

## LETTER FROM THE MANAGING DIRECTOR

Dear Shareholders,

I am pleased to present to you our results for the half year ended 31 December 2013. Managing Directors are not normally pleased to report declines, and I am no different. However, recent industry circumstances have been highly unusual and the underlying result is both unusual and quietly encouraging.

### First Half Year Results

Compared to the first half results from the previous year, the results for the six months to 31 December 2013 were as follows:

- Revenue (statutory) down 29.6% to \$14.8 million
- Revenue (OTC) down 26.3% to \$21.3 million
- NPAT down 36.1% to \$2.5 million
- EBITDA down 31.0% to \$4.7 million
- Earnings Per Share down 36.1% to 10.69cps
- First half fully franked dividend down 35% to 6.5cps

To explain the unusual underlying result I must first review a little of the recent industry history.

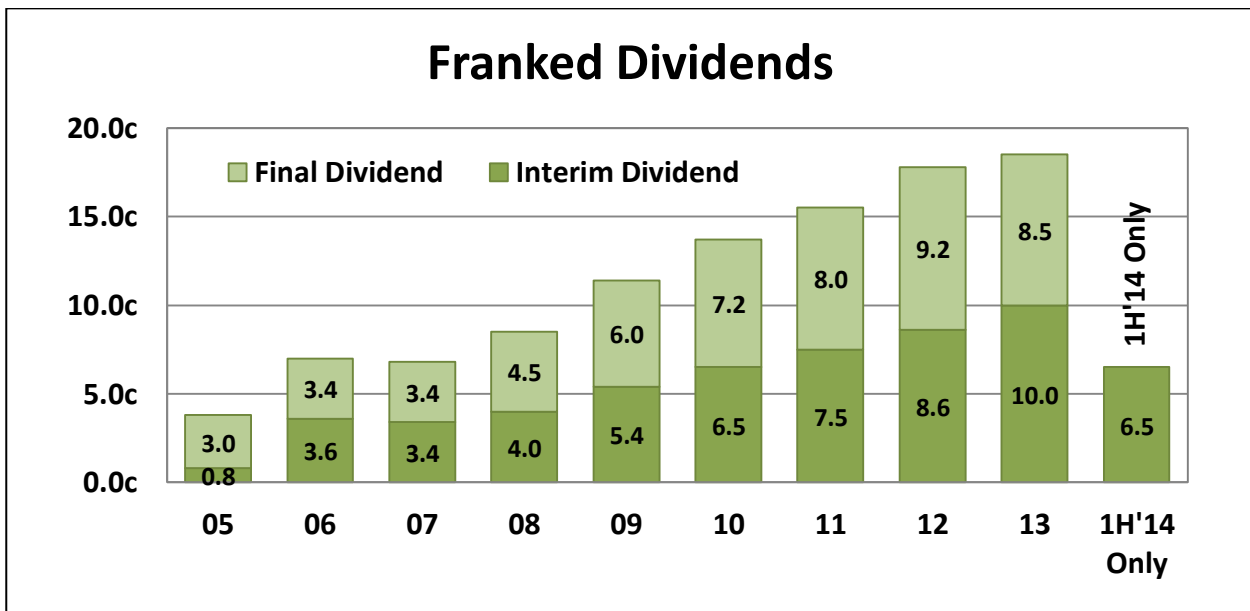
As I have previously covered in significant detail, the entire industry underwent a step-change downward to a significantly reduced size a bit over a year ago, courtesy of the sudden closure of the commonwealth government's Medicare Chronic Disease Dental Scheme (CDDS). The flurry of activity in the first half of the 2013 financial year and the rush to complete treatments before the end of the CDDS produced a significant spike in that half year's Revenue. I forewarned that this half year's Revenue would be lower as a consequence, and that is what we have seen.

Over-the-Counter (OTC) Revenue declined by 26.3% to \$21.3 million compared against the artificially high 2013 first half. Statutory Revenue declined by 29.6% to \$14.8 million. Because it has the larger decline, I will refer to Statutory Revenue in the remainder of this letter to be conservative, albeit as I have explained in detail in previous shareholder letters I consider OTC Revenue to be the more meaningful measure.

NPAT declined by 36.1% to \$2.5 million, again compared against the artificially high 2013 first half. That the company has posted a profit at all, let alone a strong profit, is very pleasing. That NPAT declined by *only* 36.1% is a very pleasing result indeed.

Over the years shareholders have joined me in looking forward to the steadily growing dividends delivered by our steadily growing and conservatively managed business. For the current half I must ask shareholders to join me in recognising that our dividend ultimately derives from our results. For the reasons discussed at length in this letter, our NPAT for the first half was down by 36.1% compared to the NPAT for the previous year's first half. Shareholders will also recall that last year's interim dividend, at 10c, was the highest ever, reflecting the unusual and artificially high levels of Revenue and NPAT we enjoyed in that period. Compared to that record high dividend, the current year's interim dividend of 6.5c, fully franked, represents a decrease of 35%. Shareholders will be aware that my reward for serving as managing director comes overwhelmingly from my dividends, so you can have no doubt whatever that the dividend reflects the board's willingness to make the hard decisions, and its commitment to responsible financial management for the long term benefit of the company and all shareholders.

Over many years we have made every effort to treat shareholders in 1300SMILES as the true owners of the business. Shareholders have had the experience of running a real, transparent business, and they've known the satisfaction of participating in the company's growth. This year I ask shareholders to participate in the company's effort to build the strongest possible foundation on which to build our business further.



Here is the unusual and quietly encouraging underlying result: in most businesses, a 29.6% decline in Revenue would reduce NPAT by 100% or more. I dare say that all but a tiny fraction of listed companies would deliver a loss if their Revenue declined by 29.6%. In real terms, the 36.1% decline in NPAT off a 29.6% lower Revenue base, remembering that many expenses usually remain fixed or increase, indicates that our underlying NPAT may have grown on a normalised basis, if you were to strip out the distortion of the CDDS.

I will not sugar coat it: the comparative results are clearly down. However, I would suggest that shareholders reflect on the full picture. In these unusual circumstances, the traditional comparison against the previous corresponding period becomes entirely meaningless. The gross results are important. They represent our new baseline and starting point for renewed growth. The period-to-period comparisons are misleading because the previous half year results were achieved in industry circumstances which no longer apply. A significant part of the industry has changed in a fundamental way, yet the strong gross results presented here, achieved in the new industry circumstances, give me comfort that the economics of the industry remain attractive and that our core business remains strong.

I congratulate our management team on successfully navigating our company safely through and now past this unusual period, achieving gross profit margin improvements amidst the turmoil through their discipline and management controls. I cannot imagine ever again applauding anything other than growth, however credit must given where it is due, and it is well due. It is a slow clap but a clap nonetheless. We pride ourselves on growing revenues, earnings and margins, and I am determined that we will resume normal growth in these areas, starting from our new baseline.

#### **The new baseline**

So far, the 2014 year has delivered no disruptive changes in government policy, other than a positive development which I will mention shortly in this letter, and it has given us the chance to simply operate our core business to the best of our ability. The first half of the 2014 year represents a half-year of normal operations, and it will become the base against which we will compare future half-yearly results. I would encourage shareholders to look at it this way also, as I believe this will be the most meaningful way of measuring our progress from here.

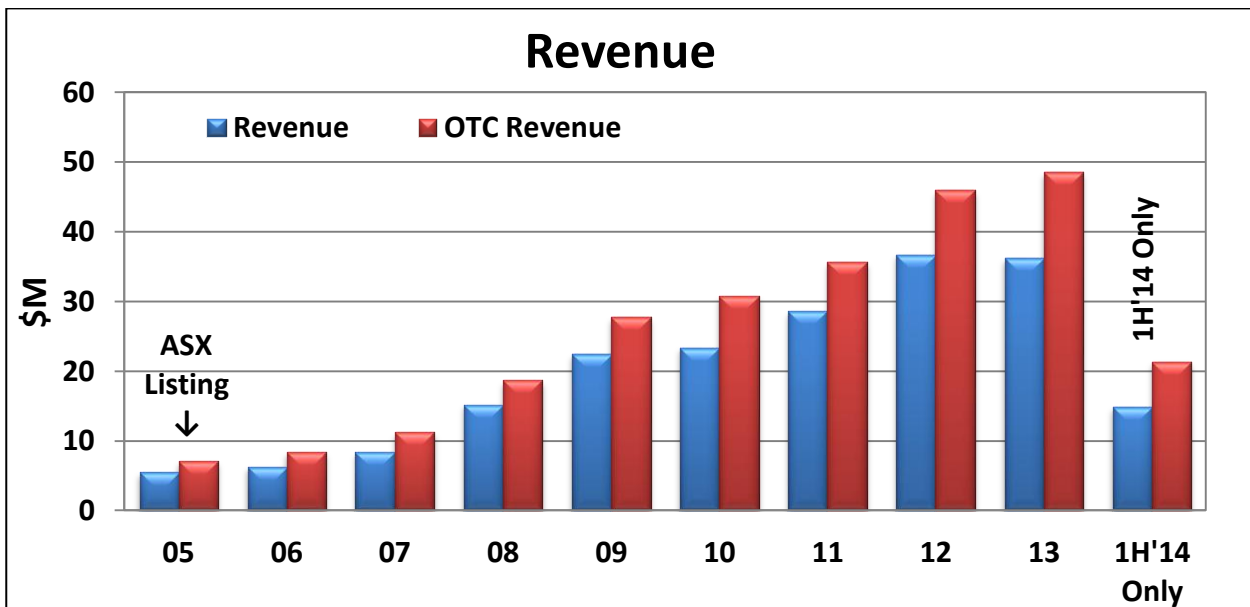
The first half has the following features:

- No inflated revenue from CDDS.
- Organic and incremental growth.

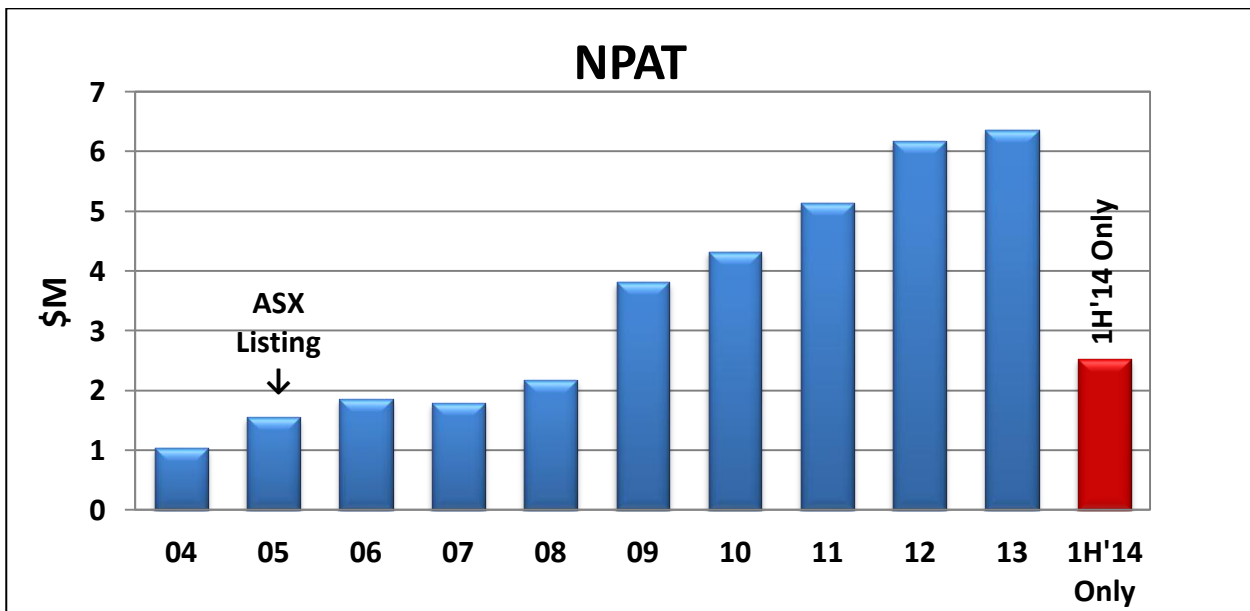
- An early contribution from our \$1 a day Dental Care Plan--not yet a big impact on Revenue, but an important additional driver to organic growth.
- A growing contribution from our public private partnerships with the Queensland government, which form part of our organic growth but without creating any dependence on a big market-distorting government scheme.
- Generous latent capacity within our surgeries, supporting our organic growth.

Alert readers will notice the emphasis on organic growth above. Careful followers of our company will by now be well aware that the attention we pay to organic growth is perhaps our company's greatest strength (behind our people, of course). Our excess surgery capacity costs extremely little to carry and gives our company the ability to add dentists and through them additional revenue and profit at little capital cost. We continue to build in additional capacity to ensure our supply can always meet demand.

We have a clear new baseline, and our clear task and responsibility is to now grow the company off this baseline as effectively as we have in the past for the benefit of shareholders. Whilst our past track record is strong, and we are equipped with great people ready for the challenge that lies ahead, there is no place for complacency.

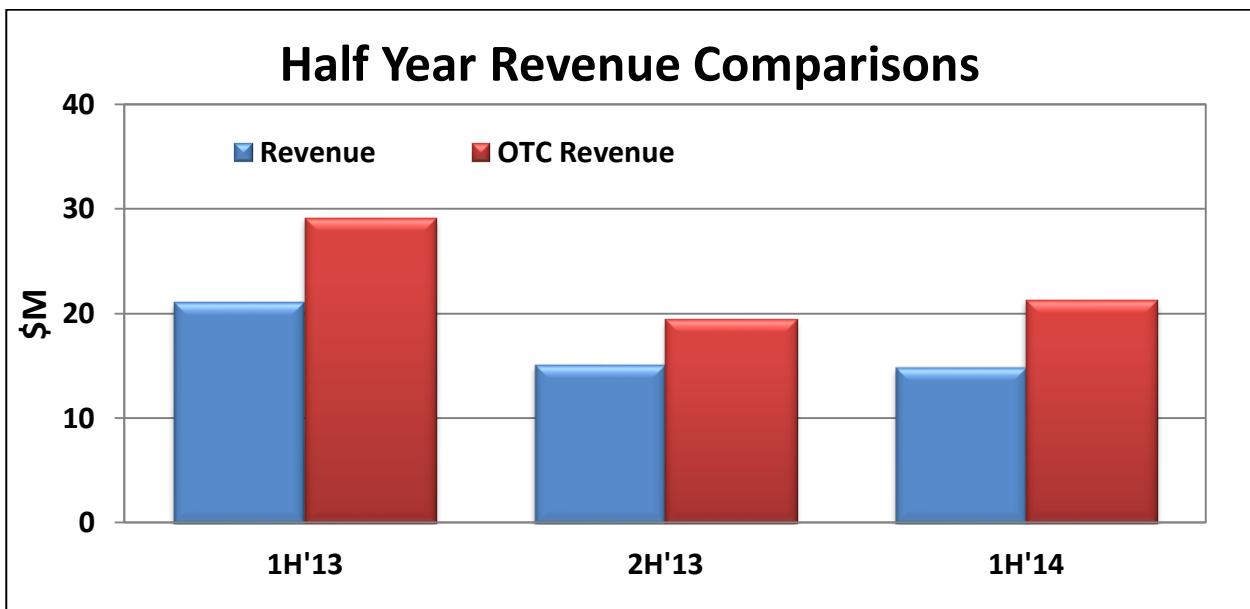


Reconciliation of OTC Revenue (non-IFRS) to Statutory Revenue (per Financial Statements)										
	'05	'06	'07	'08	'09	'10	'11	'12	'13	1H'14
<b>OTC Revenue (\$m)</b>	7	8.3	11.2	18.6	27.6	30.7	35.7	45.9	48.5	21.3
Less amount retained by self-employed Dentists (\$m)	1.9	2.1	2.8	3.4	5.2	7.4	7	9.2	12.3	6.5
<b>Statutory Revenue (\$m)</b>	5.1	6.2	8.4	15.2	22.4	23.3	28.7	36.7	36.2	14.8



**First Half Year 2014 Results compared to Second Half Year 2013 Results**

As shareholders would know, the 2013 full year comprised an inflated first half and a subdued second half. In that second half we saw the full impact of the end of the CDDS and the beginnings of several new initiatives, the most notable of which is our \$1 a day Dental Care Plan. While the full year results for 2013 were acceptable, all things considered, the second half of that year was notably weak, and probably the bottom for both our company and for the dental industry generally. This is illustrated by a comparison between the first half of the 2013 year, the last half of the 2013 year and the first half of the 2014 year.



Compared to the preceding six month period, the first half of 2014 saw a Statutory Revenue decrease of 1.9% (an OTC Revenue increase of 10.6%), an EBITDA increase of 9.6%, and a Net Profit After Tax (and Earnings Per Share) increase of 5.3%.

I continue to regard the first half of 2014 as the hard deck baseline against which our future performance should be measured, even though the adoption of the second half of 2013 as the baseline would make for more eye-catching future comparisons. I do, however, draw confidence from this early evidence that our

results are headed in the right direction. The positive start to the second half of 2014, and the early results from a new government scheme which I will mention shortly, give me comfort that that confidence is well founded.

### **Benefits from losing a billion dollars**

The CDDS was by far the largest single buyer of dental services in Australia, paying about one billion dollars to the industry annually, but it is now history.

I disagree strongly with the policy position taken by the former commonwealth government. It is short sighted, has set back the cause of good oral health in this country by years, and has health implications reaching well beyond dental health. Investors who wish to understand the implications in greater depth should refer to my previous shareholder reports, including my letter this time last year. My letters and addresses are available on our company web site.

However, I have to concede that the closure of the CDDS does create benefits and opportunities for a business such as ours. For example:

- We are unlikely to see a single buyer of dental services gain such prominence any time soon, and that helps to improve the defensiveness of our business.
- We are likely to see former CDDS patients and new patients through our public private partnerships with the Queensland government.
- The CDDS has been partially replaced by the new Child Dental Benefits Schedule (CDBS). The CDBS is the positive development which I alluded to earlier in this letter. The CDBS is said to cover 3.4 million eligible children aged from 2 to 17 years, funding up to \$1,000 worth of treatment over 2 years. The CDBS commenced on 1 January 2014, so the first half result includes no revenue from it at all. I will be in a better position to report on results from the CDBS at the end of the full year, although I can say that it has gotten off to a surprisingly fast start.
- We are likely to continue seeing strong demand for our \$1 a day Dental Care Plans as more people look for an affordable way of caring for their dental health.
- We are likely to see more mortgagee and other distressed sales of dental practices, and again that too helps a business such as ours. As I indicated above, a Revenue decline such as that which we have experienced would result in a loss for most businesses. Many dental practices around Australia have experienced exactly that. Unlike our company, many of those businesses carry debt. Their owners will have to make some hard decisions or others will make the hard decisions for them. Our name is our phone number, so it will be easy for owners or their banks to reach us when they are ready. To paraphrase a former prime minister: my name is Daryl, I am from Queensland, and I am here to help.
- The closure of the CDDS and the influx of new graduates fresh out of the dental schools have combined to create a more difficult job market for dentists. That is a happy situation for our company. More dentists have seen our company as a safe harbor and the best opportunity for their practices, which has helped our ongoing recruitment drive. The tougher job market is also delivering more dentists who are not just excellent clinicians, but who are also highly skilled at quickly growing their patient base and practice. For example, our January 2014 starters boast 55 years of clinical experience among them. It is lovely to be able to pick and choose from a deep talent pool. These factors all combine to help our organic growth.

We will be doing our best to make the most of these benefits and opportunities, and other initiatives which I will cover later in this letter, in the current half and future periods to help us move forward off our new baseline.

### **Good things come to those who wait**

I have commented in earlier correspondence that there are aspects of our business which are old-fashioned. We endeavour to control costs while delivering the best possible service. We have a simple

capital structure and a transparent business. We carry no debt. We make money, pay the tax due, and pass franked dividends to our shareholders.

We also make use of the timeless virtue of patience in our business strategy in a particular way: we combine it with impatience.

We are *impatient* for growth in profit and the other financial measures of importance to most shareholders, but *patient* for growth in practice numbers. I will take one high-profit practice any day ahead of 100 stragglers (although owners and receivers of good businesses that have fallen on difficult times should please note that I enjoy a challenge).

In the context of our investment in Dental Members Australia, we are *patient* for profit but *impatient* for growth in members. I am pleased to note that the number of members on active care or treatment plans grew by more than 100% over the first half. The fees paid by members are now a useful revenue stream in their own right.

As an aside, the success of the care and treatment plans is also proving to be very helpful in attracting dentists to 1300SMILES. The plans are now playing an important role in the Snowball Effect we observe, wherein more members (or patients) attract more dentists; more dentists bring different skills and special interests, which gives their colleagues the opportunity to further develop their own skills and interests; many dentists like to work alongside the very best, so the deeper the skill base the more that dentists are keen to join 1300SMILES; the depth of high quality dentists attracts more patients; more patients attract more dentists; and so on.

### **Shareholders**

We celebrate a minor milestone this half year in passing 2,000 shareholders. Our shareholders cover the full spectrum from very young children to grandparents, along with institutions and other professional investors. We are honoured that you have placed your faith in us. We take your faith very seriously, and will continue to do our best to create value for you. I like to occasionally remind our staff that their grandparents might be relying on them for their dividends. I swear they always walk a little taller and faster afterward.

We could, of course, easily expand the number of shareholders by issuing more shares, however we prefer to keep the share register tight. We issued no new shares during the half year.

### **Future developments**

As mentioned earlier in this letter, the CDBS commenced at the start of the second half, so will be a factor in future periods which will be compared to the first half and later full year baselines. Based on our early results and industry research, we think it's likely that this side of our business will grow at a surprising pace.

At our AGM I also hinted at an example of world class thinking from our people. The details are still coming together, however this is too exciting an idea to keep secret any longer. I am delighted to reveal that we will soon be attempting to set a new world record at 1300SMILES Stadium. There has been enormous interest in this initiative, and we expect significant national exposure for our company out of the attempt. If you are planning a trip to north Queensland some time this year, please time it to coincide, if you can, so that you can do your bit in securing the world record. More details will be revealed, along with the exact record in question and the date, as soon as the logistics have been ironed out.

### **Corporate Social Responsibility**

There is a very serious side to our world record attempt. Even more important than the record is the opportunity, through the attempt, to promote awareness of the importance of oral health. We acquired the naming rights to 1300SMILES Stadium in part for that purpose, and we look forward to making progress on that objective and participating in the community discussions that this latest initiative will prompt.

We are determined to make a positive difference to oral health in Australia and beyond. This is too important to leave to chance. Despite the positive start to the CDBS, we cannot rely on the government of the day or others to provide the solution. We have to be a part of the solution, and to that end the next initiative we will shortly be rolling out is the provision of mouth guards to school-aged children through our network of practices at no out-of-pocket cost. Watch this space.

Long-term shareholders will be aware that we are a committed participant and supporter in the activities of the YWAM Medical Ship, run by Youth With A Mission. Vital medical and dental services are delivered on the Medical Ship directly to high need remote villages in Papua New Guinea. I continue to encourage 1300SMILES staff and dentists to join me in volunteering for rotations on board. The work is important and life changing for patients and volunteers alike.

**Thank you**

As always, we thank all shareholders for your support, and we thank our hard-working employees and the growing number of dentists who choose to conduct their practices in our facilities.

Yours faithfully,



Dr Daryl Holmes  
Managing Director

## **ABOUT 1300SMILES LIMITED**

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

1300SMILES Ltd owns and operates full-service dental facilities at its sites in the ten major population centres in Queensland and also in Adelaide, South Australia. 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 also encouraged to contact Dr. Holmes directly or email [dentalcareers@1300smiles.com.au](mailto:dentalcareers@1300smiles.com.au) or visit our website [www.dentalcareersaustralia.com.au](http://www.dentalcareersaustralia.com.au).