

**LETTER FROM THE MANAGING DIRECTOR**

Dear Shareholders,

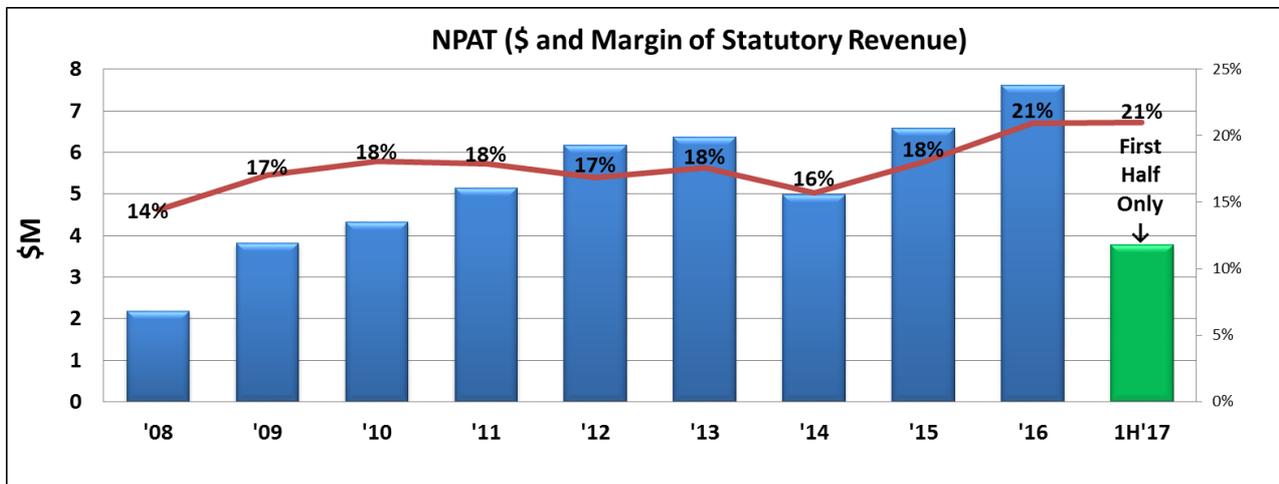
I am very pleased to present to you our accounts for the first half of the 2017 financial year. These results, delivered in a period which presented some challenges to our entire industry, speak to the soundness of our management and business model.

Thanks to our solid operations and our intense focus on cost control and operational efficiency, I have the privilege of announcing a record interim dividend of 11.25c per share, fully franked.

**Financial results for the half year to 31 December 2016**

- NPAT down 2.4% to \$3.8 million
- Revenue (Statutory) down 5.2% to \$18.0 million
- Normalised NPAT up 4.5% to \$3.8 million
- Normalised Revenue down 3.4% to \$18.0 million
- Earnings per Share down 2.4% to 16.0c
- Cash balance up 14% to \$8.6 million
- Interim dividend up 2.3% to 11.25c
- Bank debt unchanged at \$0

While I never like to see negative numbers in our financial reports, I take some comfort from these results. Above all, I note that during the twelve months from 31 December 2015 1300SMILES paid a record full-year dividend and also experienced a slight decline in Revenue, but nevertheless we have delivered a 14% increase in our cash balance to \$8.6 million. As discussed in detail below, our normalised NPAT for the period was up by 4.5%. Our bank debt, of course, remains at zero.



**Economic and political environment**

At the commonwealth government level, the main program of direct relevance to our business, the Child Dental Benefit Scheme, produces a non-material portion (that is, less than 5%) of our Revenue. Our CDBS revenue continues to grow at a moderate double-digit pace.

At the state level, our company continues to provide services to public dental patients in Queensland under an outsourcing arrangement with Queensland Health. Our revenue from this activity ebbs and flows noticeably, affected by the size of public dental service waiting lists and perhaps by budget cycles within government. Our relationship with Queensland Health is practical and positive, and our revenue from these services continues on an upward trend.

I am pleased to say that there were no significant changes to government policy affecting our business at either the state or federal level.

Broader economic factors did have a noticeable effect on our results. The first of these is ongoing political uncertainty and gridlock here in Australia. Both the commonwealth government and the state government in Queensland (our largest market) hang by slender threads, susceptible to disruption at any time.

In Queensland the state government depends on the support of a single independent member. An election is not due for another year but there's plenty of speculation that it will come much sooner. This sort of leadership and policy vacuum always creates distress for consumers and exerts downward pressure on consumer spending.

A second factor is the shock result in the recent American elections. This has created great uncertainty in the outlook for employment in industries across all sectors of our economy. Whether the economic result eventually turns out to be good or bad, consumers react to this sort of uncertainty by waiting it out with their wallets closed.

A third factor is the growing gulf between the booming big city markets in Sydney and Melbourne and the rest of Australia. In those two big cities, consumer spending seems to be supported by the wealth effect of increasing real estate prices. Personally, I can't see how it makes sense to buy more dental care because the price of houses in your neighbourhood is increasing, but it's an observable effect. Elsewhere it's quite a different story.

A fourth factor is the sharp contraction of the mining industry generally, which has had an effect on our Revenue in a number of regional centres. It appears that the mining sector has passed through the worst of the current downturn, with activity increasing in a number of regional areas important to our company.

Our monthly results toward the end of the first half and over the first several weeks of the second half have been improving, subject to the usual complications of the holiday period. Having been through these cycles many times, my sense is that conditions are improving. Without making any forecast I can say that I believe that we've now seen the worst effects of the mining downturn on our business.

### **First half results**

The first half of the current year gives shareholders a good opportunity to understand the inner workings of our company.

1300SMILES Ltd has been dealing with the economic factors discussed above for more than a year now, and our first half result suggests that our management response has been effective. Our statutory Revenue for the first half was down by \$1 million, from \$19 million to \$18 million. That's a decrease of 5.2%.

Carrying on from the previous full year, however, we have continued our relentless campaign to streamline and simplify every aspect of our business with the aim of improving our operating efficiency in every possible way. I am proud to say that we've managed to improve the quality of our result in a period of decreasing Revenue. At the Net Profit After Tax line we see a decrease of just 2.4%, down just \$93,000 to \$3,785,000.

In a static business, a revenue decline of a given percentage almost always delivers an NPAT decrease of a greater percentage. 1300SMILES has been anything but static, significantly improving the less-visible parts of our operation during this spell of consumer unease.

**Normalised results**

The normal ebb and flow of business activity means that income or expense sometimes get bunched up in a particular period, affecting the year-on-year comparisons.

In the accounts for the first half of the 2016/2017 year there is one factor which has a noticeable effect on both Revenue and NPAT.

In the previous half year our company sold a dental practice which no longer suited our business. In doing so we recorded a significant capital gain (\$365,000), which had the effect of boosting both our Revenue and our profit in the first half of the 2016 year. This means that the base against which we measure the first half of the 2017 year was noticeably higher than it otherwise would have been.

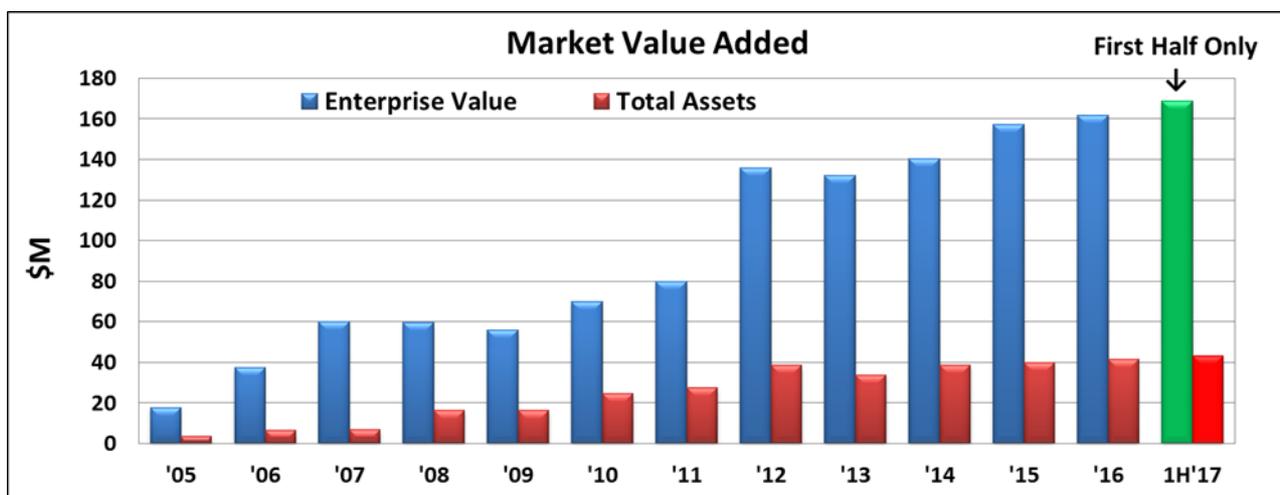
Because we don't regard trading dental practices as part of our core business (while recognising that we will from time to time dispose of some) we need to acknowledge the effect of this transaction on our period-to-period comparisons. It certainly does shareholders no harm when we realise gains on asset disposals, but in these accounts this particular transaction has the effect of making the current first half look worse in comparison to the previous year's first half than it otherwise would.

In the previous year's first half, this non-operating gain of \$365,000 flowed through to an increase in Revenue of the same amount. Excluding this boost to the prior period's Revenue, for the first half of the current year normalised Revenue is down by 3.4%, somewhat better than the 5.2% decline in statutory Revenue.

Similarly, the non-operating gain of \$365,000 in the first half of the previous year had the effect of increasing our reported NPAT (after company tax at 30%) by about \$255,000.

As noted above, our statutory Net Profit After Tax is down by \$93,000 or 2.4%. If we were to normalise this result to exclude the capital gain in the first half of the preceding year, our NPAT would actually be up by about \$163,000 or up 4.5%.

These effects all even out in the long run, of course, but understanding our results from an owner's point of view requires us to note that normalised NPAT from core operations was up by 4.5% on the previous year's first half.



"Enterprise Value" is a measure of the value of our business as determined by the market. It is calculated as the market value of all issued shares in 1300SMILES minus our net cash balance. It's counter-intuitive to subtract the cash balance, which is clearly a good thing, but this measure gets at the pure value of the operating business and ignores borrowings and cash holdings.

**Acquisition and expansion**

I would also note that the our recent acquisitions in Stanmore and Waterloo (both in Sydney) have not yet had a chance to show their effects in our accounts. We acquired these practices in October 2016 and we have recognised all of the acquisition expenses in the results for the first half year.

Both of the new Sydney practices make positive contributions to Revenue and profit but these contributions over a short spell during the first half were offset by the up-front expenses. For the second half of the 2016/2017 year we expect solid contributions from both of these facilities.

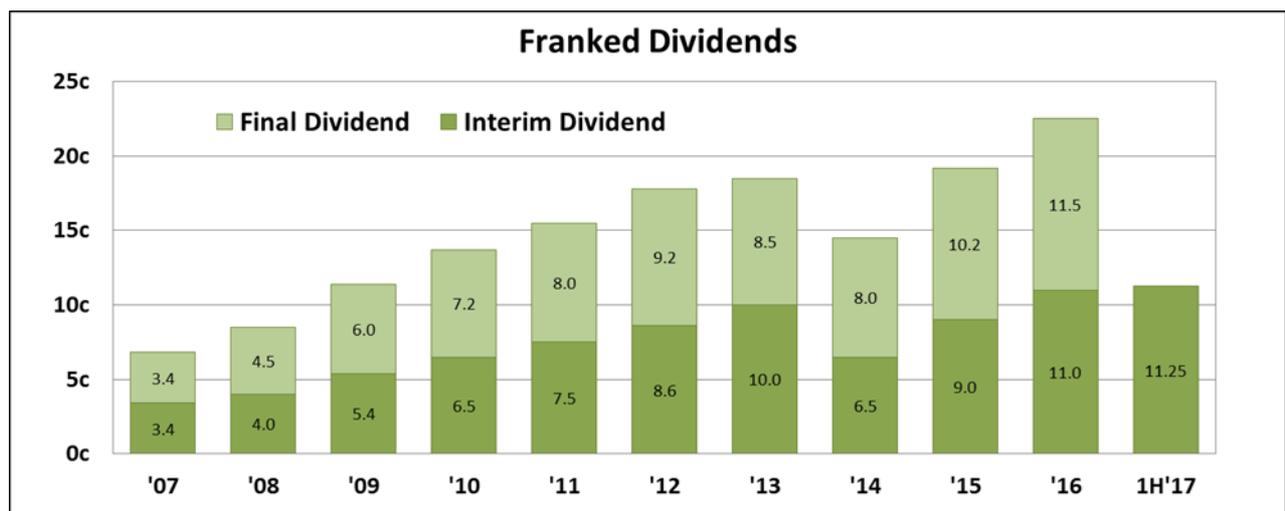
Subsequent to 31 December 2016 we entered into a contract to acquire an established practice in Kirwan, in the fast growing northwestern corridor of Townsville. While not by itself a financially material acquisition, this additional facility expands our network of facilities across Townsville and underscores our continuing confidence in north Queensland. It is located near the main entrance to a Coles-anchored shopping centre and offers services six days a week.

In Smithfield (Cairns) we are most of the way through the process of relocating our practice to a significantly better shopping centre location. The new location gives our facility a notably higher profile and significantly more passing foot traffic.

**Dividend**

All of the factors discussed in this report were considered in setting the interim dividend at 11.25c per share, a small increase on the previous year’s interim dividend.

As always, the board of 1300SMILES seeks to ensure that all shareholders in our company share in the experience of business ownership. If ours were a private company we would consider all of the key facts and make the same decision: our business is strong; our cash situation is excellent, and our outlook is sufficiently positive to support a small increase in the dividend.



**Affordable, accessible dentistry**

Our DMA dental vouchers program continues to make a solid and growing contribution to our results, growing steadily both in dollar terms and as a proportion of our Revenue.

The essence of the voucher program lies in making more extensive and complex dental care available to people who might not otherwise be able to afford it. Using our vouchers, patients select payment plans which suit their budgets with manageable automatic payments over periods coordinated with their treatment programs and extending over some months.

This approach is good for our business and good for our dentists, as it builds a base of steady long-term revenue. But it's also just good, full stop. Already it has enabled thousands of people to get the essential dental care they need, care which might otherwise have been neglected, leading to unnecessary pain and discomfort as well as far more serious dental and medical complications down the track.

### **Dental employment market**

The supply of new dental graduates in Australia has increased significantly over the past few years. Ultimately our profitability is driven by the number of dentists we have multiplied by their productivity. As the employment outlook for new graduates generally grows a bit more difficult, the attractiveness of 1300SMILES and our ability to ensure dentists a steady flow of work increases.

It has always been our model to ensure that every facility has room for additional dentists, as it costs little extra to build in this extra capacity up front. But just having enough room isn't enough, by itself, to enable us to accommodate new graduates properly and profitably.

For that we rely on our marketing and management, which produce a steady flow of patients with needs ranging from the simple and routine to the far more complex. Because of our scale we can absorb new graduate dentists into our busy practices while always ensuring that every dentist has experience appropriate to the services required. Our multi-dentist facilities enable and encourage continuing mentoring from senior dentists.

### **Outlook**

All of the challenges facing our company in the first half of the year apply across the dental industry. These have the effect of putting the entire industry under a little stress, creating certain opportunities for 1300SMILES.

Warren Buffett put it this way: "Only when the tide goes out do you discover who's been swimming naked."

Over many years in this industry we have sometimes seen other players willing to pay more for dental practices than we believed they were worth. In such cases we've always exercised patience and discipline and pursued only those acquisitions which yield real value to our shareholders.

Today, with a slight decline in revenue across the entire industry, investors are looking on a bit more critically. Every player in our industry now has to prove that it can operate dental practices profitably.

1300SMILES has always taken a proudly conservative approach to expanding our business. Shareholders would know that we have no bank debt and significant cash reserves. We have stuck to our knitting and ensured that all of our operations make a contribution to profit while controlling our headquarters and overhead expense.

We continue to pursue sensible acquisition and greenfield development opportunities. We have many under consideration at all times, including now. While shareholders can remain confident that we will be careful about finalising these commitments, I think it's fair to say that the market is turning back in our favour. Vendor dentists increasingly have more realistic ideas of the value of their practices, and we face less competition from formerly free-spending rivals.

After all these years, a surprising number of dentists in Australia still operate in small stand-alone practices. Operating such small businesses is inevitably getting harder, as the demands of compliance and accreditation grow more onerous and require more time and money every year.

In contrast, the larger facilities operated by 1300SMILES enable our dentists to enjoy collegiality, mentoring, synergy, and flexibility. They also enable in-house cross-referrals. As the number and proportion of female dental graduates increases each year, we believe that the demand among young dentists for the opportunity to work in this sort of supportive and encouraging environment will only increase.

The increasing difficulty of running stand-alone practices profitably continues to create advantages for dentists in the 1300SMILES system. Our company has dedicated professional staff who look after all of the regulatory and administrative issues, leaving our dentists free to focus on their patients, on good communications, and on clinical expertise.

All of the key external factors affecting our business are about as bad as they get, or have recently been so: elections, governments in chaos, the mining sector in free fall, the big gulf in economic performance between the big cities and the rest of the country. Given these unhelpful circumstances 1300SMILES has delivered a sound result for the half year.

From here we expect that governments will blunder back toward some sort of stability or consumers will come to accept the current chaos as normal. We expect the mining sector will stabilise at a higher level of activity than we've seen recently. We expect that opportunities to make sensible, earnings-accretive acquisitions will increase, as will the opportunities to develop new sites compatible with our growing network of facilities.

We know that our business model and processes are solid, having just delivered good results in a difficult spell. All in all I expect our results to resume a more familiar upward trajectory, all within the bounds of the conservative management style shareholders expect from our company.

### **Thank you**

As always, I wish to thank our hard working staff in all departments and our front-line dental professionals and practice staff and management personnel.

I also acknowledge our long-term shareholders and those who have joined us more recently and thank you all for trusting our company with your capital.

Yours faithfully

Dr Daryl Holmes  
Managing Director

## **ABOUT 1300SMILES LTD**

### **OVERVIEW OF THE COMPANY'S BUSINESS**

1300SMILES Limited owns and operates full-service dental facilities at its sites in New South Wales, South Australia, and in the ten major population centres in Queensland. The company continually seeks to expand its presence into other geographical areas throughout Australia. It does so both by establishing its own new operations and by acquiring existing dental practices. The administrative and corporate offices are in Townsville.

1300SMILES enables the delivery of services to patients by providing the use of dental surgeries, practice management and other services to self-employed dentists who carry on their own dental practices. The services provided by the company allow the dentists to focus on the delivery of dental services rather than on the administrative aspects of carrying on their businesses. The dentists pay fees to the company for the provision of these services under a Dental Service Agreement with the company. In some circumstances the company also employs qualified dentists.

The dentists who use the company's services range from new graduates to experienced dental professionals. Several dentists who use the company's services have special interests and experience in such areas as endodontics, oral surgery, implants and periodontics and cross-refer work to other dentists who use the company's services.

The company provides comprehensive services in the areas of marketing, administration, billing and collections, and facilities certification and licensing to all participating dentists. The company also provides all support staff, equipment and facilities, and sources all consumable goods using the buying power which derives from such a large group of dental businesses.

### **FUTURE DEVELOPMENTS**

The company's core objective is to continue to increase profits and shareholder returns while providing a rewarding environment for our staff and the dentists using our facilities.

The company aims to achieve a combination of organic growth in its existing locations and the addition of new practice management facilities.

The key drivers for future growth of the company are:

- Increasing profits by attracting more dentists to our existing facilities and expanding those facilities which are already at full capacity;
- Assisting dentists who already practice within the 1300SMILES system to increase their turnover and income through benchmarking, training, and mentoring;
- Establishing new practices in existing and new regions (greenfield sites);
- Acquiring substantial existing practices where we can do so on favourable terms; and
- Managing dental facilities owned by others.

### **DENTIST ENQUIRIES**

Owners of dental practices who are interested in unlocking the goodwill value of their businesses (or freeing themselves from all the management hassles) are invited to contact Dr. Daryl Holmes, Managing Director, on +61 (7) 4720 1300 or [md@1300SMILES.com.au](mailto:md@1300SMILES.com.au).

Qualified dentists who wish to know more about joining one of our established facilities are encouraged to contact Dr. Holmes directly or email [dentalcareers@1300smiles.com.au](mailto:dentalcareers@1300smiles.com.au) or visit our website [www.1300smiles.com.au/careers](http://www.1300smiles.com.au/careers).