ASX Small Caps Stocks Down Under

There is no weaponry in the feminine armoury to which men are so vulnerable as they are to a smile.

- Dorothy Dix (1861-1951), Journalist and columnist

PACIFIC SMILES GROUP

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Stocks Down Under rating: ★★★★

ASX: PSQ
Market cap: A$232.2M

52-week range: A$1.39 / A$3.08
Share price: A$1.46

Pacific Smiles (ASX: PSQ) has been significantly disrupted by COVID-19, but the guidance it gave for FY23 suggests it thinks the worst is over. The dental franchise is expecting patient fees of $270-$285m and EBITDA of $24-$27m, which would be up 23% and 126% on FY22 respectively. If it can achieve these figures, there could be significant upside in the stock. But the bar has been set quite high.

Share price chart

Source: Tradingview

The last listed dentists

Listing in 2014 at $1.30 per share, Pacific Smiles is the ASX's only remaining dental practice operator. Smiles Inclusive gave up the ghost, 1300 Smiles was acquired and while SDI is listed, it is an equipment manufacturer. Pacific Smiles owns and operates the Pacific Smiles Dental Care Centres as well as the nib Dental Care Centres in the ACT, NSW, Victoria and Queensland. It was founded in 2003 and operates 127 clinics today under a franchise model with over 600 registered dentists. The individual franchise operators do the hands-on work, while the head office takes care of everything else.

Its co-founders are Alison Hughes and Alex Abrahams who own just over 10% each – although the latter retired from a full-time capacity in 2020. Between 2012 and 2021, TDM Growth Partners had the largest shareholding (just under 25%) before offloading the bulk of its stake throughout 2021. HBF Health was one of the buyers, which took a 10% stake just before Christmas last year. TDM retains one board seat, filled by Hilton Brett although Ben Gisz departed.

COVID disruption

COVID-19 resulted in a significant hit to the business, albeit one mitigated by a strong performance in 1HY20. Officially, the business was only in hibernation for a few weeks in April 2020. But fear of the virus led to people putting off routine check-ups or even non-essential procedures. For the 8 months to 29 February 2020, patient fees and EBITDA were tracking 14% higher compared to the prior corresponding period. Ultimately in FY20, patient fees contracted 4.5%, NPAT fell 9.7% (to $8.1m) although EBITDA grew by 2.9% (to $23.5m). It paid a 3.5cps dividend in FY19 but opted not to pay up in FY20.

FY21 was a better year, with patient fees growing 29.3% to $240.8m, EBITDA growing 41% to $33.1m and NPAT growing 73% to $14m. Once again, the company did not pay a final dividend after paying an interim dividend of 2.4cps. Arguably, this was because the company opened 15 new centres during the year. It also entered into a relationship with HBF to commission and operate dental centres on their behalf for at least the next 10 years. It received $7.6m in JobKeeper payments during FY20 and $8.8m in FY21.

Inflation disruption

The company released its FY22 results earlier this month and these actually went backwards. Patient fees dropped 6% to $226m and underlying EBITDA fell 66% to $11.3m. It's $14m NPAT became a $3.2m loss. Again, it blamed a softer trading environment, labour costs and an investment in new centres – another 19 were opened. As we noted above, the company expects demand to bounce back in FY23. Well, the words CEO Phil McKenzie used were 'cautiously optimistic', but the guidance suggests a higher degree of optimism. It is expecting patient fees of $270-$285m and EBITDA of $24-$27m, which would be up 23% and 126% on FY22.

Again, we note that if it can achieve these figures, there could be significant upside to the stock. The fact that it has guided to a more conservative expansion strategy this year, predicting just seven new centres in FY23 (two of which will be HBF Dental centres), is one beacon of hope. Still, it has not put off aggressive expansion forever – management reiterated a long-term goal of reaching 250 dental centres (nearly double what it has now). Even if capex drops, we are not convinced revenues will lift with the rising inflationary environment. Given the cost of dentistry we fear that people will put off non-essential expenditure and it will be hit with higher costs.

But, looking to the US (a possible indicator of how Australia might perform given it has had higher inflation for longer), demand for dental services increased 1.9% in June 2022. Yet research also showed that rising costs were a significant concern – nearly 50% of dentists indicated gloves had at least tripled in price and eight in ten reported issuing pay rises for hygienists and assistants. As for consumers, more than a third are skipping dental visits and half of adults say they are struggling to pay general healthcare costs. This is not just an American problem. In the UK, the NHS has estimated that lab bills are increasing by 15% and almost one fifth of dentists are seeing utility bills rise by more than 50%. Furthermore, we note that Pacific Smiles is only a small player in the industry (there are 15,000 dental practices in Australia and Pacific Smiles has just over 100), which gives it less scope to be a price setter in this environment. Ultimately, we're not seeing a drop off in demand yet and if demand holds firm, PSQ will be able to weather the storm.

One positive with this company is that it regularly updates shareholders outside of reporting season, which means you won't be left guessing how it is performing for too long. If the company achieves its guidance - 23% revenue growth and 126% EBITDA growth – it is a no-brainer, and we're giving it four stars assuming it can. However, investors should be aware that the bar has been set high and the stock could be punished if it underperforms.

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