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Letter to Unitholders – March 2024

Tax Year	Monthly Performance (Pre-Tax)												Pre-Tax	Post-Tax
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	YTD	YTD
2023											(1.5%)	3.4%	1.9%	1.9%
2024	1.8%	1.2%	3.0%	(3.6%)	3.4%	4.1%	1.9%	(3.3%)	(0.9%)				7.6%	5.5%
												Annualised	10.9%	8.5%
												Cumulative	9.6%	7.5%
												Sortino	0.8	-

Dear Unitholders,

The performance table has been adjusted with the removal of the relative ASX300 benchmark and addition of a post-tax return, which is based on an estimated calculation (see appendix 2) for the trust. The trust is now looking to target an annual post-tax net return of 20% p.a. which replaces the prior pre-tax gross return of 25% p.a. This is to ensure that the trust is prioritising after-tax outcomes for its unitholders. I have also updated the daily unit pricing spreadsheet which is available on the website, front and center. It is worth mentioning that the High Watermark is $1.1581 vs the current $1.0959 unit price, meaning that performance fees don't kick back in until the trust returns to above that price (ignoring any distributions).

I was able to attend the Coffee Microcaps Conference and was pleased to be able to talk to those of whom I was looking forward to many new faces including several Australian micro-cap fund managers. I was fortunate enough to have one of these develop into a vote of confidence by way of an investment into the Hurdle Rate Unit Trust.

Firstly, entries and exits. New cash was partially used to make a new investment but otherwise the remaining cash has been used opportunistically to rebalance our existing holdings. To date I feel I have taken the approach to position sizing outlined in the October 2023 too far so am looking to rebalance things not to the extent that they become equal weight, but the skew is less pronounced. The approach I've taken here is for 50% of the portfolio to be equal weight and 50% to be skewed in the same way outlined in that letter with the distribution over time expected to look something like a 5% average position with ~2.5% being a standard deviation up or down.

A relatively small position in Pensionbee (LSE:PBEE) was purchased during the month after their announcement of an expansion into the US, backed by a larger partner who intends to provide substantial marketing spend and know-how. In addition to the already well-oiled UK market there is substantial optionality on the US working out as well. An optically expensive price of ~7x EV/ARR was paid, but I expect the business to be an order of magnitude higher in the next 5 to 10 years.

Finexia Financial Group (ASX:FNX) was an admission of error and I have sold in full during the month after what I believe was an incredibly amateur showing for their inaugural results call from Neil Sheather who was unable to answer simple questions about significant changes in the balance sheet. The direction of the group is to lean further into private credit which I have doubts of their ability to underwrite and subsequently carry significant leverage. This lean included selling down what I believe was the crown jewel of the group, the co-investments into Stayco and Childcare funds. In addition to this, the group lost Scott Beeton to Arc Funds (ASX:ARC) impairing their ability to expand distribution. After discussion with several people who have been involved with the services and people involved in this business, this brought into question the aptitude of those running the business. The trust lost 18% on this investment over an average holding period of ~5 months, and it represented ~5% of the portfolio for the life of the investment.

Some of the proceeds were used to participate in the AF Legal (ASX:AFL) entitlement offer after the announcement of the acquisition of the Armstrong Contested Wills & Estates (ACWE) business from GTC Legal, which if you have been following AF Legal you would recognise as the failed acquisition attempt from 2022 under previous management. The ACWE business is complementary to the existing family law business for obvious reasons being an area of law which involves a highly strung family group in a different stage of life, but with many of the same motives as a family law case. On the other hand, ACWE often requires going through the courts in a time-consuming manner and this type of law is often billed near the end of a dispute, meaning that there is substantial working capital demands relative to the average mediation settled family law case. Fortunately, the acquisition includes all the current lockup of the ACWE business, which is the same as the purchase price of the business, meaning that there is little goodwill being acquired (provided that the remaining net assets being acquired are in a neutral position). With this business growing from $2m to $3.1m in revenue over the prior 3 years, not paying a dollar for the business is a great allocation of capital and I am happy to have received double the trust's full entitlement by the acceptance of all applied shortfall shares.

Kulcs-Soft 2023 results showed +19.5% in revenue and +22.6% in earnings per share with an increase of ROE from 97.7% in 2022 to 103.3% in 2023 and dividend payout ratio proposed to be 100% again. This continues a track record of exceptional results for the company and trades at 11x earnings as of the time of writing.

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[Orchard Funding (LSE:ORCH)](#) once again updated the market with the detection of a small case of fraud in their loan book from a specific introducer. This introducer has current loans amounting to £0.5m with the business of which Orchard is raising a full provision for and is reviewing the entire loan book for any further fraudulent introducers. The market reacted in kind with an intraday decline of 33.9% on the date of announcement. The provision was <3% of book value and frankly the group has a strong history of cash flows evidenced with dividend payments more than the current market price since IPO in 2015 along with a majority shareholder in Ravi Takhar. The trust took decisive action to add more shares at around 20% of book value despite a history of high single digit/low double digit returns on equity. Opportunity cost would suggest sizing this substantially greater than I have however, with the Takhar family owning >55% of the company, a purchase of the Gresham stake of ~15% could get them ample voting power force a take private (atleast this is the view of a certain ex-shareholder), so there is a hesitancy to go 'too' heavy on Orchard. It is so cheap that there is a risk that the Takhar family acts on crystallising that.

[Getbusy (LSE:GETB)](#) released its full year 2023 report which I viewed as somewhat of a disappointing year. Revenue was up 10% in constant currency terms which was 'fine' but the group suffers most from a change in UK R&D tax credit rules which will likely halve their claim (~£0.3m less WC benefit) and a shift towards Smartvault resale partners which pay monthly, diluting the group's proportion of annual renewals. Obviously, this is intended to be worthwhile but this and the R&D claim have resulted in a free cash outflow of (£1.0m) for the year, meaning that the business will likely have to reduce its reinvestment rate to self-fund in the short-medium term future.

On a positive note, the group shifted away from non-accountant subscribers in favour of larger firms which has assisted both ARPU (£281 up from £256) and monthly churn (reducing from 0.9% to 8%). Although if you take out the run-rate from the Virtual Cabinet unlimited upgrade that came in in the 1st half, the 2nd half ARR only grew 3% which is far from where I would like it to be. Nevertheless, the group trades at 1.7x EV/Sales and 5.4x their "standstill EBITDA" and management are heavily incentivised to realise a divestment of some kind at a substantial premium.

[ASIRO (TSE:7378)](#) also reported its 1st quarter 2024 result with revenue +40.7% on the prior year. Profit was negative due to a minor impairment of the Bikkore business, which funny enough was the one I was not sold on in our write up, so I am not mad to see focus shifted away from it. Free cash flow amounted to ¥96m and pre-investment EBIT was ¥208m, up 19.3% on the prior year. Overall, the progress is very sound and the trust remains a satisfied shareholder. Interestingly, the group has a target of ¥5.5B in revenue and ¥1.1B in EBIT by October 2025, but has also outlined a 2028 plan which the CEO has quoted in the 1Q transcript:

"Regarding the investments we are currently making, the main focus is on increasing medium- to long-term growth potential rather than short-term performance. We believe that even if we stop investing in FY25, we will be able to concentrate resources on existing businesses and that our growth will not stop."

This therefore implies that the group will be able to generate a drastically improved return on its invested capital over time. Whether that is true or not, it is still exciting to think that it may be possible. Unfortunately, however, after an email I was informed that the company is ceasing it's English disclosures…bad timing.

Lastly, I would like to announce that the Hurdle Rate Unit Trust Annual General Meeting is to be held on the **10th of July 2024 at 6PM AEST**. This time frame has been chosen not only to accommodate for the Australian unitholders, but also the European based managed accounts. More details relating to this will be shared later. For now, please bookmark the time and date.

Yours sincerely,

Tristan Waine, CPA
Hurdle Rate Pty Ltd

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Appendix 1 - Principles of the Hurdle Rate Unit Trust

"When we dropped our hurdle rate, it dragged down the expected IRRs for all the opportunities that we subsequently pursued, not just those at the margin. We try to capture this idea by saying hurdle rates are magnetic. It now takes a very brave soul to propose a hurdle rate drop at CSI."

— Mark Leonard, Constellation Software 2015 President's Letter

Remuneration

The trust operates on the same fee model as the likes of the Warren Buffett Partnership with no management fees and a performance fee equating to a 25% profit share on any profit which exceeds a 6% annual return.

Ownership

The trust was seeded with all of the capital from Tristan's family trust, having sold all of his personal investments and purchased units within the Hurdle Rate Unit Trust to demonstrate complete alignment of interest.

Hurdle Rates

The name "Hurdle Rate" is inspired by the Canadian software company Constellation Software. A hurdle rate is the minimum rate of return an investment must offer before it becomes investable. Constellation initially had a hurdle rate of a 25% annual return whereas the trust is intending to adopt a 20% post-tax net return to unitholders.

Game Selection

We believe that Tristan has a unique advantage of being an experienced practitioner in the accounting and advice industries and are looking to leverage this by considering investments in professional and financial services firms and stakeholders of these firms such as service providers, software, staffing, education, investment managers etc.

Competition

We seek to limit competition by investing into public equities which have much in common with an investment into a private business. This leads us to a skew to smaller companies which have less sophisticated shareholders, which coupled with our specialised game selection provides a compelling opportunity to perform.

Portfolio Management

Our intent is to manage an appropriately diversified portfolio of 10 to 20 companies and maximise our ability to 'turn over rocks'. We aim to hold our investments for 3 to 5 years on average, meaning we will need anywhere from 2 to 7 ideas per year.

Taxation

As the trustee is an accountant, it should be of no surprise that we are acutely aware of tax. Our intention is to prioritise and maximise after-tax outcomes for our investors.

Volatility

The Hurdle Rate Unit Trust does not carry PERMANENT capital and is therefore intent on stabilising the variation of profitability over time, ensuring that when investors do want to purchase or sell units, that they are not being disadvantaged by their timing. We track this with the Sortino ratio, with a hurdle of 2.0 or more.

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Appendix 2 – Tax Calculations

Hurdle Rate Unit Trust
Statement of Taxable Income
For the Year ended 30 June 2024

	Total $	Tax @ 34.1%
Accounting Profit	**7,561**	**(2,577)**
Less		
Realised Capital Gains	(21,701)	(7,398)
2023 Carried Forward Tax Losses	(220)	(75)
	(21,921)	**(7,473)**
Add		
Franking Credits	8,141	2,775
Foreign Tax Credits	1,325	452
Taxable Capital Gains (100% ST)	21,701	7,398
Unrealised Capital Loss	29,008	9,889
	60,175	**20,514**
Taxable Income	**45,815**	**10,463**
Franking Credits		(8,141)
Foreign Tax Credits		(1,325)
Net Tax Payable		**997**
Reversal of DTA		**9,466**
NAV & % Tax Impact	**541,376**	**-1.9%**

Hurdle Rate Unit Trust
Estimated Weighted Average Tax Rate
As of the 29 March 2024

Entity	Units	Ownership	Marginal Tax Rate	CGT Discount
Family Trust	90000	18.2%	34.5%	50.0%
SMSF	61628	12.5%	15.0%	33.3%
Family Trust	57105	11.6%	47.0%	50.0%
Unit Trust	55580	11.3%	47.0%	50.0%
SMSF	53500	10.8%	15.0%	33.3%
Family Trust	48883	9.9%	47.0%	50.0%
Company	30000	6.1%	30.0%	0.0%
Individual	27212	5.5%	47.0%	50.0%
Family Trust	22676	4.6%	39.0%	50.0%
SMSF	14276	2.9%	15.0%	33.3%
SMSF	13123	2.7%	15.0%	33.3%
Individual	10000	2.0%	47.0%	50.0%
Individual	10000	2.0%	47.0%	50.0%
	493981	**100.0%**	**34.1%**	**42.2%**

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