

## 27 January 2009 to ACAD-CID in Japan

The organisers of this conference suggested that I speak on the topic “Corporatisation—Good or Bad?”

With all due respect, that would be a little like arguing about whether women should have the vote. You can have the argument, if you want, but universal adult suffrage is the rule in all civilised countries and it's not going away. Neither is the corporate dental sector.

Instead of talking about whether corporatisation is good or bad, I propose to speak instead about which corporate operators will do a good job of it. By a good job, I mean providing a sound permanent infrastructure from which you can operate your practice on your own terms. I mean a setting in which you have truly collegial relations with other dentists, one in which you can learn from the more senior dentists and pass your knowledge and experience to younger dentists. I mean a setting which enables each dentist to give top quality service to every patient.

But first let me say that I recognise that not every dentist will end up in a corporate setting. Some dentists will always prefer to operate solo or in small partnerships. Nothing will stop them from doing so. Over the next few years, however, we will see a sudden shift in the industry. The trend toward corporatisation is accelerating rapidly, and the equilibrium between solo practices and professionally managed practices will be entirely transformed over the next five years.

Corporatised dentistry is here to stay. Over the next few years every one of you will have to face this fact. Some of you will choose to shift your practices to a corporate setting. Others of you may find that you have to change your practices somewhat to meet the competition from colleagues working in larger, professionally-managed practices. It doesn't matter whether you love the fact of gathering corporatisation or you hate it; all of you will have to deal with it.

I'll organise today's talk around three topics:

First, I'll tell you a bit about 1300 SMILES Ltd and our approach to managing dentistry on a large scale.

Second, I'll tell you a bit about why dentists have chosen to base their practices within facilities operated by 1300 SMILES.

Third and last, I'll talk a bit about some of the different corporatisation models and tell you which ones I think will survive. This last bit is important to you because you don't want to waste your time and risk your practice with a company which isn't going to last.

### 1300 SMILES Ltd

1300 SMILES Ltd grew from an aggregation of seven multi-dentist practices in north Queensland which I built up under the name Townsville Family Dental, except in Cairns, where we used a different name for reasons you can appreciate.

In 2002 and 2003 I considered the idea of listing on the Australian Stock Exchange for the purpose of raising our profile and assisting with our expansion across Australia. The stockbroker who advised me on this told me to wait until we had a full year which delivered an after-tax profit of over \$1 million. We achieved this in the 2004 year, so we prepared a prospectus for the offer of shares which was eventually registered in December 2004.

Unlike most small companies offering shares to the public, we didn't actually need any money, as we had a positive cash balance and we were profitable in every period. But we did need the ASX listing for future growth, and for that we had to have 500 shareholders. We let it be known quite clearly that subscribers for our shares would be allocated only \$2,000 worth each, being 2500 shares at the issue price of 80c.

Some people didn't believe us; some didn't listen. We received many applications with cheques for \$10,000, \$20,000, and \$50,000. We cut them all back and issued to every applicant exactly \$2,000 worth, despite the fact that it just didn't feel right to send back all that money. But we knew that we did not want to issue too many shares at 80c, because we knew for sure the company would soon be worth a lot more than that.

Our shares started trading on the market in March 2005. The first trade took place at 99c and the shares closed at \$1.00 on the first day—a nice 25% rise for our subscribers at 80c. The shares never again traded below \$1.00.

Recently they've been trading at around \$2.50—a bit more than three times the issue price less than four years ago—despite the remarkable downturn in the broader share market over the past year. Our dividend has grown from 4c in 2005 to 8.5c in 2008, a compound growth of more than 28% per year.

At this point I'll invite you to think of any other company whose shares are presently trading at three times their 2005 prices. It's hard to find one. The market's not always right about these things, but the fact that 1300 SMILES has held its value in the face of the biggest market wipe out since 1987 does, I suggest, tell you something.

So how have we delivered these lovely financial results? By pursuing a simple business model and exercising some old-fashioned virtue.

Our model is this. We seek to operate attractive, efficient dental facilities in which self-employed dentists operate their own practices as they see fit without taking on the hassles of running a small business. They never have to worry about facilities, purchasing, IT, or staff problems. Dentists who do not own practices elsewhere can simply join us and have top-quality facilities and a steady flow of new patients without incurring any capital cost at all.

We are also happy to acquire good quality practices for cash. This enables the proprietor dentists to extract the value of the goodwill in their practices—for cash—while continuing to earn an income at the same level as before.

The proof is in the pudding. Since 2005 we have grown from having seven facilities in Townsville and Cairns to having eighteen multi-dentist facilities in Queensland, with a presence in all of the ten largest cities and regional centres, along with one just over the border in New South Wales. The average size of our facilities has grown along with the number of facilities.

The sustainable growth we have maintained over several years results from our ability to deliver an attractive bundle of services to dentists. The key aspects of this package are our facilities, support staff, new patient flow, and minimum interference. Dentists who locate their practices within 1300 SMILES are self-employed and operate their practices as they see fit. Without dentists, we have no business. The fact that the business of 1300 SMILES Ltd has continued to grow over the past several years would seem to be evidence enough that we have the package right. We're always working to improve our offer to dentists, of course, but the evidence suggests that we're already on the right track.

#### Why dentists choose to locate their practices within 1300 SMILES Ltd facilities

For a dentist who does not own a practice, joining 1300 SMILES is pretty obvious. For no capital outlay at all, a suitably qualified dentist gets the use of top facilities and equipment, qualified support staff, professional marketing and purchasing, and a steady flow of new patients. Within a few practical limits, dentists can craft a practice to suit their life styles. If you're a keen surfer, you might choose to practice on afternoons and evenings and have your mornings free. If you're responsible for your children, you can work during school hours during those years when your kids are young. If you're on the glide path toward retirement, you can gradually wind back to 80%, then 50%, then perhaps 20% time. For many dentists this proves to be a far more agreeable and healthier way to retire than simply stopping all at once.

If you already own a good quality practice, you might choose to sell that practice to us. You'll get all of the advantages I just outlined, plus you'll get the agreed cash value of the good will in your practice. We have a good track record of acquiring established practices, and we certainly know how to keep our hands off if you already have a well-managed operation.

I mentioned at the outset that every dentist remains free to operate a solo practice and some will always choose to do so. I would suggest, however, that most of you should take a serious look at whether owning your practice is the best way to achieve your personal, professional, and financial goals. Most dentists run their practices as small businesses just because that's the way it's always been done. I would urge each of you to think had about whether this traditional approach is the best for you.

#### Different models of corporate dentistry

Now let me turn to a consideration of the different models of corporate dentistry. I always have to start this discussion by telling you what 1300 SMILES Ltd does not do.

The main thing we don't do is this: we do not seek to trade shares in our company for the ownership of your practice. Period. We never have. I'll say this over and over because the anti-corporatisation segment of the dental community constantly accuses us of doing this.

A certain number of dentists are just opposed to any sort of aggregation and opposed to any way of doing dentistry other than as sole practitioners or in very small partnerships or associations. To this sort of dentist, any larger aggregation, in any form, is the work of the devil. People who hold this view are entitled to organise their professional lives however they see fit, but this does not give those people the right to tell lies about how we do business.

That's why I'll say it again: we do not seek to trade shares in our company for the ownership of any dental practice. Doing so is the central element of an aggregation model which has failed spectacularly in other industries, most notably medical centres, accountancy, and even dental labs. The core of this approach is to acquire ownership of established businesses in exchange for shares in a company which is not yet listed, with the implied promise that the former business owners will make a fortune when they eventually sell their shares on the market.

Every example of this aggregation model has been a total, agonising failure. All of the ex-proprietors have rushed to sell their shares as soon as possible, usually for a price one-tenth or one fiftieth of what they were hoping for, or they've been unable to sell at any price. Think Stockford in accounting or Foundation Healthcare in medical centres or Pearl Dental in dental labs. 1300 SMILES has nothing in common with any of these companies, but those who object to our very existence inevitably put forward the false idea that we do.

1300 SMILES Ltd works in exactly the opposite way. We keep the number of issued shares in our company under very tight control. By keeping the number of shares small, we have a far easier job of increasing earnings per share and, of course, dividends per share. These are the results which really matter to investors. After all, if a company doubles its profit but the number of issued shares also doubles, existing shareholders have gained nothing at all.

When we acquire an existing practice, we do so for cash. On three occasions we have also issued some shares in connection with an acquisition, but in both cases these represented less than 20% of the agreed purchase price. In both cases we did so only because the vendors specifically asked that we include some shares in the deal so that they could participate in the upside.

Forgive me for lingering on this point, but it is essential. If you go home and mention to a colleague that you heard a speech from the bloke at 1300 SMILES, your colleague will probably chuckle and say "oh, yeah, the crowd that wants to buy our practice with dodgy stock." You're now equipped to set your buddies right on this point. We might offer to buy your practice, but we'll only pay cash unless you can give us a compelling argument for why you should also get some stock. Some other organisation might be hoping to trade dodgy stock for your practice, but you can be sure it's not 1300 SMILES.

We believe that our company will grow dramatically from its present size, and we believe that the share price—sooner or later, and subject to the mood of the market—will eventually be a big multiple of the present price. For that reason we have no interest in giving away any shares at the present price unless it's the only way we can seal a purchase deal we really want.

This brings us to the main competitors in the dental consolidation market.

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. That doesn't mean that every dentist will be convinced, and some dentists will always prefer to operate solo. But the changing market for

dental service delivery means you need to think about your options more carefully than you did a few years back.

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 just \$4 million at the end of the 2008 financial year, an amount smaller than our free cash flow since that date. One of the other operators in this business, which has only been going for a couple of years, already has borrowings of *\$180 million!* This company owns some very good practices, but *one hundred eighty million dollars!*

Did someone just say ABC Learning Centres? Sorry, I must have imagined it.

Some of the other new players seek to use their shares 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. As I mentioned, we have on occasion issued a few shares as part of a purchase deal (never more than 20% of the agreed purchase price) and then 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.

I look forward to meeting those among you whom I haven't met before. As we go forward, I hope to welcome some of you into the 1300 SMILES Ltd system and as shareholders in our company.

I would be pleased to take any questions you may have.