BELL POTTER

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Pacific Smiles Group (PSQ)

1H19 - Strong Top-line growth, offset by lower margins, EBITDA guidance revised

Recommendation
Hold (unchanged)
Price
$1.27
Target (12 months)
$1.40 (previously $1.46)

Expected Return	
Capital growth	10.2%
Dividend yield	4.3%
Total expected return	14.5%
Company Data & Ratios	
Enterprise value	$203.0m
Market cap	$193.0m
Issued capital	151.99m
Free float	40%
Avg. daily val. (52wk)	$123,659
12 month price range	$1.20 - $1.80
GICS sector	Healthcare Equipment and Services

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	1.36	1.35	1.61
Absolute (%)	-6.62	-5.93	-20.87
Rel market (%)	-11.34	-14.11	-24.46

Double digit revenue growth, NPAT miss on lower margins

Underlying NPAT of $4.5m (down 8.3% y/y) was 2.5% below our forecast of $4.6m, with the miss driven by lower gross margin, increase in opex and D&A costs. 1H19 revenue of $59.8m (up 18.5% y/y) and patient fees of $92.0m (up 14% y/y) were better than our forecasts. Same centre patient fees growth of +9% was higher than pcp (+3.3%) driven by 16% growth in younger centres and stabilising of the ex ahm centres. Both EBITDA margin and EBITDA to patient fees margin were below pcp and our forecasts, impacted by higher telco costs and lower fees/appointment. Interim dividend of 2.30cps (flat over pcp) fully franked was ahead of our forecast of 2.10cps. PSQ had net debt position of $10m.

Guidance for FY19 revised

PSQ has revised its FY19 EBITDA guidance (~5% growth over pcp vs. at least 10% earlier) and patient fees growth of 12-15% (was 10-15%). New centre target of at least 10 (3 opened in 1H19) and same centre patient fees growth of >5% (YTD tracking at +8.4%) remain unchanged. Dividend payout ratio reaffirmed at 70-100% of NPAT.

EPS downgrades

We have downgraded our EPS forecasts in FY19, FY20 and FY21 by ~3%, 6% and 13% respectively. The downgrades have been driven by increases in our D&A forecasts and single digit percentage reductions in our EBITDA margins, partially offset by higher revenue. We forecast ~13% patient fees growth (low point of guidance) and FY19 EBITDA growth of ~4% over FY18 underlying EBITDA, which is below guidance.

PT reduced to $1.40, Retain Hold

Our PT has reduced to $1.40 (was $1.46) following changes to our EPS forecasts, market movements affecting our relative valuation multiples and increase in the WACC used in DCF from 10.5% to 10.9%, due to the risk we see of the company not meeting its underlying EBITDA guidance. We continue to be positive on the long term outlook for the company, however margin expansion is still a few years away. We are unlikely to see any meaningful re-rating in the short term. Hence, we retain Hold.

Absolute Price

SOURCE: IRESS

Earnings Forecast

Year end 30th June	2017A	2018A	2019E	2020E	2021E
Total Revenue (A$m)	91.5	104.5	119.4	132.5	148.9
EBITDA (A$m)	20.9	21.5	22.3	23.6	25.5
NPAT (reported) (A$m)	10.0	6.6	8.0	8.2	8.6
NPAT (normalised) (A$m)	10.3	9.3	8.3	8.2	8.6
EPS (reported) (cps)	6.6	4.3	5.2	5.4	5.7
EPS (normalised) (cps)	6.7	6.1	5.5	5.4	5.7
EPS -normalised growth (%)	0.9%	-9.7%	-10.3%	-1.8%	6.0%
PER (normalised) (x)	18.8	20.9	23.2	23.7	22.3
EV/EBITDA (x)	9.7	9.4	9.1	8.6	8.0
Dividend (incl. spl div) (¢ps)	5.9	6.1	5.5	5.4	5.4
Yield (%)	4.6%	4.8%	4.3%	4.2%	4.3%
Franking (%)	100.0%	100.0%	100.0%	100.0%	100.0%
ROE (%)	23.5%	21.5%	20.1%	20.1%	21.1%

SOURCE: BELL POTTER SECURITIES ESTIMATES

1H19 - Results Summary

A summary of the reported 1H19 result is shown in the Table below:

Table 1 – 1H19 result summary

	Result vs PCP			Result vs Forecast		Comments
	1H18A	1H19A	% change	1H19E	Variance (%)	
Gross Patient fees	**80.7**	**92.0**	**14.0%**	**89.5**	**2.8%**	**Gross Patient fees 2.8% ahead of our forecasts**
Share of service revenue	*62.2%*	*64.7%*	*4.0%*	*62.2%*	*4.0%*	*PSQ's share of service revenue ahead of our forecasts likely due to more locums in the mix*
Total Revenues	**50.5**	**59.8**	**18.5%**	**56.0**	**6.8%**	**Revenue 6.8% ahead of our forecasts**
Direct Expenses	3.1	5.7	83.4%	3.6	57.2%	Direct expenses 57.2% higher than expected due to more locums
Operating Expenses	37.1	43.5	17.4%	41.6	4.6%	**Opex 4.6% ahead of our forecasts adjusted for $0.5m of one off costs**
EBITDA	**10.9**	**11.2**	**2.5%**	**11.4**	**-1.9%**	**Small miss in EBITDA due to weaker gross margin, higher opex, partially offset by better revenue**
Depreciation & Amortisation	-3.7	-4.4	19.7%	-4.4	0.1%	Depreciation mostly in-line with our forecasts
EBIT	**7.2**	**6.8**	**-6.3%**	**7.0**	**-3.1%**	**~3% miss in EBIT, with slightly higher D&A increasing variance from EBITDA line**
Net Interest Income/(expense)	-0.1	-0.3	NM	-0.3	-4.6%	Modestly lower interest and finance charges than our forecast
Pretax Profit	7.1	6.5	-9.2%	6.7	-3.0%	
Tax expense	2.2	1.9	-11.1%	2.0	-4.3%	Lower tax expense adjusted for one offs
NPAT - normalised	**4.9**	**4.5**	**-8.3%**	**4.6**	**-2.5%**	**2.5% miss in NPAT**
Diluted EPS (cps)	**3.2**	**3.0**	**-8.3%**	**3.1**	**-2.5%**	**EPS 2.5% below our forecast**
One-off items	*-2.2*	*-0.3*	*NA*	*0.0*	NA	$0.3m of one-off costs related to severance expenses in 1H19
NPAT - reported	***2.7***	***4.2***	***52.3%***	***4.6***	***-9.9%***	*Reported NPAT 9.9% below our forecasts*
Diluted Reported EPS (cps)	***1.8***	***2.7***	***52.3%***	***3.1***	***-9.9%***	
Interim dividend (cps)	**2.30**	**2.30**	**0.0%**	**2.10**	**9.4%**	**Interim Dividend ahead of our forecast**
Franking	*100%*	*100%*		*100%*		
Payout ratio (on total ordinary dividend)	*71%*	*77%*		*69%*		Payout ratio of 77% ahead of expectations
Effective Tax Rate	*30.6%*	*30.0%*	-64bps	*30.4%*	-39bps	Effective Tax rate modestly below our forecast
Gross Margin	*93.9%*	*90.5%*	-337bps	*93.5%*	-305bps	Gross margin significantly below our forecast
EBITDA Margin	*21.7%*	*18.7%*	-292bps	*20.4%*	-166bps	EBITDA margin lower than our forecast
EBITDA to patient fees Margin	*13.5%*	*12.2%*	-137bps	*12.8%*	-58bps	EBITDA to gross patient fees margin below our forecast
EBIT Margin	*14.3%*	*11.3%*	-300bps	*12.5%*	-116bps	EBIT margin below our forecast
Net Margin	*9.8%*	*7.6%*	-221bps	*8.3%*	-72bps	Net margin below our forecast

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

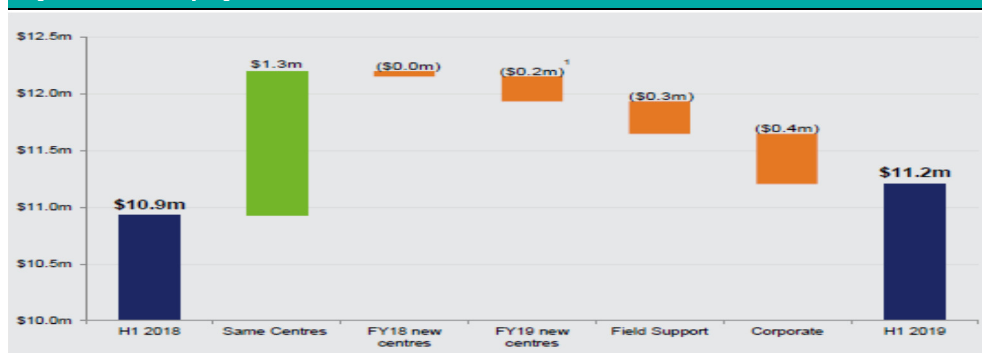
The key highlights from the result were:

- **Revenue higher than our forecast:** Total revenue of $59.8m (up 18.5% y/y) was 6.8% ahead of our forecasts (BPe $56.0m). Patient fees of $92.0m (up 14.0% y/y) was also ahead of our forecasts (BPe $89.5m) as was PSQ's share of fees at 64.7% (BPe 62.2%). The share of fees was impacted by having locums in the mix.
- **Same centre patient fee growth was +3.3%:** Same centre patient fee growth (SCPFG) was +9.0% (110bps higher than 1H18 rate of +3.3%) and is tracking in-line with the FY19 guidance of >5% at a much higher rate than expected. It also improved since the last reported rate of 8.5% at the AGM, suggesting December was a particularly strong month for PSQ this half. The YTD rate has since then reduced to +8.4% (as of 16th February, 2019). PSQ has kept its guidance for FY19 of SCPFG unchanged at >5% and has not seen the need to revise the minimum rate expectation despite seeing a much stronger growth rate. This suggests to us that they may be expecting the rate to slow down a bit by end of June'19. We note that the strong same centre growth was led by the 16% growth in younger centres, as part of their expected ramp up. Pleasingly, the former Medibank ahm centres in Parramatta and Town Hall have stabilised and are no longer a drag on SCPFG, which potentially accounts for the consistent high growth rate seen in YTD FY19. PSQ now treats them as any centre and will not be reporting their result separately going forward.
- **1.9% miss in Underlying EBITDA:** Underlying EBITDA of $11.2m (up 2.5% y/y) was modestly below our forecast of $11.4m. The modest miss was driven by higher direct

expenses with lower gross margin (90.5% vs BPe 93.5%) and higher operating costs (after adjusting for $0.5m one off costs), however was partially offset by the higher than expected revenue.

- **EBITDA margin and EBITDA to patient fees margin declined over pcp and were below our forecasts:** EBITDA margin of 18.7% was below our forecast (BPe 20.4%), and 292bps below pcp. EBITDA to patient fees margin of 12.2% was also below our forecast (BPe 12.8%) and 137bps below pcp margin of 13.5%. The decrease in margins over pcp were impacted by higher corporate costs (6.3% of patient fees vs. 6.1% in pcp), higher field support costs, overrun of telecommunication infrastructure costs of $0.3m and also lower than expected fees per appointment (~$0.3m impact), lower contribution from FY18 new centres in the half (as 3 were opened over May and end June 2018) and start-up losses from the 3 new centres opened in 1HFY19.

Figure 1 – Underlying EBITDA drivers for 1H19



SOURCE: COMPANY DATA

- **2.5% miss in underlying NPAT:** Underlying NPAT of $4.5m (down 8.3% y/y) was 2.5% below our forecast of $4.6m. The variance reduced from EBIT level due to lower tax rate (following one off adjustments). Without the one-off costs adjustment (related to severance expenses), reported NPAT was $4.2m, which was 9.9% below our forecast and up 52.3% over pcp. D&A increased 19.7% over pcp reflecting the acceleration of new centre roll outs.
- **Interim dividend ahead of our forecast:** The interim dividend of 2.30cps (fully franked) was ahead of our forecast of 2.10cps (fully franked), and was flat over pcp (1H18 dividend was 2.30cps). We continue to expect the dividend to be skewed towards the second half.
- **Net debt position:** PSQ has a net debt position of $10.0m. Cash balance at the end of 1H19 was $6.7m and borrowings were $16.0m. Borrowings increased during the half with PSQ drawing down $4.0m debt to supplement its operating cash flow and support its ongoing new centre roll out, while maintaining its high dividend payout ratio. Operating cash flow was weaker in 1H19 ($8.2m vs. $9.1m in 1H18), being impacted by an increase in tax receivable.

FY19 Guidance and operational updates

Management has revised its guidance for FY19 since the last update at the AGM. The reiterated guidance implies continued strong Top-line growth with a further reduction in margins and increase in opex, to impact underlying EBITDA result in 2HFY19.

Revised Guidance for FY19

- **EBITDA guidance:** Underlying EBITDA guided to ~5% growth on FY18 EBITDA (was at least 10% growth, revised down). PSQ believes the lower fees per appointment seen in 1H19 is likely to continue and impact the full year. PSQ noted that they are also not seeing price increases coming through from PHI's.
- **Patient fees growth:** Patient fees growth is expected to be 12-15% over pcp (was 10-15% over pcp, range narrowed with lower point revised up).
- **FY19 new centre target:** New centre target of 10 maintained. 3 centres were opened in 1H19 and 7 sites have been committed to for 2H19. 3 of these are expected to be opened in March/April'2019 – 2 in QLD (Aspley Hypermarket and Stockland Birtinya) and 1 in NSW (Mount Hutton).
- **Same centre patient fees growth**: Same centre patient fees growth target maintained at more than 5% in FY19.
- **Dividend Payout Ratio:** Dividend policy is unchanged, with payout ratio for FY19 expected in the range of 70%-100% of NPAT.

Operational Updates

- **Number of centres increased to 82:** PSQ opened 3 new centres in 1HFY19 and closed down 1 centre moving its patients to another nearby centre. The company is now operating 82 dental centres in Australia. Out of these, 72 are Pacific Smiles Dental branded centres and 10 are nib dental care branded centres. We give a summary of PSQ's centres by geographic market below:

Figure 2 - Pacific Smiles' centres by geography

No. of centres	NSW	VIC	QLD	ACT	Australia
Pacific Smiles Dental	31	22	14	5	72
NIB Dental	7	1	1	1	10
Total	**38**	**23**	**15**	**6**	**82**
% distribution	46%	28%	18%	7%	

SOURCE: COMPANY DATA

- **Number of active chairs now 320, with capacity to add 90 more dental chairs.** At the end of 1HFY19, the group had 320 active dental chairs across its centres, with capacity to add 90 more dental chairs. We note that 7 new chairs were added in existing centres in 1HFY19 and the company plans to add 13 more chairs in existing centres in 2HFY19, bringing the total added to 20 for FY19, a significant increase over the numbers seen for the last few years (FY18 was 14 new chairs in existing centres).
- **Large number of centres relatively immature (less than 3 years open):** 35% of the company's dental centres have been open for less than 3 years and therefore have significant growth runway ahead. The strong same centre patient fee growth in 1H19 was driven by 16% growth in the younger centres (opened since July 2010) vs. the mature centres which only grew 3% over pcp. New centre economics improve with maturity as depicted below:

Figure 3 - Pacific Smiles' new centre profitability profile

	New Centres (opened FY14-18)[1]			All Centres
	Year 1	Year 2	Year 3	> 5 years old[3]
Patient Fees per centre	$0.8m	$1.0m	$1.3m	~$2.5m
EBITDA per centre[2]	($0.1m)	$0.1m	$0.2m	~$0.5m
EBITDA / Patient Fees (centre level)	~(13%)	~10%	~15%	20%+

SOURCE: COMPANY DATA

In summary, PSQ delivered a strong Top-line result in 1H19. Both revenue and patient fees were better than our forecasts and up significantly over pcp. However, underlying EBITDA and NPAT were below our forecasts, driven by lower gross margins and higher opex. The company has revised its FY19 guidance for EBITDA down. Pleasingly the Ex-ahm centres (Parramatta and Townhall) have stabilised and are no longer a drag on same centre patient fee growth rate, which was very strong this half. The company continues to look at opening 10 new centres per annum, with long term target of +250 intact and maintained a dividend payout ratio in the form of 70-100% of NPAT.

We continue to be positive on the long term outlook for the company driven by a) 35% of centres are still less than 3 years old and have significant growth opportunity, b) Strong pipeline of new centres (long term network of 250 centres) and c) margin expansion in the longer term driven by scale and efficiencies from streamlining operations.

However, margin expansion is still likely a few years away. New centres will continue to drag margins down and overheads (in terms of employee expenses, occupancy expenses and IT investments) will continue to increase for a few more years, which is likely to limit any meaningful re-rating in the short term. In order for the margins to expand either significant cost management needs to be implemented, or PSQ needs to vary its centre roll out plan, allowing the ones opened in the last few years to contribute more to the EBITDA to offset the start-up losses from the new centres. **Hence we retain our Hold, recommendation.**

Earnings Changes

We have reviewed our assumptions and forecasts for PSQ based on the 1H19 results and comments by management. This has impacted earnings and valuation.

Key assumption changes

- We now expect same centre patient fees growth in FY19 at +8.2% (was +5.2%), in-line with guidance of >5% and near the current YTD rate. We have also increased our assumed growth rate for FY20 and FY21 to 5.5% (was 5%). We have also increased PSQ's share of patient fees to 64% for FY19 and 63% for FY20-21 (was 62.5%). This has led to single digit percentage increase in our revenue forecast for FY19-21.
- For FY19 we have increased our assumption of chairs added in existing centres to 20 (was 12) as per company guidance. We have also increased the number of chairs added in existing centres for FY20 and FY21 to 14 (was 10). We have increased our capex forecasts based on the higher than expected capex for 1HFY19 and more chairs being added in existing centres.
- We have reduced our gross margin for FY19 to 91.6% (was 93%).
- We have reduced our tax rate forward assumptions to 30% (was 30.4%).
- We now include $8m (was $3m) drawdown of debt in FY19.
- Our DPS forecasts have reduced for FY19-21, owing to downgrade in our earnings forecasts. Our FY19-20 payout ratio is unchanged at 100% (high point of guidance range). For FY21 the reduction is lower than the downgrade to our EPS forecasts on account of higher payout ratio than we were previously forecasting (95% vs. 90%).
- We have reduced our EBITDA margins for FY19 by single digit percentages based on the higher opex and lower than expected margins in 1HFY19. Given that the majority of the centres for FY19 are expected to be opened in 2HFY19 and likely at least 4 may be opened in the last quarter of FY19, we expect it to be impacted by higher level of start-up losses. We also continue to expect that the growth in operating expenses would exceed the growth in patient fees, similar to pcp. Forward year margins (FY20-21) are also impacted as we would expect lower contribution from the FY19 new centres, given 7 would be opened in 2HFY19.
- Our D&A forecasts have increased due to higher capex assumption.
- We now forecast FY19 EBITDA growth of 3.8% (was 4.5%) over FY18 underlying EBITDA, which continues to be below guidance (revised guidance of ~5% growth).
- We now forecast FY19 patient fee growth of 12.9% (was 11%) on FY18, which is towards the low-point of the revised guidance range of 12%-15%.

The net result is downgrades to our EPS forecasts in FY19, FY20 and FY21 by ~3%, 6% and 13%. The downgrades have been driven by increases in our D&A forecasts and reduced EBITDA margins, partially offset by higher revenue forecasts.

Table 2 - Key Changes to our last published FY19-FY21 Forecasts

	FY2019E			FY2020E			FY2021E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenues ($m)	114.7	119.4	4.1%	128.5	132.5	3.1%	144.2	148.9	3.3%
EBITDA ($m)	22.5	22.3	-0.7%	24.2	23.6	-2.4%	27.3	25.5	-6.8%
EBITDA margin (%)	19.6%	18.7%	-4.6%	18.8%	17.8%	-5.3%	19.0%	17.1%	-9.8%
EBIT ($m)	13.0	12.6	-3.4%	13.1	12.3	-6.1%	14.7	12.6	-13.7%
EBIT margin (%)	11.3%	10.5%	-7.2%	10.2%	9.3%	-8.9%	10.2%	8.5%	-16.5%
NPAT -normalised ($m)	8.6	8.3	-3.1%	8.7	8.2	-5.8%	10.0	8.6	-13.4%
Diluted EPS -normalised (cents)	5.64	5.46	-3.1%	5.70	5.37	-5.8%	6.57	5.69	-13.4%
DPS (ordinary) (cents)	5.64	5.46	-3.1%	5.70	5.37	-5.8%	5.90	5.40	-8.4%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Valuation Changes

PT reduced to $1.40

Our Price Target (PT) for PSQ is generated using a blend of PE ratio, EV/EBITDA and DCF valuation techniques. We have updated each methodology to reflect the earnings changes as well as recent market movements. We use FY19 earnings for our relative multiples. We have increased the WACC used in our DCF from 10.5% to 10.9%, due to the risk we see of the company not meeting its underlying EBITDA guidance. This was partially offset by rolling forward of our DCF model.

We provide a summary of our valuation and price target below.

Figure 4 - Summary of Valuation and Price Target

Methodology	Valuation	% weighting	Price Target
DCF	1.58	60%	0.95
EV/EBITDA	1.42	20%	0.28
PE ratio	0.85	20%	0.17
Total			**1.40**

SOURCE: BELL POTTER SECURITIES ESTIMATES

The figure above shows our price target for Pacific Smiles Group is $1.40/sh. The price target is a 10.2% premium to the current share price of $1.27/sh and the total expected return (including the forecast dividend yield) is 14.5%. Hence, we retain our Hold recommendation.

Pacific Smiles Group (PSQ)

COMPANY DESCRIPTION

Pacific Smiles Group is one of the largest branded dental groups in Australia. It operates full-service dental centres at 82 sites, mainly located in NSW, Victoria and Queensland. It offers dentists who are self-employed the opportunity to focus on delivery of dental services rather than on administrative aspects of running a business. Dentists pay service fees to PSQ for the use of facilities and provision of services under a Service and Facility Agreement. The business has a solid growth path due to increasing demand for dental services driven by a growing and ageing population, more older Australians keeping their natural teeth, rising household disposable incomes and growing private health insurance coverage. The company has a long-term license agreement with nib to operate dental centres under the nib brand.

INVESTMENT STRATEGY

We have a Hold recommendation on Pacific Smiles Group. Our investment thesis is based on:

$1.40 price target: Our 12 month price target on PSQ is $1.40. The price target is generated from a blend of three valuation methodologies we apply to the company: PE ratio, EV/EBITDA and DCF. The price target is a 10.2% premium to the current share price of $1.27/sh and the total expected return (including the forecast dividend yield) is 14.5%.

Solid growth path ahead backed by Strong Industry fundamentals: The outlook for the Australian dental services industry is positive with steady growth expected for the next 5 years. Industry revenue is expected to rise by a compound annual 2.3% over the 5 years through 2022, to reach $11.3bn. Key trends which work in PSQ's favour are a) fragmented industry with no players having a market share over 5%; b) less reliant on government funding with patient paying out of pocket or through private health insurance extra cover; c) growing private health insurance coverage; and d) increasing proportion of women and part time workers in the dental workforce. PSQ has less than 2% market share of the multi-billion dollar market, with significant opportunity to grow its share.

Clear growth strategy: The focus of the company's business model is organic growth. Historically, the group has experienced strong organic growth via new centre openings and selective acquisitions. We expect growth to continue, driven by increasing utilisation of existing facilities and roll out of 10 new centres each year, in locations where supply and demand dynamics are favourable. 35% of PSQ's dental centres have been open for less than 3 years and therefore have significant growth still left.

Pacific Smiles is a capital light model. At the end of 1HFY19, PSQ had net debt of ~$10.0m. We continue to expect PSQ to fund its future growth internally through growing operating cash flow, modest debt, while also maintaining its targeted 70-100% dividend payout ratio.

Strong revenue growth with improving EBITDA growth: We expect the company will continue its double digit revenue growth and forecast single digit albeit improving EBITDA growth from FY19 onwards, driven by increased utilisation of existing practices and roll out of new centres. We expect PSQ to deliver 3-year compound growth in EBITDA of 5.8%.

Risks

The key risks specific to the company include, but are not limited to, the following:

- **Deterioration or loss of key insurer relationships:** Pacific Smiles has developed strategic relationships with two of Australia's largest private health insurers, Medibank Private (including ahm) and nib. The company also obtains substantial benefits from preferred provider arrangements between the PHI's and the dentists who practise from Pacific Smiles dental centres. 10 out of 82 Pacific Smiles centres are nib branded. Changes or termination of these relationships may impact patient volumes and thus earnings of Pacific Smiles.
- **Reduction in private health insurance coverage or membership rates:** Private Health Insurers (PHI) fund ~23% of dental expenditure in Australia (including rebates). PHI coverage has been growing steadily. However, a worsening economic climate, change in rebate and tax incentives or increases in the private health insurance premiums may cause material reductions in the PHI membership levels. This could reduce the demand for dental services in Australia and hence affect the earnings of Pacific Smiles.
- **Termination of Services and Facility Agreements by large number of dentists:** Pacific Smiles enters into Service and Facility Agreement (SFA) with dentists who provide dental services at clinics operated by Pacific Smiles. The terms of the SFA allow dentists to terminate the agreement subject to the provision of 1 months' notice within the first year and on 3 months' notice after that time. If a significant number of dentists who contract Pacific Smiles terminated their SFA without other practitioners engaging Pacific Smiles in their place, this could adversely impact earnings.
- **Fee pressures from dentist over supply:** An increase in the number of qualified dentists relative to population in Australia, could lead to increased price based competition amongst dentists. Such an increase in price based competition could lead to fee pressures on the dental services industry over time.
- **Regulatory risk and changes to government policies or declines in Government funding:** There are a number of government policies and regulations, changes to which, may have a material impact on the performance of Pacific Smiles. Whilst government funding is low compared to other medical sectors, any funding changes by the government may lead to patients facing higher out-of-pocket expenses. This may cause the dental industry and Pacific Smiles to experience reduced demand.
- **Integration risk:** Pacific Smiles may make acquisitions of established dental centres from time-to-time (eg. the acquisition of the Dental Practice from Medibank (ahm) in June 2014). There is a risk that the acquired centres suffer patient or dentist attrition, which may impact Pacific Smiles through reduced earnings or management distraction.
- **Exposure to reduced demand in the Australian dental industry due to general economic conditions:** Although a number of dental services are non-discretionary in nature, there is a degree of economic sensitivity for certain dental services (for example, teeth whitening, dental implants or other cosmetic treatments). Pacific Smiles' future business performance may be adversely affected by a worsening economic climate in Australia. Key macroeconomic factors which could adversely impact the company's business include rise in unemployment and decrease in household disposable income in Australia.
- **Continued delays in margin expansion:** PSQ has set a long term target of >250 centres. They expect significant leverage to overheads as economies of scale improve, allowing for a lift in margins. So far the margin expansion seems to be still a few years away.

Pacific Smiles Group
as at 25 February 2019

Recommendation	Hold
Price	$1.27
Target (12 months)	$1.40

Table 3 - Financial summary

Pacific Smiles Group (PSQ)	Share price (A$)	$1.270
As at 24 February 2019	Market cap (A$m)	193.0

Profit and Loss					
Y/e June 30 (A$m)	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Service Revenues	91.0	104.0	118.9	131.7	148.1
Sale of goods	0.5	0.5	0.5	0.7	0.8
Total Revenue	**91.5**	**104.5**	**119.4**	**132.5**	**148.9**
Gross Profit	85.9	96.5	109.4	123.2	138.5
Other Revenue	1.2	1.6	1.3	1.3	1.3
EBITDA	**20.9**	**21.5**	**22.3**	**23.6**	**25.5**
Depreciation & Amortisation	-6.0	-7.8	-9.8	-11.3	-12.8
EBIT	**14.9**	**13.7**	**12.6**	**12.3**	**12.6**
Net interest & Other Income/(Expense)	-0.2	-0.4	-0.7	-0.7	-0.3
Pre-tax profit (loss)	**14.7**	**13.3**	**11.9**	**11.7**	**12.4**
Tax expense (benefit)	4.4	4.0	3.6	3.5	3.7
NPAT (normalised)	**10.3**	**9.3**	**8.3**	**8.2**	**8.6**
One off items	-0.2	-2.6	-0.3	0.0	0.0
NPAT (Reported)	**10.0**	**6.6**	**8.0**	**8.2**	**8.6**

Cashflow					
Y/e June 30 (A$m)	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Reported NPAT	10.0	6.6	8.0	8.2	8.6
Non-cash items	6.0	10.0	9.7	11.4	12.9
Change in Working capital	1.1	0.9	1.2	2.5	2.1
Operating cashflow	**17.1**	**17.5**	**18.8**	**22.1**	**23.7**
Capex	-13.6	-13.8	-16.0	-12.1	-12.1
Investments/Acquisitions	0.0	-0.8	0.0	0.0	0.0
Other investing cash flow	0.0	0.1	0.0	0.0	0.0
Investing cashflow	**-13.5**	**-14.5**	**-15.9**	**-12.1**	**-12.1**
Change in borrowings	4.9	7.0	8.0	1.6	-12.6
Equity issued	0.0	0.0	0.0	0.0	0.0
Dividends paid	-8.7	-9.1	-9.3	-8.2	-8.2
Other financing cash flow	0.0	0.0	0.0	0.0	0.0
Financing cashflow	**-3.8**	**-2.1**	**-1.3**	**-6.6**	**-20.8**
Net change in cash	**-0.2**	**0.8**	**1.6**	**3.3**	**-9.2**
Cash at start of period	6.1	5.9	6.7	8.3	11.6
Exchange rate impact	0.0	0.0	0.0	0.0	0.0
Cash at end of period	**5.9**	**6.7**	**8.3**	**11.6**	**2.4**
Free cash flow (op. CF less capex and acquisition)	**3.6**	**2.9**	**2.8**	**10.0**	**11.6**

Balance sheet					
Y/e June 30 (A$m)	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Cash	5.9	6.7	8.3	11.6	2.4
Current receivables	1.0	1.6	2.1	1.2	1.3
Inventories	2.9	3.3	3.6	4.1	4.4
Other current assets	0.7	0.5	0.5	0.5	0.5
Current assets	**10.5**	**12.0**	**14.4**	**17.3**	**8.6**
PPE	41.9	47.3	53.6	54.5	53.9
Non-current receivables	0.0	0.0	0.0	0.0	0.0
Intangible assets - Goodwill	10.6	10.3	10.3	10.3	10.3
Intangible assets - Other	0.8	0.7	0.7	0.6	0.5
Deferred Tax Assets	4.4	5.0	5.2	5.5	5.7
Non-current assets	**57.7**	**63.3**	**69.8**	**70.9**	**70.4**
Total assets	**68.2**	**75.3**	**84.2**	**88.2**	**79.0**
Payables	9.8	11.2	12.4	13.8	15.7
Current debt	0.0	0.0	0.0	21.6	0.0
Current Provisions	3.0	3.3	3.5	3.6	3.8
Current tax liability	0.0	0.0	0.0	0.0	0.0
Non-current debt	5.0	12.0	20.0	0.0	9.0
Non-current Provisions	6.0	7.0	7.7	8.4	9.3
Deferred tax liabilities	0.0	0.0	0.0	0.0	0.0
Other liabilities	0.0	0.0	0.0	0.0	0.0
Total liabilities	**23.9**	**33.5**	**43.5**	**47.5**	**37.8**
Shareholders' equity	35.1	35.1	35.1	35.1	35.1
Reserves	0.2	0.3	0.4	0.5	0.6
Retained earnings/ (losses)	9.1	6.5	5.2	5.2	5.6
Total shareholders equity	**44.3**	**41.9**	**40.7**	**40.7**	**41.3**

Earnings ratios at current price of $1.27					
Y/e June 30	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Diluted EPS - Reported (c)	6.6	4.3	5.2	5.4	5.7
Diluted EPS - Normalised (c)	6.7	6.1	5.5	5.4	5.7
EPS growth (%) -normalised	***0.9%***	***-9.7%***	***-10.3%***	***-1.8%***	***6.0%***
DPS - Ordinary (c)	5.9	6.1	5.5	5.4	5.4
DPS -Special (c)	0.0	0.0	0.0	0.0	0.0
DPS -Total (c)	5.9	6.1	5.5	5.4	5.4
Yield (%) (including special div)	**4.6%**	**4.8%**	**4.3%**	**4.2%**	**4.3%**
Franking (%)	100%	100%	100%	100%	100%

Valuation ratios at current price of $1.27					
Y/e June 30	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Net profit -normalised (A$m)	10.3	9.3	8.3	8.2	8.6
P/E ratio (on normalised EPS) (x)	18.8	20.9	23.2	23.7	22.3
FCF per share (c)	2.3	1.9	1.9	6.6	7.6
Price/FCF per share (x)	54.4	67.4	67.9	19.4	16.7
EV/EBITDA	9.7	9.4	9.1	8.6	8.0
EV/EBIT	13.7	14.8	16.2	16.5	16.1
NTA per share (c)	21.6	20.3	19.6	19.6	20.0
Price/NTA (x)	5.9	6.3	6.5	6.5	6.3

Performance ratios					
Y/e June 30	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Gross Profit Margin (%)	93.9%	92.3%	91.6%	93.0%	93.0%
EBITDA margin (%)	22.9%	20.6%	18.7%	17.8%	17.1%
EBITDA to patient fees margin (%)	14.2%	13.1%	12.0%	11.3%	10.8%
EBIT margin (%)	16.3%	13.1%	10.5%	9.3%	8.5%
NPAT - Normalised margin (%)	11.2%	8.9%	7.0%	6.2%	5.8%
Return on assets (%)	16.0%	12.9%	10.4%	9.5%	10.3%
Return on equity (%)	23.5%	21.5%	20.1%	20.1%	21.1%
ROIC (%)	25.8%	21.0%	17.6%	16.7%	18.0%
Payout Ratio -ordinary dividend (%)	87%	100%	100%	100%	95%
Effective tax rate (%)	30.2%	30.4%	30.0%	30.0%	30.0%

Growth (%)					
Y/e June 30	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Gross Profit Growth	9.4%	12.3%	13%	12.6%	12.4%
EBITDA Growth	6.3%	2.9%	4%	5.6%	8.0%
EBIT Growth	1.6%	-7.9%	-8%	-1.9%	2.7%
PBT Growth	0.5%	-9.5%	-11%	-1.8%	6.0%
NPAT - normalised Growth	0.9%	-9.7%	-10%	-1.8%	6.0%

Leverage ratios					
Y/e June 30	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Net debt/(cash) (A$m)	-0.9	5.3	11.7	10.0	6.6
Net debt/equity (%)	-2.0%	12.7%	28.8%	24.5%	16.0%
Net debt/EBITDA (x)	0.0	0.2	0.5	0.4	0.3
Net Interest cover (x)	net cash	34.8	18.2	18.6	43.1
Gearing (net debt/net debt + equity) (%)	-2.0%	11.3%	22.3%	19.7%	13.8%

Key Operating Metrics					
Y/e June 30	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Number of Dental Centres (EOY)	70	80	89	99	109
Number of Dental Chairs commissioned (EOY)	276	309	347	381	415
Average Active chairs/centre	3.9	3.9	3.9	3.8	3.8
Extra chair capacity (uncommissioned chairs) (EOY)	96	92	91	97	103
Extra capacity at EOY (% of total chairs capacity)	26%	23%	21%	20%	20%
Total Gross Patient Fees Revenue (A$m)	147.0	164.5	185.8	209.1	235.0
Service Revenue to PSQ (share of gross patient fees) (A$m)	91.0	104.0	118.9	131.7	148.1
PSQ Share of Patient Fees (%)	61.9%	63.2%	64.0%	63.0%	63.0%

Interims					
Y/e June 30 (A$m)	**2H17A**	**1H18A**	**2H18A**	**1H19A**	**2H19E**
Total Revenue	45.9	50.5	54.1	59.8	59.6
Other Revenue	0.5	0.6	1.0	0.6	0.7
EBITDA	10.2	10.9	10.6	11.2	11.1
…EBITDA margin (%)	22%	22%	20%	19%	19%
EBIT	7.0	7.2	6.5	6.8	5.8
Pre-tax profit	6.9	7.1	6.2	6.5	5.4
NPAT (normalised)	4.9	4.9	4.3	4.5	3.8
NPAT (reported)	4.6	2.7	3.9	4.2	3.8

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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