New Zealand Shareholders Association Inc.

Many Investors, One Voice

Shareholders Association Comments on Proposed Abano Partial Takeover

Members will be aware that Healthcare Partners (HP), a company controlled by Peter and Anya Hutson and James Reeves has made a partial takeover bid seeking 50.01% of Abano. Generally, NZSA is philosophically opposed to partial takeover offers as they do not guarantee shareholders the opportunity to sell all of their shares at the offer price. On the other hand, such an offer may sometimes create an opportunity to dislodge poor performing directors and management or may incentivise them to lift their game.

NZSA has had meetings and received a range of information from HP and Abano, as well as assessing other information including the Independent Report by Grant Samuel, various other analysts' reports and direct conversations with both larger institutional shareholders and smaller retail shareholders.

The offer of $9.84 (ex dividend) per share initially appears close to the low end of the independent valuation range. However, this valuation range was determined valuing all of the shares in Abano - not just those shares sought by HP in order to achieve a control position. The real issue is that the HP offer is just a partial offer for 38% of the shares not already held by HP. As shareholders will likely retain most of their shares if the HP offer is successful, the implied average price across the entire holding is well below the Independent Advisor's valuation. The current share price of $8.60 suggests that the market thinks the share price of the remaining 62% (or 49.99% of total shares issued) not purchased by HP could drop to approximately $7.80.

It is also important to consider that, given the statements made by HP, a successful partial offer leading to a change in control will likely result in significant management and board instability and a departure from Abano's current strategy, which has over the medium and longer term delivered significant value to shareholders.

HP raises three significant matters to explain this latest attempt to take control. The first is that Abano shares have underperformed the NZX50 gross index in the last 12 months. Using their dates, November 2015 to November 2016, this is certainly true for the short term. However, looking at medium to longer term performance (3 to 10 year periods), which we believe most Abano shareholders will be focussed on, Abano has significantly outperformed the NZX gross index.

Secondly, HP point out that EBITDA being achieved is considerably less than EBITDA being obtained via acquisition of dental practises. And they are absolutely right. Abano counters that this is largely related to the upfront costs in providing infrastructure to support growth before it occurs – the critical mass argument. There is support for this view from independent analysts. The benefits of scale are already showing through for the NZ Lumino business with much higher EBITDA margins than Australia where investment, particularly in brand building is ongoing. Exchange rates have also had some effect. Comparisons with other dental consolidators are also difficult as the models are quite different. Recent commentary from Abano released on NZX indicates that revenue and margins are tracking up in Australia particularly in line with forecasts used in the independent report. Whether these remain sustainable and improve further will need more time to determine, but it does suggest that the modelling being used is at least realistic.

Thirdly, HP says that Abano is carrying too much debt and this is suppressing returns. Their figures show an approx. 200% increase in debt from the start of FY 2012 to close of FY 2016, but this increase is from a time when Abano had sold down some business interests and debt was at a low point. It also excludes the $32m proceeds from the sale of Abano's stake in Bay Audiology to Mr Hutson – a stake that he attempted to obtain at a "nominal value" during his last failed proposal in 2013/2014. These funds were received after the close of FY16. Abano has satisfied us that its current debt is significantly below the HP estimate and well within banking covenants.

HP have announced that if they gain control, they will halt dental practice acquisitions in the short to medium term and focus on improving the performance of Abano's existing practices before recommencing any acquisitions. This is a significant change as Abano's current focus is to build scale through acquisition across both its NZ and Australian dental businesses. We have been unable to obtain much detail of how HP expects these strategic changes and performance improvements to be achieved. Ceasing acquisitions would presumably require significant cuts to support services and marketing costs that are in place to support the dental businesses as they grow. This may be effective short term, depending on the cost of doing so, but it will require rebuilding capacity at a later stage. In our view, HP should have provided more information to allow shareholders to adequately assess how they intend to improve margins and what a change of control might mean for minority holders.

In the end, the key questions for shareholders are which leadership team is the most credible, and which strategy will best support attractive returns to shareholders. Many shareholders were not impressed by Mr Hutson and Mr Reeves 2013/2014 attempt to obtain control. We note that following this attempt, Mr Hutson turned down an opportunity to sell his 50% share of Bay Audiology to Abano, initially for a consideration of $12.9m and later for $19.8m - both figures well in excess of his own valuation mid-point of approximately $7.8m. In July 2014 he did offer $9.5m to buy Abano's share. This was rejected by the Abano board. More recently (using a contractual right to match any other bid), Hutson interests paid $32m for Abano's 50% interest in Bay Audiology – a figure Abano had negotiated with a separate third party. In our view, this justifies Abano's (and Grant Samuel's) earlier assessments of value for the audiology assets, figures that were ridiculed by Mr Hutson and Mr Reeves at the time. Whether Hutson and Reeves current claims around value and prospects for the dental assets are any more realistic is something shareholders need to consider carefully.

We think Abano could do some things better at the margins. For example we have criticised the company for buying practises over a number of Australian states rather than concentrating on one or two states in order to create logistical efficiencies and make it easier to build brand awareness. We have also questioned management about whether a greater number of greenfield sites should be started in developing areas, and whether larger rather than smaller practises would be better acquisition targets

On balance however, given the returns that shareholders have enjoyed, over the medium and longer term, they have been well served by the current Abano board and management. With infrastructure in place to support a doubling of practice numbers and limited incremental support costs, the company is positioned to achieve the desired economies of scale for its Australian and NZ dental businesses. Ceasing acquisitions at this stage, as proposed by HP, is likely to lead to a short term increase in EBITDA, as infrastructure is wound back, but will move Abano away from its growth focus and limit its ability to achieve scale and a competitive market position relative to other dental consolidators.

How HP funds the acquisition of a control position in Abano could also potentially impact on the position of minority shareholders if HP itself comes under financial pressure. HP has not disclosed its sources of funding or the extent of leverage that it will apply.

If HP obtains control, Abano shares will have less liquidity – there will be significantly fewer available for sale. This tends to impact negatively on companies, with generally less investor interest and analyst coverage. In addition, should a follow up bid be made by HP to buy the remaining shares, this would not attract a control premium.

What is the timing?

The current offer runs until 13th February. HP also has an option to extend or vary the offer for a further period, at their discretion, by 30 January. Further extensions or variations are also possible. The absolute final closing date is 5 March.

What are your options?

- If you are happy with the current way Abano is being run, you should do nothing. Failure to achieve 50.01% means the offer will lapse and no shares will be purchased by HP.

- We believe you should wait and see. Currently only 1% of shares have been offered to HP. We believe that institutional shareholders are unlikely to accept – some have stated this publically. If there is a last minute rush of acceptances and the 50.01% threshold is reached in the last week, the offer will automatically extend for 14 days to give you time to make up your mind. Because of this provision, there is no advantage in accepting early unless you want the bid to succeed.

- If you believe that the HP proposal is attractive, you can offer your shares using the forms sent by Computershare for that purpose. While you can offer to sell all your shares, you may be scaled if more shares are offered than HP wish to purchase. If everyone attempted to sell, only 38% of your shares would be accepted.

- Note that in the event that scaling is required, all shareholders wishing to sell will be treated equally regardless of the time they accepted the offer (i.e. it won't be "first come, first served"). The same scaling will apply to all shares offered into the takeover.

As always in these situations, NZSA is legally unable to offer direct advice on whether or not you should accept the offer. We have set out what we see as the key issues for shareholders to consider, and recommend that you read the independent report and consult your financial advisor if you are in doubt about what to do.

The Team at NZSA
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