.2%
Hold Return (ROIIC x RIR + DY)		13.4%	19.6%	17.7%	22.0%	22.0%

A similar piece is Michael J. Mauboussin and Dan Callahan's '[Total Shareholder Return: Linking The Drivers of Total Returns to Fundamentals](#)' which also breaks down where returns come from in good detail. In that piece you can find a section which breaks down return into sub-drivers. In essence I can also break down the above expectations using the TSR formula outlined earlier as:

	Contribution	% of Total (Pre-Tax)	% of Total (Post-Tax)
Revenue Growth	12.6%	38.7%	43.7%
+ Change in Margin	4.1%	12.5%	14.2%
= Earnings Growth	16.7%		
+ Multiple expansion	11.4%	34.7%	39.3%
= Price appreciation	28.1%		
+ Dividend yield	4.6%	14.0%	15.9%
= Total Shareholder Return (Pre-Tax)	32.7%		
- Tax Payable	-3.8%		-13.0%
= Total Shareholder Return (Post-Tax)	28.9%	100.0%	100.0%

If you compare this to the column chart above, our contribution is relatively in line with the average which itself is interesting. No sub-driver has any concentration, which suits us well as I believe a strong return comes from a lollapalooza of these sub-drivers. Whilst the S&P return is much lower than the expected trust return, it is because earnings growth comes at a much higher incremental return on invested capital and there is much greater multiple expansion as the average business improves greatly over the period and gains investor interest.

You may also be wondering why our tax is so low at a rate of just 11.6% of our pre-tax TSR. The trust has an average unitholder marginal tax rate of 38% as of the time of writing, and an average CGT discount of 44%. Thus, we pay a tax rate of 21% on our price appreciation and the tax on the cash component of dividends gets cut from 38% down to 11% due to the accumulation of franking credits. Lastly, as I am a tax agent we benefit from a long window between when returns are received, and the tax is due to be paid. If we assume that return would fall halfway through a financial year, it gives us 1 year and 5 months to pay tax on dividends and 6 years and 5 months to pay it on capital gains (5-year hold), if the value of compounding the deferred tax liability is considered our tax drag is 3.8% whereby if tax was paid upfront it would be 6.1%.

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