THE AUSTRALIAN

A low hurdle rate and high returns are a powerful combination

ROGER MONTGOMERY THE AUSTRALIAN AUGUST 16, 2014 12:00AM

AT its most basic level, a company raises capital to fund an enterprise with the objective of creating a return that is at least acceptable to its investors.

For a creditor or an investor that lends capital to a business with a priority of repayment, the acceptable level of return might be, say, 5 per cent in the current market environment for a term of five years.

For a shareholder, an acceptable level of return may be around 10 per cent, reflecting the higher degree of risk the equity investor is taking. After all, capital return is not guaranteed and equity investors are near the end of the queue of stakeholders to be repaid in a bankruptcy.

The company's overall hurdle rate of return is simply the blended average of these two rates: for a company that is funded with relatively more debt, perhaps the blended hurdle rate is around 7 per cent; while a company funded with relatively more equity might have a hurdle rate around 9 per cent.

This hurdle rate can be viewed as the minimum return needed to keep investors satisfied.

In simple terms, the way a publicly listed company can make its share price go up quickly is to generate a return that is materially above its blended average hurdle rate.

It is similar to a scenario in which you own a house that can be rented out for a monthly rate that is higher than your monthly mortgage repayments. In this scenario, the asset — your investment property in this case — is generating a return higher than what is required by your primary investor — your bank or mortgage provider. The surplus falls to you — the shareholder — and it is essentially this surplus that makes a company's share price rise rapidly.

Even better than this is if the company can take a portion of its annual profits to reinvest back into the business while maintaining its high returns.

A recent addition to the Australian Securities Exchange is a company that appears to be doing exactly this: Burson Group Limited (ASX: BAP). Burson Group is Australia's largest trade focused distributor of automotive aftermarket parts. The company listed on the ASX in April and has already surged over 20 per cent above its listing price. The market index, by contrast, is up by only a little over 1 per cent over the same period.

At its most basic level, the reason for Burson Group's success is that the company can generate returns that far exceed its blended average hurdle rate when taking into account its roughly 60-40 split between equity and debt funding. Furthermore, Burson Group has demonstrated an ability to take a material share of its earnings each year and reinvest them back into its business to grow.

There are two parts to Burson Group's ability to achieve this highly attractive dynamic. The first is around its ability to generate very high returns. This relates to an advantageous strategic position the business exhibits in a fairly concentrated market. In the Australian market for trade distribution of auto parts, there are few competitors of the size and scale of Burson Group.

The second part relates to Burson Group's ability to debt-finance incremental expansion, should management wish to proceed along these lines. The company generates significant cash flow to cover its interest expense around 10 times over. A creditor would likely have no problem with lending the company more money to expand its business. As the company borrows more money to fund its expansions, this will only decrease its blended average hurdle rate further.

Remember, it is not just about how high a company's returns are, it is also about how low the hurdle rate it needs to clear is. Burson Group is a company that can generate returns that are very high while at the same time lower its hurdle rate. This is a very powerful combination that will serve to benefit the company's shareholders over time.

Roger Montgomery is the founder of Montgomery Investment Management.