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Australian Institute of Company Directors

Ladies & Gentlemen, I stand before you at one of the more interesting times in Australia's economic history. In the past year we've seen the supply of capital to all but the very strongest of companies dwindle to a trickle. We've seen highly leveraged companies of all kinds descend into bankruptcy and liquidation, despite, in some cases, the high quality of their core assets. We've seen the All Ordinaries Index decline by about 40% from its peak just over one year ago, on the first of November 2007.

I stand before you as the managing director of a small but fast-growing ASX-listed company, a company which requires ongoing access to capital to carry on with its aggressive growth plans. Yet I stand before you entirely relaxed and confident. How can this be so?

To explain this happy situation I have to tell you a bit of the history of 1300 SMILES Ltd. I qualified as a dentist back in 1987 then practiced as a Dental Officer in the Royal Australian Air Force for 3 years after that, finishing off my time in Townsville in August, 1991. Thereafter, I owned and operated numerous dental practices in the Burdekin and here in Townsville. Along the way I made many mistakes and learned plenty about how to run multiple facilities employing highly qualified professionals.

By 1999 I had refined my approach and settled on the business name Townsville Family Dental. This grew to comprise six facilities here in Townsville and one in Cairns—where we used a different name, as you can imagine. It took some years to get many aspects of the business worked out, from purchasing and collections to the massively important and massively difficult business of human resource management. All of these areas can still be challenging, but you would all understand that you know a lot more about a business after you've spent ten or more years wrestling with it.

By around 2002 I started to toy with the idea of a listing on the Australian Stock Exchange, but not for the usual reasons. Most small companies that seek listing do so because they need more capital. That wasn't a problem for us, as the business had been profitable for several years and it delivered positive cash flow every month.

My objective was to expand the business well beyond north Queensland, and the primary object of listing on the ASX was that of raising the company's profile. We thought it would make it that much easier to recruit dentists and acquire practices if we were more widely known. I tossed this idea around with a stockbroker friend for quite a long time. He told me that it would be easy to get the company listed, but not before the company delivered an after-tax profit of at least \$1 million. In the year ended June 2004 we achieved this, with a profit of just over \$1 million, and we decided to go ahead and seek listing.

One of the first things we needed to do was to come up with a better name, as Townsville Family Dental didn't exactly reflect our aspiration to achieve a nation-wide presence. Eventually we settled on 1300 SMILES. Everyone involved agreed that it was a great name, with the lovely twist being that it was both our name and our telephone number. We all felt very pleased with ourselves at the time, but since then there's been no evidence that anyone in Australia has *ever* noticed the fact that if you know our name, you also know our phone number. It hasn't hurt us, but all the effort we devoted to reserving 1300 and 1800 numbers with similar names was probably wasted.

We set to work on a prospectus for an offering of shares as soon as the June 2004 accounts were ready. We believed that there was no barrier to getting a prospectus together in time and that those accounts would be all that we would need. As it turned out, everything took longer than we had hoped, with the result that we also had to prepare accounts for the September quarter for inclusion in a prospectus which was finally registered on the 23rd of December 2004.

That timing wasn't great, but the brokers we worked with assured us there would be no trouble achieving our objective, which was to procure a minimum 500 shareholders as required for listing on the ASX. A further wrinkle arose when we discovered an error in our 2004 accounts involving some depreciation and tax issues. This made a difference of, from memory, \$6,000 to our 2004 accounts. No one else had noticed, but we had discovered it internally and our legal advice was that we should issue an amended prospectus, so we did.

This had the effect of slowing the process down by several weeks, but didn't do any real harm. Our instruction to the stockbrokers handling the issue was that we did not seek to raise a great deal of money and that we did not wish to place more shares than necessary at the issue price of 80c per share. We just wanted to achieve listing, and for that we needed 500 shareholders, plus a few more as a margin for error

and subsequent consolidation. Our brokers told everyone who applied that it was pointless to apply for more than \$2000 worth of stock—that is, 2500 shares at the 80c issue price—because larger orders would be cut back.

Some people either didn't listen or didn't believe that a small company would turn down subscription money. We received lots of cheques for amounts ranging from \$10,000 to \$50,000. Every one of those people received exactly \$2,000 worth of shares, although my broker mates did tell me that it went against all of their instincts to send back all that money.

By early March 2005 we stopped accepting applications and drew the line at 607 new shareholders, each with just \$2,000 worth of our stock. Our shares started trading on 11 March 2005. The first trade ever was at 99c, and they closed that first day at \$1.00 even, giving our subscribers a 25% gain on the first day. The shares never went below \$1.00 after that.

If you're wondering, shares in 1300 SMILES now trade at around \$2.40—three times the issue price. That's after the biggest share market decline of our generation. You'll have to forgive me for pointing out that there aren't many shares trading at three times their 2005 prices in the current market. The main market indices—the All Ordinaries and the ASX-200—are both now below their levels of March 2005.

The stockbrokers involved deserve some credit for looking after the issue well. They had made it clear to all subscribers that the available parcels were small, and that subscribers who wanted bigger parcels would simply have to buy on-market. This group of pre-primed buyers was very important to us, because new companies are often forgotten soon after listing, with their share prices drifting away to nothing.

Since listing, 1300 SMILES has continued to run its business as always: it's a clear, simple, totally transparent business. Shareholders can understand the business of operating facilities in which dentists work as much as they like and share revenue with the company. We pay relatively generous dividends, as our promise to shareholders has always been that owning shares in 1300 SMILES will be truly analogous to owning a pro rata share of a conservatively-managed business. Also, our brokers advised us that a steady and growing dividend would help overcome investor scepticism about the new company on the block.

Because we had hoped to achieve listing some months earlier than we actually did, we had already committed to pay a dividend in respect of the December 2004 quarter. This means we declared a maiden dividend of 0.8c per share just three weeks after listing. This was fine with us, as it set our relationship with shareholders on the right path. Our dividends have grown with our business, from a full-year franked dividend of 4c per share in 2004 to 8.5c per share in 2008. That works out to a compound growth of 28% per year. In 2008, shareholders received a franked dividend return of 10.6% on the shares they bought in the float for 80c.

We have succeeded in delivering this growth in profit and dividends while expanding rapidly. We now have seventeen multi-dentist facilities in ten different population centres in Queensland & northern New South Wales (being Tweed Heads – our most recent addition). We're the largest by far in Queensland, but we regard this as just the beginning. We aim to have a similar presence throughout Australia.

So how does all this relate to my present relaxed and happy state of mind?

First, 1300 SMILES Ltd is profitable. Our profit has grown steadily from \$1 million prior to listing to \$2.4 million in 2008. Historically we have avoided forecasting future profit because that can become a real burden, requiring you to update the stock exchange whenever your expectations change more than the tiniest amount. But recently we've broken that tradition and released to the market a profit forecast for the first half of the 2009 financial year – up 67%. We've had to do so because the increment to profit this year is expected to be large indeed. Recently we released a forecast profit of \$1.9 million for the first half only, a figure not far short of our profit for the previous full year.

Second, we operate in a classically defensive industry. If the economy goes sour for an extended period, people may defer certain non-essential or cosmetic dental work, but this is only a small part of our business. Our experience is that people will find a way to pay for important dental work even if it means forgoing expenditure on something else. The services we sell are services which people keep on buying through good times and bad.

Third, we have access to abundant capital. The credit crisis briefly threatened to increase the cost of borrowed funds, but with recent interest rate declines we find that we're paying no more for borrowed

funds than we were a year ago, and we're on our way to paying less. Our current analysis is that it is far better for us finance our internal growth and to make further acquisitions with borrowed funds, as this approach delivers a greater positive addition to earnings per share and because our gearing is still quite modest in any case.

So, in summary, I'm happy and relaxed because 1300 SMILES is a transparent, simple, profitable business in a defensive industry which enjoys the support of its shareholders and bankers.

We use debt judiciously. In other times critics might look at our balance sheet and accuse it of being lazy or under-gear'd. But in these times a conservative, low debt financial structure and a high-cash flow business make it easy for both me and for our shareholders to sleep at night.

This brings me to a few predictions for our industry. 1300 SMILES is not the only company seeking to profit from the inevitable consolidation of the dental industry. Many other players are trying to copy our model, but what they don't seem to get is the fact that we built the business for ten long years before we sought listing on the ASX. I think some of the copycats reckon they can just copy our style and achieve the same success. Well, I wish them luck.

I mentioned a moment ago that the consolidation of the dental industry is inevitable. I don't mean that every dentist will end up practicing in a corporate setting. What I would point out, though, is that the industry is still dominated by one and two-man practices. The advantages of practicing from bigger, professionally managed, up-to-date facilities without taking on any personal debt seem pretty obvious to me, as they are to the many dentists who join 1300 SMILES each year. Some dentists will always prefer to operate solo, and nothing will stop them from doing so. But the industry will at some point reach a new equilibrium, with dental practices divided among professionally managed organisations and small businesses. The consolidation of the industry is obviously accelerating, and only those players with proven operations and proven financial stability will be there five years from now.

Some of the new players have models which seem to be built on the notion that infinite debt funding will be available to them. As I mentioned, 1300 SMILES had debt of \$4.5 million as of last June. One of the other operators in this business, which has only been going for a couple of years, already has borrowings of more than *\$150 million!* This company owns some very good practices, but *one hundred fifty million dollars!*

Other new players seek to use scrip as currency. We've all seen what a disaster that approach has delivered in other industries, most notably medical centres and accountancy. Professionals traded the goodwill in their businesses for shares in not-yet-listed companies, with disastrous results when they all tried to sell their shares as soon as they were able.

1300 SMILES Ltd does not seek to trade its shares for dental practices we acquire. On occasion we issue a few shares as part of a purchase deal (never more than 20% of the agreed purchase price) and then generally only when specifically requested by the vendor. We believe that we can deliver the greatest growth in earnings per share by buying practices for cash and keeping the number of issued shares as small as possible, so we only offer shares as needed to close a deal.

As this is a meeting of company directors, I will conclude by mentioning that 1300 SMILES Ltd has just three directors, the minimum required for a public limited company. The two directors other than myself are both non-executive, and the small board is nimble and responsive.

I don't know if I should mention in this crowd that we also believe that directors' fees should be kept as low as possible. Our directors deserve some compensation for the significant time they devote to the company, but equally I believe that it's important to sing from the same hymnbook as our shareholders. We keep all costs as low as we can—including directors' fees—and encourage anyone who wishes to participate in the resulting profit to own shares and collect the lovely dividends.

The outlook for 1300 SMILES is rosy indeed, and this happy state of affairs results entirely from some old fashioned virtues. We pursue a single, simple business, and we do it as best we can. We keep our debt to the minimum practical level. We examine every single item of expense over and over to see what costs we can squeeze out. We treat our shareholders as what they are: the owners of the business. As owners, they're interested in sustainable, steady growth, growing profit, and growing dividends. We'll do our best to stay on that track.

Thank you for your time today. I'll be happy to answer any questions you may have.