WILSONS

Equity Research

Date: 23 December 2020

Theme: Initiating Coverage

Company

Silk Laser Australia Limited (SLA)

New OVERWEIGHT: Smooth operator

Recommendation	OVERWEIGHT
12-mth target price (AUD)	$4.15
Share price @ 22-Dec-20 (AUD)	$3.60
Forecast 12-mth capital return	15.3%
Forecast 12-mth dividend yield	0.0%
12-mth total shareholder return	15.3%
Market cap	$170m
Enterprise value	$147m
Shares on issue	47m
Sold short	
ASX 300 weight	n/a
Median turnover/day	$0.4m

We initiate coverage on Silk Laser Australia (SILK) with an OVERWEIGHT rating and a 12 month price target of $4.15 per share. SILK is the first corporatised network of non-surgical aesthetics (NSA) clinics to list its securities on the ASX. The business operates a network of 56 branded clinics, grown primarily via greenfield expansion and franchising. The NSA industry is growing faster than conventional healthcare services sub-sectors, supporting SILK's strategy to add 6-10 clinics per year, pursuing an aspirational target of 150+. The company's thesis on winning in the NSA industry features disciplined site selection, local market share acquisition, systems investment to maximise the products available to clients and data to optimise the economics of delivering services. The sector offers M&A consolidation opportunities to open new jurisdictions and accelerate scale.

Key points

Initiating on SILK: a high-growth, self-funded network expansion story in healthcare services. SILK has built a genuinely corporatised operating model behind its network of 56 NSA clinics. Four growth strategies are being pursued: a) organic initiatives driven by digital marketing, market share capture, 'best practice' systems and a trend towards higher value services; b) network growth leveraging latent capacity within their clinics plus selective M&A; c) optionality between Greenfields or franchise expansion as a high-ROIC competitive tactic in select jurisdictions; and d) strategic scale benefits in terms of pricing, procurement and cost control.

Forecasts. We forecast EBITDA of $15.5M in FY21e (+150% v pcp and 10% ahead of Prospectus). EBITDA grows another 16% in FY22e to $18.0M. Our model assumes six new clinic openings each year over the forecast period and zero M&A contribution.

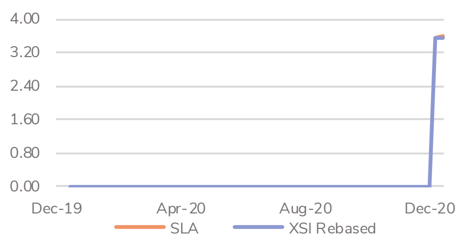
Returns. We assess attractive ROIC and ROE characteristics via self-funded expansion. SILK is well placed to introduce debt funding to its balance sheet and could readily support the acquisition of at least $5M incremental EBITDA in the short term with modest net leverage and gearing.

Price target set at $4.15 per share. Our approach comprises a comparative multiples-based approach supported by DCF scenario modelling. Our PT implies an EV/EBITDA of 9.6x (FY22e basis) which would rank SLA in line with leaders in other healthcare services subsectors (e.g. IDX in radiology at 10.6x; PSQ in dental at 9.8x; MVF in fertility treatment at 9.9x). The most important valuation sensitivity we identify is the outlook for margin stability during an important phase of clinic network growth (transition from 60-80 clinics).

Dr Shane Storey
shane.storey@wilsonsadvisory.com.au
Tel. +61 7 3212 1351

Dr Melissa Benson
melissa.benson@wilsonsadvisory.com.au
Tel. +61 2 8247 6639

12-mth price performance ($)



	1-mth	6-mth	12-mth
Abs return (%)			
Rel return (%)			

Risks and catalysts

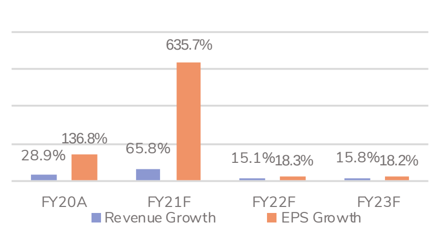
Risks: a) competitive intensity; b) macro factors influencing demand; c) margin stability during growth phase. Catalysts: a) organic growth; b) earnings upgrades; c) margin development via network leverage & procurement; d) accretive M&A.

Earnings forecasts

Year-end June (AUD)	FY19A	FY20A	FY21F	FY22F	FY23F
NPAT rep ($m)	-2.2	0.8	6.5	7.9	9.3
NPAT norm ($m)	-2.2	0.8	6.5	7.9	9.3
Consensus NPAT ($m)					
EPS norm (cps)	-5.2	1.9	14.2	16.8	19.8
EPS growth (%)	-128.2	136.8	635.7	18.3	18.2
P/E norm (x)	-68.7	187.0	25.4	21.5	18.2
EV/EBITDA (x)	-147.5	23.7	9.5	8.2	7.0
FCF yield (%)	1.7	4.0	5.6	5.4	6.7
DPS (cps)	0.0	0.0	0.0	0.0	15.8
Dividend yield (%)	0.0	0.0	0.0	0.0	4.4
Franking (%)	0	0	0	0	100

Source: Company data, Wilsons estimates, Refinitiv

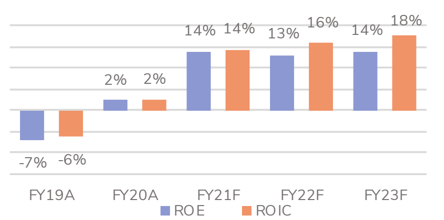
Growth rates



Key assumptions

	FY18A	FY19A	FY20A	FY21F	FY22F	FY23F	FY24F
Revenue Growth (%)		93.1	28.9	65.8	15.1	15.8	11.8
EBIT Growth (%)		136.5	-153.2	535.4	15.0	17.6	18.8
NPAT Growth (%)		128.2	-136.8	713.1	22.1	18.2	18.9
EPS Growth (%)		**128.2**	**-136.8**	**635.7**	**18.3**	**18.2**	**18.9**
EBIT / Sales (%)	-9.4	-11.6	4.8	18.3	18.3	18.6	19.7
Tax Rate (%)	26.5	27.4	26.4	30.0	30.0	30.0	30.0
ROA (%)	**-1.7**	**-3.3**	**4.8**	**17.2**	**13.0**	**13.2**	**14.5**
ROE (%)	**-6.7**	**-13.6**	**4.3**	**11.6**	**12.5**	**13.3**	**15.2**

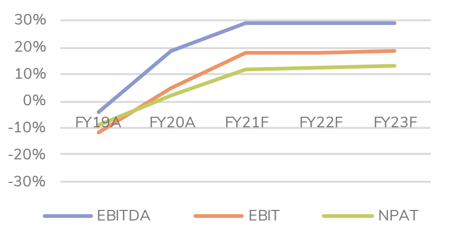
Returns



Financial ratios

	FY18A	FY19A	FY20A	FY21F	FY22F	FY23F	FY24F
PE (x)	-158.1	-69.3	188.6	25.6	21.7	18.3	15.4
EV/EBITDA (x)	-271.1	-147.5	23.7	9.5	8.2	7.0	6.0
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0	4.4	5.1
FCF yield (%)	-0.4	1.7	4.0	5.6	5.4	6.7	8.5
Payout ratio (%)	0.0	0.0	0.0	0.0	0.0	80.0	79.1
Adj payout (%)	0.0	0.0	0.0	15.9	0.0	37.7	55.2

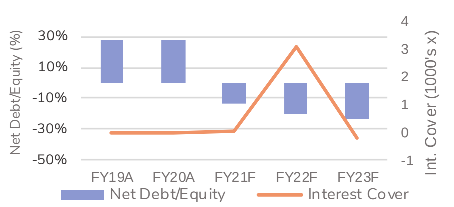
Margin trends



Profit and loss ($m)

	FY18A	FY19A	FY20A	FY21F	FY22F	FY23F	FY24F
Sales revenue	13.0	25.1	32.3	53.6	61.7	71.5	79.9
EBITDA	-0.5	-1.0	6.2	15.5	18.0	21.1	24.5
Depn & amort	0.7	1.9	4.6	5.7	6.7	7.8	8.8
EBIT	**-1.2**	**-2.9**	**1.5**	**9.8**	**11.3**	**13.3**	**15.8**
Net interest expense	0.0	0.1	0.5	0.6	0.0	-0.1	-0.1
Tax	-0.3	-0.8	0.3	2.8	3.4	4.0	4.8
Minorities/pref divs	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Equity accounted NPAT	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net profit (pre-sig items)	**-0.9**	**-2.2**	**0.8**	**6.5**	**7.9**	**9.3**	**11.1**
Abns/exts/signif	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reported net profit	**-0.9**	**-2.2**	**0.8**	**6.5**	**7.9**	**9.3**	**11.1**

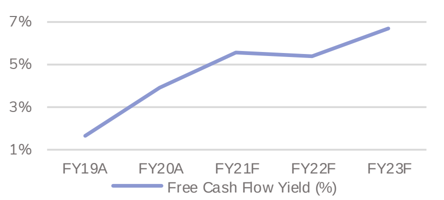
Solvency



Cash flow ($m)

	FY18A	FY19A	FY20A	FY21F	FY22F	FY23F	FY24F
EBITDA	-0.5	-1.0	6.2	15.5	18.0	21.1	24.5
Interest & tax	0.0	-0.1	-0.5	-1.7	-3.4	-3.9	-4.7
Working cap/other	0.9	4.0	3.2	-0.6	-0.9	-0.7	-0.8
Operating cash flow	0.3	2.9	8.9	13.1	13.7	16.4	19.1
Maintenance capex	-1.0	-0.1	-2.2	-3.7	-4.6	-5.0	-4.6
Free cash flow	-0.7	2.8	6.7	9.4	9.1	11.4	14.4
Dividends paid	0.0	0.0	0.0	-1.5	0.0	-4.3	-8.0
Growth capex	-2.7	-7.0	-2.9	-3.0	-3.4	-3.8	-4.6
Invest/disposals	0.0	-3.3	0.0	0.0	0.0	0.0	0.0
Oth investing/finance flows	-0.4	-2.2	-1.8	-0.5	0.0	0.0	0.0
Cash flow pre-financing	-3.8	-9.6	2.1	4.5	5.7	3.3	1.9
Funded by equity	0.0	0.0	0.0	13.9	0.0	0.0	0.0
Funded by debt	0.0	0.0	-1.6	0.0	0.0	0.0	0.0
Funded by cash	3.8	9.6	-0.5	-18.4	-5.7	-3.3	-1.9

Free cash flow yield



Interims ($m)

	1H21E	2H21E
Sales revenue	28.6	25.0
EBITDA	9.7	5.8
EBIT	7.3	2.5
Net profit	**4.9**	**1.5**
Norm EPS	**11.2**	**3.2**
EBIT/sales (%)	25.6	9.9
Dividend (c)	0.0	0.0
Franking (%)	100.0	100.0
Payout ratio (%)	0.0	0.0
Adj payout (%)	20.3	0.0

Balance sheet summary ($m)

	FY18A	FY19A	FY20A	FY21F	FY22F	FY23F	FY24F
Cash	13.8	4.1	4.6	23.0	28.7	32.0	33.9
Current receivables	3.0	3.0	3.8	2.5	3.0	3.6	4.3
Current inventories	1.4	2.0	2.1	4.5	5.1	5.9	6.6
Net PPE	6.0	10.0	22.3	23.3	24.6	25.6	26.1
Intangibles/capitalised	15.0	28.7	32.0	33.3	34.6	36.0	37.5
Total assets	42.7	53.4	71.6	93.5	103.1	110.4	115.7
Current payables	3.0	4.0	5.9	7.5	9.0	11.0	13.0
Total debt	8.0	13.0	14.8	15.7	15.7	15.7	15.7
Total liabilities	14.4	21.7	34.7	37.2	38.7	40.7	42.7
Shareholder equity	28.2	31.7	36.9	56.4	64.4	69.7	73.0
Total funds employed	36.2	44.7	51.7	72.0	80.1	85.3	88.6

Table of contents

Investment view 4
Investment merits 4
Risks and issues 5
Business overview 6
Financials 10
Valuation 19
A.1 Industry overview 21
A.2 Board and management 25

Investment overview

Initiating at OVERWEIGHT. $4.15 PT

Silk Laser Clinics (SILK) is one of Australia's largest specialist clinic networks offering non-surgical aesthetic (NSA) products and services. SILK's four core offerings comprise laser hair removal (LHR), cosmetic injectables, skin treatments and non-surgical fat reduction. SILK is the first company in its category to list its securities on the ASX. SILK operates a network of 56 clinics of which 39 are owned by SILK or operated as a joint venture (typically with a cosmetic injectable nurse) plus 17 franchised clinics. SILK has invested to create an industry best practice regulatory and safety framework to drive standards of care and differentiate from other organised networks and the broader, fragmented competitive field. Its operating model produces strong margins and is well placed to harvest latent organic growth. The company's thesis on winning in the NSA industry features disciplined site selection for new to industry (NTI) clinic openings, minimising exposure to saturated jurisdictions, local market share acquisition, capital investment in technology and systems to maximise the services available to clients and data to optimise the economics of delivering care. At the sector level, SILK and its peers are expanding. M&A opportunities complete the growth outlook.

Investment merits

A diversified operating model to capture market share in a high-growth industry. The NSA industry typically sees higher levels of organic growth than other health services subsectors (double digit versus low single digit). The eligible treatment population is relatively young with a high willingness to pay (20s-50s). SILK's marketing is delivering above average new client additions post-COVID and showing encouraging trends in terms of revenue per client and per clinic.

Pursuing Greenfields and JVs in tandem. Management has demonstrated success across four approaches to clinic network growth: greenfield expansion, brownfield maturation, franchising and M&A. Execution skills and the high background sector growth allows new clinic addition to be achieved with minimal drag on underlying earnings. We rate SILK the best greenfield operator in the sector.

NSA sector expanding organically but M&A is likely to feature over the next three years. NSA market growth has rebounded well, post-COVID and NTI clinic openings have resumed. We assess good availability of mid-size M&A targets that SILK may pursue as a listed company with access to debt and equity funding. As is the case in other health services sub-sectors, the drive to seek scale and pursue direct, mutually beneficial corporate relationships with suppliers is obvious.

Predictable cash flows. The revenue and cost structure within individual clinics is well described, so that SILK's client fee collection, statutory revenue and earnings should be relatively predictable at both the clinic and group levels. Many of the SILK network practices are well established in their local communities and on average, generate gross client fees >$1.8M per annum.

Potential for EPS growth exceeds that of peers. SILK generates higher margins than peers in other healthcare service subsectors. SILK's operating model looks capable of generating higher cash EPS growth than peers. Assuming that operating margins are held stable in the core, corporately owned clinics, the growth of franchise collections can leverage margin expansion at the group level. Disciplined self-funded Greenfields growth can only improve this outlook, with expanding ROIC and ROE.

Key risks

The NSA industry is becoming tougher to succeed in. Notwithstanding the many supportive demographic drivers the NSA category has, it has become an increasingly tough, competitive business, which relies more heavily than ever on the relationships between practitioners and their clients. As the industry simultaneously becomes more corporatised, there will be increased reliance on good systems and processes to monitor and maintain high service levels whilst containing costs.

Limited differentiation among larger operators. In core categories such as LHR and Injectables, the larger operators compete primarily on scale and price. All large operators make similar claims with respect to the medical/regulatory oversight they bring to Schedule 4 cosmetic injections. SILK's breadth of service is as good as or better than its larger competitors, noting that some categories are not available at all clinics.

Earnings growth and liquidity have held the listed healthcare services sector back. Healthcare services has been less accessible as an investable sector with only a small number of companies listed ASX and few of them generating organically driven EPS growth. We have diagnosed two root causes (not shared by all companies): a) moribund organic growth, often through a lack of co-ordination, systems and strategy; and/or b) 'cost-discovery', usually in relation to support and systems, having historically under-invested. SILK has systems to address both but there is no guarantee of success.

The challenge of affordability. With no realistic prospect of formal reimbursement supported by government or health insurance, NSA products and services remain a healthcare cost that clients pay themselves. Tougher economic conditions may translate into softer levels of growth and even recessions in "same clinic" cash sales growth. Clients may be more likely to defer, avoid or downgrade the costs of treatment at low points in the economic cycle or changes in personal circumstances.

Low evidence of efficacy and the risk of substitution or adverse events. NSA treatments are often medically unnecessary and expensive considering their comparatively low evidence quality. Competitors may launch low-cost, DIY alternatives to some products and services via social media platforms. The long term safety of certain NSA products and services is not well characterised. Unexpected side effects, including injury or harm to consumers would adversely impact SILK and the broader sector.

Non-compliance with regulations and clinical guidelines. SILK or its JV partners/franchisees may fail to comply with applicable laws and regulations in operating its business and delivering services. Non-compliance with applicable laws and regulations, and associated adverse publicity, could damage SILK's brand and reputation. Any future changes in regulation or in current interpretation that apply to SILK's operations, including changes that apply to the NSA industry and franchising industry, may have an adverse impact.

Table 1: Earnings summary for Silk Laser Clinics (SILK)

	FY18	FY19	FY20	FY21e	FY22e	FY23e
Network cash sales	15.8	38.4	50.7	83.4	100.4	119.1
- growth		*143%*	*32%*	*65%*	*20%*	*19%*
Reported revenue inc franchising	12.8	24.1	32.3	53.6	61.7	71.5
- growth		*88%*	*34%*	*66%*	*15%*	*16%*
EBITDA	(0.5)	(1.0)	6.2	15.5	18.0	21.1
- growth				*151%*	*16%*	*17%*
- margin			*19.1%*	*28.9%*	*29.1%*	*29.5%*
NPAT	(0.9)	(2.2)	0.8	6.5	7.9	9.3
- growth				*713%*	*22%*	*18%*

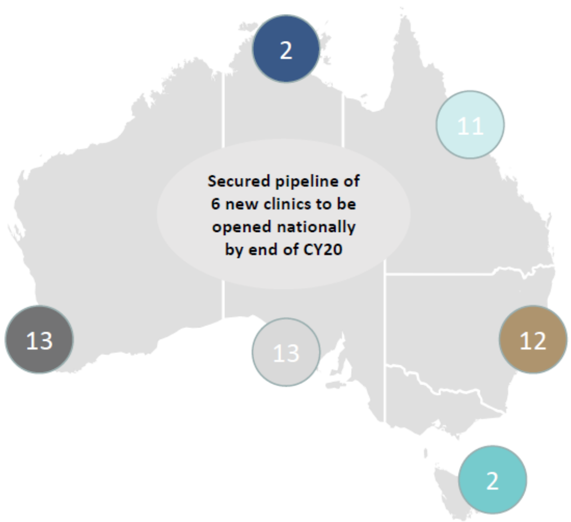
Source: SILK, Wilsons

Business overview

Introduction

Silk Laser Clinics (SILK) is Australia's third largest provider of non-surgical aesthetic (NSA) products and services and the first such company to list its securities on the ASX. SILK operates a network of 56 branded clinics developed principally via greenfield roll-out but with an interesting mix of joint ventures and traditional franchise models. SILK is pursuing differentiation on a number of fronts including digital marketing, training and enabling its practitioners to offer a breadth of higher value services. SILK clinics bring together over 300 cosmetic injector nurses, laser and dermal technicians. The clinic network is strong in QLD, WA, SA and NSW. Recent openings include Ipswich, Burleigh Heads and Mount Barker. SILK has no presence in Victoria at present.

Figure 1: SILK practice locations



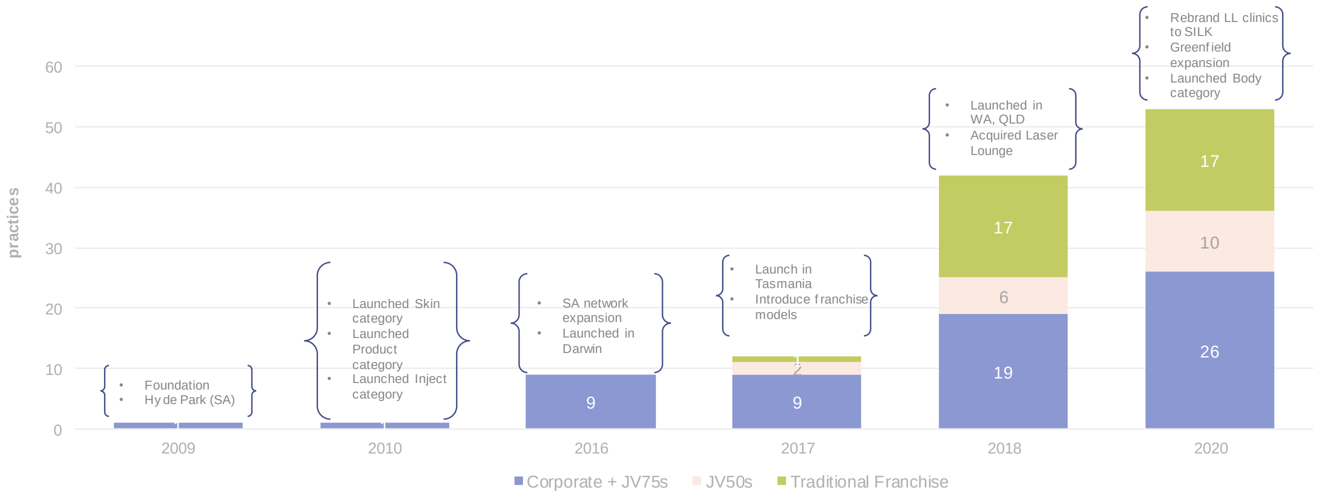
Queensland		
Bundaberg	Maroochydore	Paddington
Mackay	Robina	Fairfield
Cairns	Brookside	Townsville
Rockhampton	Coorparoo Square	
New South Wales		
Balmain	Bateau Bay	Warners Bay
Castle Hill	Erina	Wagga Wagga
Double Bay	Coffs Harbour	
NorthBridge	Green Hills	
Rouse Hill	Port Macquarie	
Tasmania		
Eastlands	Hobart	
South Australia		
Adelaide Rundle Mall	Henley Beach	Prospect
Adelaide Rundle Place	Hyde Park	Tea Tree Plaza
Burnside Village	Marion	West Lakes
Elizabeth	Noarlunga	
Glenelg	Norwood	
Western Australia		
Baldivis	Innaloo	Perth
Carousel	Joondalup	Rockingham
Cockburn	Karrinyup	Whitford City
Ellenbrook	Midland Gate	
Garden City	Ocean Keys	
Northern Territory		
Casuarina	Palmerston	

Source: SILK, Wilsons

History

SILK was founded as a "start-up" business in 2009 by Martin Perelman, opening its first clinic in Hyde Park, South Australia. SILK initially focused on laser hair removal, although quickly expanded to offer Skin and Product categories. By 2016 SILK had formed a nucleus of 9 clinics from which to create a genuinely corporatised NSA provider in Australia 'from scratch', seeing the opportunity for industry expansion. In 2018, the Advent Fund acquired 67% of the equity in SILK. As part of its investment, the Advent Fund provided capital to improve and grow SILK's network of clinics. SILK continued to grow clinic numbers both organically, and through acquisitions, expanding across Australia and reaching 53 clinics by September 2020. Of the 53 clinics, 39 were opened organically and 14 were acquired. In 2018, SILK acquired the business and assets of The Laser Lounge which included 16 clinics across New South Wales, Queensland and South Australia (two of which were subsequently released from their franchise agreements as a result of an overlap with an existing store and a redevelopment requiring the franchisee to vacate the premises). At the end of 2020 SILK can authentically claim to have 'built the platform' for sustained expansion and increased participation in M&A.

Figure 2: Historical development of Silk Laser Clinics



Source: SILK, Wilsons

Business model and strategic initiatives

SILK operates its facilities as an accredited network, seeking to differentiate itself from small independent competitors on the basis of practice quality, service excellence and range of offering. The company has a focus on metro areas, providing a retail-orientated environment with consistent branding. Site selection is guided by demographic profile seeking jurisdictions with latent demand, the capacity to pay and where the market is under-served. Alternatively, SILK will identify local injector nurse talent and use a franchise model to combat higher competitive intensity in lucrative jurisdictions.

SILK's clinics are typically 70-130m^2 in floor space and built to ultimately accommodate up to five treatment rooms as the clinic matures. All clinics start equipped for LHR, dermabrasion and LED/Dermapen skin treatment. Every clinic employs at least one Registered Nurse (RN) to administer cosmetic injections under the oversight of the Group Medical Director.

Clinic models

SILK operates three different clinic ownership models: Corporate, Joint Venture and Traditional Franchise. Corporate clinics are straightforward but JVs and franchise arrangements bear further description. These arrangements offer franchisees the opportunity to run their own SILK businesses at either 25% (JV75), 50% (JV50) or 100% (traditional franchise) ownership. Initial costs to the franchisee vary with the degree of ownership but briefly:

- JV50 partners pay ~$325K in set-up capex and costs including a $75K upfront franchise fee;
- JV75 partners pay ~$185K in set-up capex and costs including $60K upfront franchise fee;
- Traditional franchisees pay 100% of the set-up costs and the $75K franchise fee.

Broadly, SILK collects a monthly franchise service (8%-10% of revenue), a marketing levy (3% of revenue) and a management fee of $750 per week. We understand that franchisees operating a number of practices have negotiated variations to these indicative terms.

Table 2: SILK clinic ownership models

	Corporate	Joint Venture	Traditional Franchise
Number of clinics	24	15	17
SILK ownership[1]	100%	50% or 75%	0%
Franchisee ownership	0%	50% or 25%	100%
Description	• Model used to enter new markets • Ability to execute the opening of a new site faster than the other two models to take advantage of opportunities without franchise partners • Enables SILK to extract maximum profits and synergies from attractive markets	• SILK receives franchisor economics and profit share • Typically used to incentivise and retain leading cosmetic injectable nurses and other key talent • Established cosmetic injectable nurses may have an opportunity to generate up to $1 million of Network Cash Sales[2] so this model can be effective in entering already crowded markets	• Model mainly adopted in regional towns and locations with smaller catchments
Investment accounting	Fully consolidated into SILK results	• 75% - consolidated into SILK results • 50% - equity accounted	n/a
Other returns to SILK	-	• Franchise fees • Margin on sales from Owned Brand skincare and cosmetic injectables for 50% SILK owned Joint Venture clinics (reflected in SILK accounts)	• Franchise fees • Margin on sales from Owned Brand skincare, cosmetic injectables and skin treatments (reflected in SILK accounts)

Source: SILK, Wilsons

[1] Corporate and Joint Venture stores are owned via subsidiaries of SILK Laser & Skin Holdings Pty Ltd.
[2] Based on FY2020 Network Cash Sales of existing SILK clinics operated as a joint venture with cosmetic injectable nurses.

Products and services

The majority of SILK's revenue comes from performing services in clinic. The business is divided across five categories: laser hair removal (LHR), cosmetic injectables, skin treatments, body contouring and skincare products often sold in conjunction with other services.

Table 3: Product and service overview

	Laser Hair Removal	Inject	Skin	Body	Product
Key product / service offering	treatment plans for unwanted facial and body hair using medical grade laser	anti-wrinkle and dermal filler injections prescribed and administered by health practitioners	microdermabrasion, dermal peels, microneedling, laser pigmentation removal and LED	cryolipolysis (destruction of fat cells through freezing) EmSculpt body contouring	SILK's acquired Aesthetics RX and post-treatment products and a range of other facial products
How products and services are typically purchased	Majority of services purchased through prepaid packages	Treatment paid for at time of service across one or more products/areas	Majority of services purchased through prepaid packages	Majority of services purchased through prepaid packages	Majority of products purchased by clients from other SILK service categories
Clinics offering service	56	56	56	32 EmSculpt 22 CoolSculpting	53
Existing client penetration[3]	69%	22%	25%	0%[4]	49%
Average transaction value[5]	$118	$426	$142	$1,514	$95
Client stickiness	✓ 8 – 12 month packages	✓ High loyalty to injector	✓ 6 – 12 month packages	Ongoing maintenance	Ongoing maintenance

Source: SILK, Wilsons

[3] The Laser Lounge clinics have been excluded as they were not in the SILK format for the period. A client is considered penetrated if they made a purchase in FY2018, FY2019, FY2020 or FY2021 year to date. Penetration is estimated using the number of penetrated clients as a percentage of SILK's entire client base (excluding The Laser Lounge).
[4] Body category has only been in operation for three months so existing client penetration is less than 1%.
[5] Average transaction value is the average spend per transaction (excluding transactions for $0) (includes package transactions for Laser Hair Removal, Skin and Body). Body excludes CoolSculpting as the machine was in a trial period.

Financials

Revenue

Revenue and its recognition. The majority of SILK's revenue is generated by direct sales of products and services to clients within Corporate and consolidated JV75 clinics. Both clinic formats also generate a small amount of revenue (characterised as 'other income') by selling a range of over the counter products. The company describes its performance in terms of Network Cash Sales, which represents treatments and other products paid for by clients at the point of sale, including prepaid packages for LHR, Skin and Body treatments. SILK reports their statutory revenue on an accrued basis as services are performed for clients. JV50 and Traditional Franchisee clinics contribute via collected service fees, management fees and marketing levies. These franchise revenues are calculated on the basis of those clinics' underlying turnover.

Growth assumptions. At the Group level, on a pro-forma basis, our forecast implies mid-single digit organic (same store) growth as an average across the network. Growth rates are higher in the 58% of practices at intermediate stage of maturity (less than 3 years old) and lowest in the 42% of older clinics.

Trading update. Prior to listing, Silk confirmed $38M in network cash sales and $8.7M pro forma EBITDA FYTD to the end of November. We assess that revenue was broadly in line with their Prospectus FY21 revenue forecast of $81M. At the EBITDA level we assess SILK was run-rating ~$1.1M ahead of 1H21 expectations. Our FY21e EBITDA forecast is 10% ahead of Prospectus ($14.0M).

Table 4: Earnings summary

	FY18	FY19	FY20	FY21e	FY22e	FY23e	
Network cash sales	**15.8**	**38.4**	**50.6**	**83.4**	**100.4**	**119.1**	Direct client billings including pre-paid service packages
Trading sales	12.4	21.8	29.0	48.3	54.0	62.7	Revenue recognised as services are delivered to clients
Consumables	(2.9)	(5.1)	(7.8)	(12.9)	(14.4)	(16.6)	
Gross profit	**9.4**	**16.7**	**21.2**	**35.4**	**39.5**	**46.1**	
- gross margin on trading	*76.2%*	*76.7%*	*73.1%*	*73.3%*	*73.2%*	*73.5%*	
Franchise revenue	0.5	2.3	3.3	5.3	7.7	8.8	Derived from JV50 and traditional franchise clinics
Other income	0.1	1.2	0.4	0.4	-	-	Sales of products in-clinic
Employee expense	(5.9)	(12.0)	(12.6)	(18.4)	(21.0)	(24.4)	
Occupancy expenses	(1.5)	(3.8)	(0.8)	(1.0)	(1.1)	(1.3)	
Marketing expenses	(0.2)	(1.4)	(1.3)	(1.9)	(2.2)	(2.5)	
Admin and other	(2.9)	(4.0)	(4.1)	(4.2)	(5.0)	(5.6)	
EBITDA	**(0.5)**	**(1.0)**	**6.2**	**15.5**	**18.0**	**21.1**	
- EBITDA margin			*19.1%*	*28.9%*	*29.1%*	*29.5%*	
Depreciation and amortisation	(0.7)	(1.9)	(4.6)	(5.7)	(6.7)	(7.8)	Clinic equipment, leasehold improvements
EBIT	**(1.2)**	**(2.9)**	**1.5**	**9.8**	**11.3**	**13.3**	
- EBIT margin (trading basis)				*8.5%*	*5.7%*	*6.3%*	
Net finance costs	(0.1)	(0.1)	(0.5)	(0.6)	(0.0)	0.1	
Profit before tax	(1.3)	(3.0)	1.1	9.2	11.3	13.3	
Income tax expense	0.3	0.8	(0.3)	(2.8)	(3.4)	(4.0)	Effective tax rate 30% assumed
NPAT	(0.9)	(1.3)	2.3	6.5	7.9	9.3	
Normalised NPAT	**(0.9)**	**(2.2)**	**0.8**	**6.5**	**7.9**	**9.3**	

Source: SILK, Wilsons

M&A. Our forecasts assume no contribution from M&A, although the company is well set up operationally and financially to pursue new network additions.

Key revenue sensitivities. Our broader experience in covering healthcare services operators highlights a few critical revenue drivers that could cause variation up or down from our forecasts. In this we include:

a) general economic conditions influencing demand;

b) the adoption of technology in terms of digital marketing, offering higher value services and providing real time practice KPI metrics across the clinic network;

c) introduction of formalised loyalty schemes to increase annualised revenue/client and combat competitive erosion; and

d) flexibility in the business model to best address new jurisdictions.

Profitability – operating costs and margins

High level cost structure. SILK's operating cost structure is relatively straightforward, listing similar expense categories to those disclosed by other healthcare services operators. The majority of SILK's employee cost-base is client-facing, so we expect this component of staff costs to grow proportionally with clinic numbers and revenue. Other variable costs incurred by clinics include the procurement of products, materials and consumables. We would expect SILK's non-patient facing (largely corporate) headcount expense to remain relatively fixed and moderate as a percentage of patient fee revenue as the business grows.

Income statements from select, listed healthcare service operators reveal some variations worth noting. In Table 5 below, we have compiled FY19 earnings data for a selection of operators across health subsectors. We chose FY19 to exclude the impact of COVID-19 and present a 'compare and contrast' with our FY21e forecast.

Table 5: Comparative income statement analysis for SILK versus selected ASX-listed healthcare services peers

	FY19						
	NVL	CAJ	IDX	MVF*	VRT*	PSQ**	SLA (FY21)
Revenue	116.4	149.1	231.0	152.0	274.1	187.4	**48.3**
Trading sales	116.4	149.1	231.0	152.0	274.1	187.4	48.3
Other revenue	-	-	-	-	-	-	-
Cost of sales	28.1	9.0	10.4	41.3	85.2	74.6	12.9
Gross profit	**88.3**	**140.1**	**220.6**	**110.7**	**188.9**	**112.8**	**35.4**
- gross margin	*75.9%*	*93.9%*	*95.5%*	*72.8%*	*68.9%*	*60.2%*	*73.3%*
Other income	2.4	0.1	1.4	2.4	2.4	1.7	5.7
Direct expenses, employees, consumables and supplies	52.7	91.0	131.0	48.1	99.0	63.8	18.4
Occupancy expenses†	8.7	11.0	14.6	9.7	19.9	13.4	4.0
Marketing expenses	1.2	2.6	3.8	5.0	4.3	2.0	1.9
Corporate and other expense	10.2	9.6	19.6	13.0	17.0	12.5	4.2
EBITDA†	**18.0**	**26.0**	**53.0**	**37.2**	**51.2**	**22.8**	**12.6**
EBITDA margin †	*15.5%*	*17.5%*	*22.9%*	*24.5%*	*18.7%*	*12.2%*	*26.0%*
Practices	103	63	67	90	104	89	60
Revenue per practice ($m)	1.1	2.4	3.4	1.7	2.6	2.1	0.8
EBITDA per practice ($m)	0.17	0.41	0.79	0.41	0.49	0.26	0.21
Employee expenses	*45.2%*	*61.0%*	*56.7%*	*31.6%*	*36.1%*	*34.1%*	*38.1%*
Occupancy expenses†	*7.5%*	*7.4%*	*6.3%*	*6.4%*	*7.3%*	*7.1%*	*8.3%*
Marketing expenses	*1.0%*	*1.7%*	*1.6%*	*3.3%*	*1.6%*	*1.0%*	*4.0%*
Corporate and other expense	*8.7%*	*6.4%*	*8.5%*	*8.6%*	*6.2%*	*6.7%*	*8.8%*

* - VRT & MVF analysis takes fertility specialist remuneration above the line
** - PSQ analysis takes contracted dentist facility service payments above the line
† - normalised on a pre-AASB16 basis

Source: Company data, Wilsons' estimates

Expect gross margin improvement to be offset by opex growth to support network expansion. Gross margin forecasts imply a shift towards Body and Skin categories (85% contribution margins). In broad terms, the NSA category should be more profitable than other healthcare services sectors because it does not rely on highly qualified and paid specialists (radiologists, pathologists, fertility specialists, dentists). We estimate SILK's employee costs are ~38.1% of trading sales for SLA in FY21e. We model ~39% over the forecast period allowing for modest increase in network support costs (~90bps up from FY21e). We model aggregate, non-employee support costs (rent, marketing, admin) in the mid-teens as a percentage of core clinic cash sales (post-AASB16 basis).

Recent margin expansion has come from fixed admin costs and higher franchisee collections. Note that our analysis is presented and discussed on a pro forma basis, normalised for Jobkeeper (net benefit of $880K in FY20e and $1.3M in FY21e). The margin we look at in judging this business is that of the core corporate and consolidated clinics, after backing out franchisee collections. That margin is doubling in FY21e (v FY20) due to fixed cost leverage. Our FY22-23e forecasts accommodate additional investment in that core business to support growth (people and systems). Increasing franchisee collections are essentially pure margin, supporting profitability improvements at the Group level.

Table 6: Historical and forecast cost structure and margins

	FY18	FY19	FY20	FY21e	FY22e	FY23e
Trading sales	**12.4**	**21.8**	**29.0**	**48.3**	**54.0**	**62.7**
Consumables	23.8%	23.3%	26.9%	26.7%	26.8%	26.5%
Gross profit on trading	**9.4**	**16.7**	**21.2**	**35.4**	**39.5**	**46.1**
- gross margin	*76.2%*	*76.7%*	*73.1%*	*73.3%*	*73.2%*	*73.5%*
Employee expense	48.1%	55.3%	43.3%	38.1%	39.0%	39.0%
Occupancy expenses	11.9%	17.5%	2.9%	2.1%	2.0%	2.0%
Marketing expenses	1.5%	6.2%	4.3%	4.0%	4.0%	4.0%
Admin and other	23.2%	18.5%	14.2%	8.8%	9.3%	8.9%
Core clinic EBITDA	**(1.0)**	**(3.3)**	**2.9**	**10.3**	**10.2**	**12.3**
- Core clinic EBITDA margin			*10.0%*	*21.2%*	*19.0%*	*19.6%*
Depreciation	5.5%	8.8%	16.0%	11.8%	12.4%	12.4%
Core clinic EBIT	**(1.2)**	**(2.9)**	**(1.7)**	**4.5**	**3.5**	**4.5**
- Core clinic EBIT margin				*9.4%*	*6.6%*	*7.2%*
Group EBITDA	**(0.5)**	**(1.0)**	**6.2**	**15.5**	**18.0**	**21.1**
- Group EBITDA margin			*19.1%*	*28.9%*	*29.1%*	*29.5%*
Group EBIT	**(1.2)**	**(2.9)**	**1.5**	**9.8**	**11.3**	**13.3**
- Group EBITDA margin			*4.8%*	*18.3%*	*18.3%*	*18.6%*

Source: SILK, Wilsons

Balance sheet

SILK's summary forecast balance sheet information is set out below. The company's Prospectus indicated a pro forma net cash position of $6.0M post-IPO. We assess an end-FY21 net cash position of $23.0M excluding the impact of AASB16 lease liabilities.

Table 7: Forecast balance sheet movements for SILK FY20-25e.

Balance sheet summary						
A$m	**FY20a**	**FY21e**	**FY22e**	**FY23e**	**FY24e**	**FY25e**
Cash	4.6	23.0	28.7	32.0	33.9	36.8
Accounts receivable, inventory	5.8	7.0	8.1	9.5	10.9	12.4
PP&E	13.3	13.3	13.4	13.1	12.1	11.1
Intangibles	27.6	28.7	29.9	31.1	32.3	33.7
Other assets	20.3	21.6	23.1	24.7	26.4	28.2
Total assets	**71.6**	**93.5**	**103.1**	**110.4**	**115.7**	**122.1**
Payables	5.9	7.5	9.0	11.0	13.0	15.0
Debt	-	-	-	-	-	-
Other liabilities	28.8	29.7	29.7	29.7	29.7	29.7
Total liabilities	**34.7**	**37.2**	**38.7**	**40.7**	**42.7**	**44.7**
Shareholders' equity	**36.9**	**56.4**	**64.4**	**69.7**	**73.0**	**77.4**
ROA	*1.1%*	*6.9%*	*7.7%*	*8.5%*	*9.6%*	*10.3%*
ROE	*2.2%*	*11.5%*	*11.3%*	*13.4%*	*15.2%*	*16.2%*

Source: SILK, Wilsons

Borrowings and capacity. Growth forecasts as presented here are fully funded by the cash flows generated by the business. SILK may elect to take debt on the balance sheet in the event of a material acquisition. In our experience businesses like this can readily manage net leverage ratios up to 2.5x (net debt to EBITDA).

Cash flows, capex, funding and shareholder returns

We summarise the projected cash flow features, drawing attention to significant adjustments and policies.

Table 8: Forecast summary cash flow details for SILK FY20-25e

Cash flow summary						
A$m	**FY20a**	**FY21e**	**FY22e**	**FY23e**	**FY24e**	**FY25e**
EBITDA	6.2	15.5	18.0	21.1	24.5	27.1
Interest and tax	(0.5)	(1.7)	(3.4)	(3.9)	(4.7)	(5.3)
Working capital movements	3.2	(0.6)	(0.9)	(0.7)	(0.8)	(0.9)
Operating cash flow	**8.9**	**13.1**	**13.7**	**16.4**	**19.1**	**20.9**
Conversion of post-tax EBITDA	152%	96%	95%	97%	97%	97%
Dividends	-	-	-	(4.3)	(8.0)	(8.3)
Cash flow after dividends	**8.9**	**13.1**	**13.7**	**12.1**	**11.1**	**12.6**
Capex	(5.0)	(6.7)	(8.0)	(8.8)	(9.2)	(9.7)
Other investing	(0.9)	-	-	-	-	-
Surplus (deficit)	2.9	6.4	5.7	3.3	1.9	2.9
Financing, net	(2.5)	11.9	-	-	-	-
Cash	**4.6**	**23.0**	**28.7**	**32.0**	**33.9**	**36.8**

Source: SILK, Wilsons

Operating cash flow, working capital and cash conversion. NSA clinics are typically good cash flow businesses in that they collect client fees immediately at the point of care and pay employees, contractors and suppliers on terms of 15-60 days. Approximately 40% of cash sales are packages of 2-12 LHR or Skin treatments paid in advance. We are forecasting gross operating cash flow of $13.1m in FY21e, which will represent 96% conversion of operating EBITDA.

Dividends. SILK's Prospectus did not commit to a dividend in FY21 (other than the pre-IPO dividend of $0.04 per share). The outlook for future dividends is subject to the prevailing business conditions and funding requirements. We have arbitrarily implemented a dividend in our model from FY23e (80% payout ratio) to prevent excess cash accumulation and illustrate the potential for ROE expansion (490 basis points over the four years to FY25e).

Tax. We model a corporate tax rate of 30% consistent with Australian corporate taxation legislation.

Capex. SILK's forecast of $5.0m relates to both new greenfield investment and brownfield investment at existing clinics. Going forward and based on our experience covering the sector, we would anticipate an annual maintenance capex investment level of approximately 2-3% of network cash sales.

Other significant financing cash flows. Our forecast includes a $1.5M capital return in line with Prospectus forecasts.

Growth opportunities

Growth in existing clinics. With more than half the existing clinic network at an early or intermediate phase of development (< 2 years), the organic growth within that subset of the network network is the largest component of our forecast EBITDA growth.

Roll-out. SILK has a network plan for approximately 150 clinics (including franchised clinics). SILK's objective is to open 6-10 per year from its current level of 56 clinics. Our forecasts and DCF valuation accommodate 6 new practices per year, split 50:50 between Corporate/JV75 and JV50/Traditional. The company's experience has been that new centres break even on an underlying EBITDA basis in their first year (modest drag in statutory terms). To be conservative we model new practices with a ~$0.1M EBITDA drag in their first year before ramping linearly to $0.15M by in their second year. Returns depend on site selection (demography, local competitive environment) and the quality of the practitioners at practice start-up.

M&A. The group's last material acquisition was The Laser Lounge network of 16 clinics in Queensland, New South Wales and South Australia. Our forecasts comprise no M&A contribution so it is reasonable to explore some scenarios around how that activity could potentially augment earnings. We assess borrowing capacity of up to $35M as a starting point (~3X FY22e EBIT) which could be ~15% EPS accretive if deployed at asset pricing of ~6.0x EV/EBITDA. SILK's potential free cash generation is potentially strong enough to support twice that level of geared investment over the forecast period. Scenario analyses show that SILK could acquire $10M in incremental EBITDA and only push net leverage to ~1.5x.

Table 9: Potential M&A scenario analyses adding $5M and $10M incremental EBITDA assuming asset pricing of 6.0x EBITDA.

	FY21e	+ $5M EBITDA	+ $10M EBITDA
EBITDA	**15.5**	**20.5**	**25.5**
Net cash/(debt)	23.0	(7.0)	(37.0)
D&A	5.7	8.5	11.2
EBIT	9.8	12.1	14.3
Net interest	0.6	1.5	2.4
PBT	9.2	10.6	11.9
NPAT	**6.5**	**7.4**	**8.4**
EPS	**14.2**	**16.2**	**18.3**
EPS accretion		*14.6%*	*29.2%*
ND/EBITDA	n/a	0.3x	1.5x
Gearing	n/a	35%	52%

Source: Wilsons' estimates

Assumptions

- $5M (low case) and $10M (high case) incremental EBITDA added through M&A using FY21e as a base. Acquisition analyses considered on an annualised pro forma basis.
- Given the quality of SILK's support infrastructure we would expect zero incremental support costs attached to new acquisitions.
- We modelled uniform asset pricing of 6.0x EBITDA.
- We have assumed 100% debt funding for all acquisitions with 70% paid upfront followed by three annual tranches of deferred consideration.

Outcomes

- NPAT benefit of 15-30% compared to our FY21e forecast.
- At the higher level of $10M EBITDA acquired, ND/annualised EBITDA is ~1.5x.

Investment in technology supports mix shift towards higher value services. SILK has committed time and capital to introduce higher value services – particularly in their Skin and Body categories. Examples include high intensity electromagnetic therapy (EmSculpt) and cryolipolysis (CoolSculpting).

Demand for non-invasive body contouring is growing as consumers express the desire for an easy solution to reducing fat and improving the appearance of the abdomen, buttocks and thighs. Surgical approaches to body contouring entail inherent risks and complications such as pain, swelling, prolonged recovery, scarring, hematoma and infection. Many patients, especially those with lower BMI, are not suitable candidates for surgical approaches.

EmSculpt is a technology developed and owned by BTL Industries which has FDA 510(k) clearances for strengthening, firming and toning arms, calves, buttocks, abdomen and thighs. The device employs high intensity electromagnetic (HIFEM) muscle stimulation with the intention of reducing adipose tissue and increasing muscle thickness. EmSculpt offers in-practice, non-invasive body contouring. Small clinical studies are available that suggest efficacy in select patients[6].

EmSculpt is available at 32 of SILK's 56 clinics. Anecdotally, the first 15 devices launched in FY20 enjoyed rapid adoption. SILK expects ~$180K in incremental EBITDA per device and a payback period of ~12 months assuming $15K in gross profit per month.

Figure 3: EmSculpt applicator applies energy via a magnetic coil

Source: BTL Industries

CoolSculpting works on the concept that lipid-rich tissues are more susceptible to cold-induced injury than the surrounding tissue. This cryolipolysis device was approved in 2010 for fat reduction of the flanks, abdomen and thighs. It has since been used to treat other fat deposits including arms and knees and medical conditions. A high patient satisfaction rate of 73% is attributable to a few key factors: non-invasive nature; minimal discomfort during the procedure[7]. We understand that a course of 5 treatments costs ~$2,500.

Figure 4: CoolSculpt cools tissues to below -4°C under vacuum to induce apoptosis in adipocytes

Source: Zeltiq Aesthetics (Allergan)

[6] Kinney, B. M. and Lozanova, P. (2019) *High intensity focused electromagnetic therapy evaluated by magnetic resonance imaging: safety and efficacy study of a dual tissue effect based non-invasive abdominal body shaping* Lasers in Surgery and Medicine 51: 40 – 46.
[7] Krueger, N. *et al.* (2014) *Cryolipolysis for non-invasive body contouring: clinical efficacy and patient satisfaction* Clin. Cosmet. Investig. Dermatol. 7: 201 – 205.

Valuation

DCF price target of $4.15 per share

We value SILK on a DCF basis and set a 12-month price target of $4.15 per share. Given the projected 18% upside to our target price, we initiate coverage at OVERWEIGHT. We also cross validate our DCF using implied multiples (PER, EV/EBITDA, EV/Revenue) with reference to selected healthcare services peers.

- Methodology. Our DCF treatment includes separate forecast frameworks for the expected mix of Corporate, JV75, JV50 and traditional franchisee clinic types. Note that the relatively opex-free nature of franchisee collections has a positive impact on overall group margin.
- WACC inputs. Choice of risk-free rate (3%) and risk premium (6%) is consistent across our research coverage. We have selected an equity beta of 1 which is ~200bps higher than our mid-cap healthcare services peer average. Inclusion of a terminal value component is appropriate given the long runway ahead for private NSA industry consolidation. Our valuation practice typically selects a terminal growth rate of 2.5% for healthcare services businesses. We have used 3.0% for SILK reflecting higher organic growth.
- M&A assumptions: Our forecasts have zero assumed M&A.
- Expansion provisions. We assume 3 new greenfield openings (Corporate or JV75s) per year over the forecast period. In our model this exercise is effectively self-funding (practices approximately breakeven in year one). We also factor in 3 franchise clinics (JV50s or Traditional).
- Capex: We model a ~$1M investment per practice plus maintenance capex at 3% of Group network cash sales.
- Core EBITDA margin reinvestment as a base case leaving upside should margin expansion be achieved: We can see an opportunity for margin expansion at the Group level as franchisee collections grow and as leverage develops in the core clinic business. We have modelled core clinic margin lower from FY22e because our experience in the sector suggests businesses like SILK tend to require incremental investment as the network transitions from 60-100 practices. This is offset at the Group level by the growing contribution from franchisee collections.

Table 10: Summary DCF framework for SILK

	FY21e	FY22e	FY23e	FY24e	FY25e	FY26e	FY27e	FY28e	FY29e	FY30e
Revenue	48.3	54.0	62.7	70.1	78.2	98.8	108.8	119.1	129.9	141.1
Underlying EBITDA	15.5	18.0	21.1	24.5	27.1	29.3	31.3	33.1	34.5	35.6
EBIT(1-t)	7.0	7.9	9.3	11.0	12.5	13.6	14.6	15.3	15.9	16.1
D&A	5.7	6.7	7.8	8.8	9.3	9.9	10.5	11.1	11.8	12.5
Chg WC	-0.6	-0.9	-0.7	-0.8	-0.9	-1.1	-1.2	-1.4	-1.5	-1.6
Maint capex	-6.7	-8.0	-8.8	-9.2	-9.7	-10.2	-10.7	-11.2	-11.2	-12.4
FCFF	**5.4**	**5.7**	**7.6**	**9.8**	**11.2**	**12.1**	**13.1**	**13.9**	**15.0**	**14.6**
PV of FCFF	5.0	4.8	5.8	6.9	7.3	7.2	7.2	7.0	6.9	
Terminal value										**244**

DCF Parameters		DCF Valuation	
WACC	9.0%	Forecast horizon	FY30
Risk-free rate	3.0%	Terminal growth rate	3.0%
Equity risk premium	6.0%	PV of future cash flows	93.7
Equity beta	1	PV of terminal value	112.3
		Net debt (cash)	10.7
Cost of equity	9.0%	Enterprise value	206.0
Cost of debt (post tax)	2.8%	Equity value	195.3
Forecast D/EV	0.0%	Price target	**4.15**

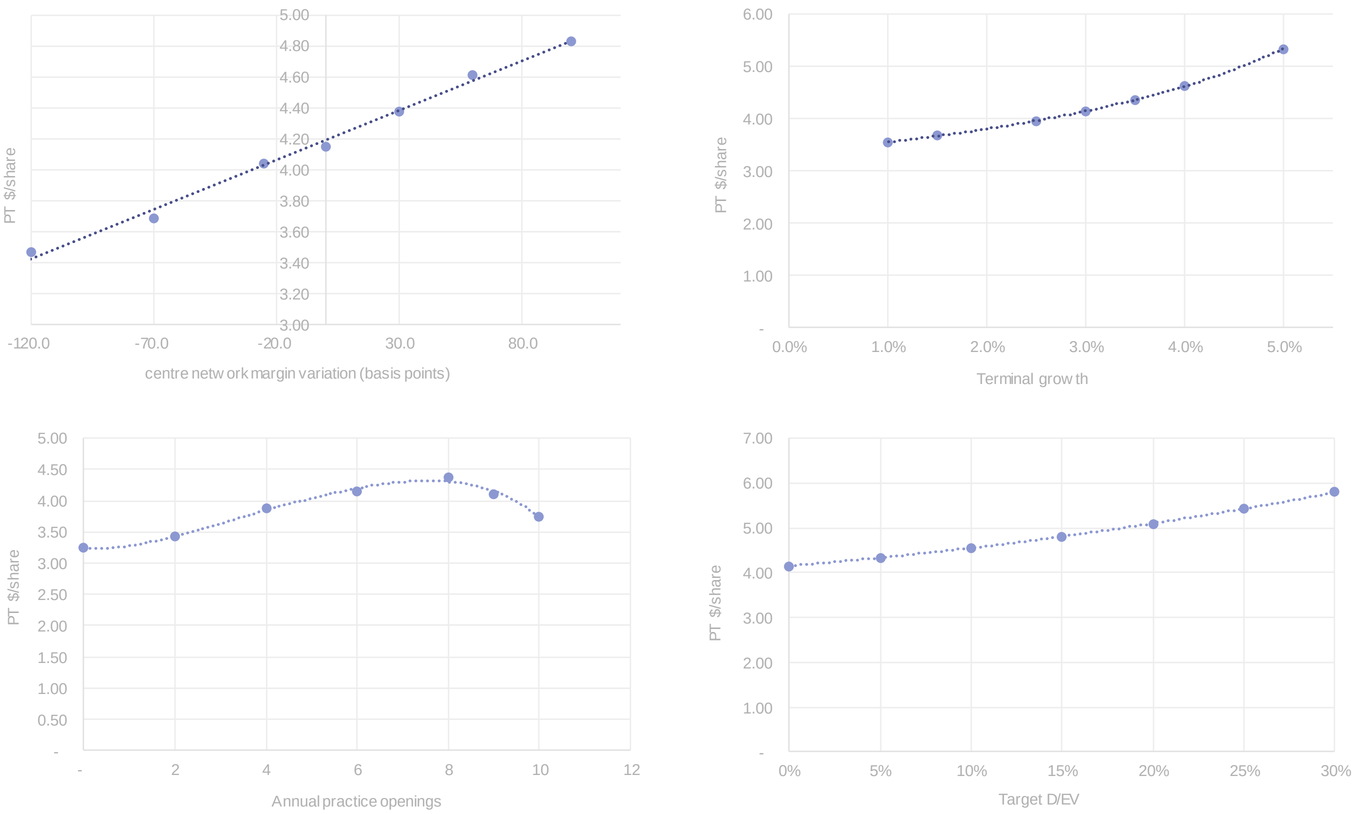
Source: Wilsons

Valuation sensitivities

Sensitivities are useful in assessing the impact of certain operating variables on DCF valuation estimates.

- Centre network operating margin. Our modelling has relatively stable EBITDA margins within the Corporate & JV75 clinics. We assessed up and downside scenarios of ±120 basis points. Scenario analysis revealed a corresponding ±16% variation in PT ($3.47 to $4.83 per share).
- Annual acquisition rate. Our base case models 6 clinic openings acquisitions per annum. Recognising the limitations of modelling this accurately, we assessed 6-8 practices as an optimal activity level. Beyond 6-8 practices per annum the incremental free cash generation begins to decline with the additional capex, transaction and operating costs.
- Terminal growth. In our view, the slightly elevated choice of 3.0% is a reasonable starting assumption for SILK which looks likely to become a growth stock (higher organic growth, certain features of the operating model). We have provided a sensitivity analysis to accommodate a range of investor views on this input. At 2.5% (a level more in line with 'average' healthcare services) our DCF would have been $3.96 per share (11.5x FY22e EV/EBITDA).
- Target capital structure. Our base case model sees SILK take on zero gearing. Increased M&A and/or accelerated roll-out activity may see the requirement for debt funding. We provide a sensitivity up to 30% (gross debt:EV) which reduces WACC.

Figure 5: Valuation sensitivity charts exploring four key variables on an 'all else equal' basis. Operating margin outlook is the most powerful potential driver of SILK valuation over the next few years.



Source: Wilsons

Earnings capitalisation

Our price target of $4.15 per share represents 9.6x FY22e EV/EBITDA, which aligns it with higher quality, sector leaders in other adjacencies (e.g. IDX in radiology at 10.6x; PSQ in dental services at 9.8x; MVF in fertility treatment at 9.9x).

Table 11: Healthcare services valuation benchmark data

Company Name	Ticker	Mkt cap ($M)	EV/EBITDA			PER (norm.)			EBITDA margin		
			FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e
ASX healthcare services											
Pacific Smiles Group Ltd	PSQ.AX	389	9.4x	9.8x	7.5x	52.0x	28.1x	26.1x	21.4%	21.2%	21.7%
Healius Ltd	HLS.AX	2,465	7.8x	8.3x	7.7x	42.0x	19.8x	21.3x	24.3%	23.2%	24.3%
Integral Diagnostics Ltd	IDX.AX	849	11.3x	10.6x	9.7x	28.9x	23.3x	21.4x	25.5%	25.4%	26.1%
1300 Smiles Ltd	ONT.AX	161	7.1x	7.0x	6.6x	NULL	16.6x	16.1x	40.7%	40.1%	39.5%
Healthia Ltd	HLA.AX	109	12.7x	9.8x	9.1x	14.5x	12.2x	8.9x	23.4%	22.9%	31.5%
Capitol Health Ltd	CAJ.AX	285	9.8x	8.3x	7.8x	31.1x	23.3x	19.7x	19.0%	19.8%	20.0%
Virtus Health Ltd	VRT.AX	468	8.2x	8.5x	8.2x	24.2x	15.3x	17.0x	27.4%	26.5%	26.5%
Monash IVF Group Ltd	MVF.AX	306	10.0x	9.9x	9.4x	16.8x	15.8x	13.2x	27.7%	27.6%	28.1%
Japara Healthcare Ltd	JHC.AX	167	14.6x	9.4x	8.4x	20.6x	NULL	75.8x	5.5%	7.9%	8.5%
Estia Health Ltd	EHE.AX	451	6.2x	5.4x	5.1x	16.7x	NULL	NULL	14.5%	16.2%	16.2%
Regis Healthcare Ltd	REG.AX	553	7.3x	6.7x	6.5x	23.1x	51.1x	29.7x	12.9%	13.5%	13.4%
Medians			**9.4x**	**8.9x**	**8.0x**	**24.2x**	**18.2x**	**19.7x**	**22.9%**	**23.1%**	**24.2%**
Means			**9.5x**	**8.5x**	**7.8x**	**27.0x**	**22.8x**	**24.9x**	**22.0%**	**22.2%**	**23.2%**
Silk Laser Australia (at price target)	**SLA.AX**	**195**	**11.1x**	**9.6x**	**8.2x**	**29.3x**	**24.8x**	**21.0x**	**28.9%**	**29.1%**	**29.5%**

Source: Wilsons' estimates

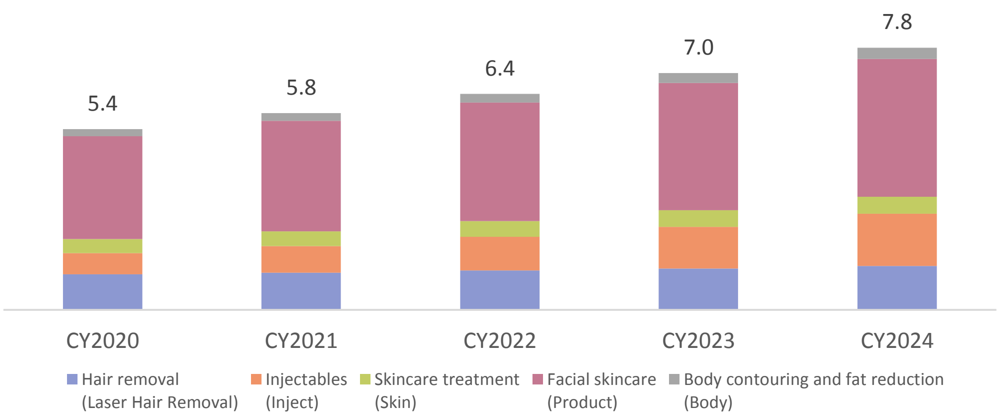
Appendices

A.1 Industry background

Industry consolidation

The Australian NSA provider sector offers much scope for consolidation and corporatisation. The sector operates under a self-pay funding environment but the base level of attendance growth appears higher than that observed in more traditional healthcare service industries (GPs, radiology etc). Affordability issues remain important but surprisingly, access is sought across most socioeconomic sections of the community. The industry has thus become very competitive and that has been a driver of both new to industry (NTI) clinic openings and consolidation as groups aggregate and deploy sophisticated marketing strategies to capture client volumes. In Australia, the estimated addressable market in which SILK operates generates annual revenue of $5.4 billion per annum and is expected to grow at a forecast CAGR of 10% to $7.8 billion by 2024.

Figure 6: Australian market size by segment 2020-2024e



Source: IMARC[8]

Outlook

The NSA sector is in its early days, with the top 5 operators operating nearly 350 clinics or ~30% of the market. We assess that the level of consolidation could ultimately reach or even exceed 60% as the larger operators remain very active with NTI clinic openings. Achieving this level of penetration would necessarily mean the creation of two or three organisations materially larger than what exists today. Key challenges for operators include: a) choice of business model (Greenfield development and franchising the two most common strategies); b) how best access material M&A targets at conducive asset pricing; c) opportunities to reach the under-served parts of the country, particularly in regional and rural centres; and d) how to adopt and integrate technology to underpin organic growth.

[8] Australia Facial Skincare, Hair Removal and Skin Treatment Market: Industry Trends, Share, Size, Growth, Opportunity and Forecast 2020-2025, October 2020

Demand drivers

Larger corporates best placed to stimulate growth in an industry that shows excellent attendance patterns. The demand for NSA care is growing, underpinned by demographic trends such as ageing population, focus on 'wellness' and the desirability of aesthetic appearance. Well-organised NSA providers are in a good position to leverage digital marketing, social media and other resources to grow their businesses above 'system growth'.

Household incomes and disposable income in the 20-49 age group. Although the ageing population has been positive for the sector, the more important trend has been younger patients adopting treatments traditionally associated with 'ageing', in particular injectable fillers. Higher levels of individual and/or family income has supported consistent growth in gross household disposable income per capita and the capacity to prioritise these treatments in personal budgets.

Top-5 practice share could exceed 40% on a 5-year view. We estimate that the top five NSA providers currently own or control approximately 30% of total clinics in Australia. We expect that those networks will grow at approximately 10% annually over the next 4-5 years, implying that market penetration could exceed 40% by FY26 without M&A. Whilst the industry is very competitive, it is highly fragmented. We expect more sub-scale aggregation to create new M&A targets over the next 5 years. Scale operators should be able to pursue M&A and grow into underserviced areas and/or compete with smaller, local incumbents.

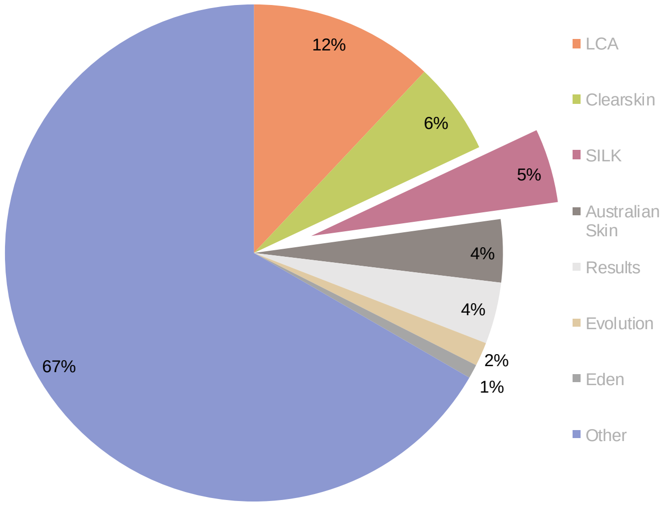
The big opportunity in regional areas. The NSA industry enjoys resilient demand which is not limited to affluent, city-dwelling sections of the population. Most NSA provider networks are concentrated around capital cities and there is likely to be under-served latent demand in large regional centres and other jurisdictions.

Differentiation on service quality, breadth of offering and access to new treatments. We expect pricing to remain relatively subdued at the industry level, reflecting increased competition and market penetration. Core offerings such as laser hair removal and injectables rely on good practitioners and service because there is little or no differentiation on the basis or technology or product. Larger NSA groups tend to have a breadth of services available which may provide some competitive advantage in more penetrated jurisdictions.

Market structure

Highly fragmented industry. The majority of NSA services in Australia are delivered by privately owned operators. The great bulk of the private sector comprises sole practitioners or other single or small practice groups. Given the relatively high organic growth available, the NSA sector is increasingly attractive to corporate buyers seeking to gain advantages through economies of scale and access to expansion capital.

Figure 7: Structure of Australia's private NSA services marketplace



Source: Company data, Wilsons' estimates

Similarity in corporate models. The leading players in the sector are taking a similar approach to building scale, relying primarily on greenfield and franchisee models. Although the acquisition opportunity is potentially large in the NSA sub-sector, the case is less straightforward than in other healthcare services industries. As a relatively new sub-sector, vendors tend to be less sophisticated and lack the motivation to sell (seeking retirement exits). M&A activity in the sector tends to favour practice networks between 10-20 clinics. Ultimately the NSA industry can support a diversity of larger scale operators (150-200 clinics each), in our view.

Laser Clinics Australia (LCA): LCA is Australia's largest corporatised participant with approximately 135 clinics, representing just 12% of practice locations, nationally. LCA approached the industry primarily via joint ventures (mostly JV50s) but has pursued selective M&A throughout its history. Private equity firm KKR acquired LCA for $650M in 2017 when it had 60 clinics. LCA has since expanded to New Zealand and the United Kingdom hiring a new CEO in April 2020 (John Veitch, ex-Travel Corporation).

Clear Skincare: Established by Dr Philippa McCaffery in 1999, this group began with a focus on acne, scarring, pigmentation issues and redness/drying. The business diversified and now offers services across LHR, acne, skincare, anti-ageing, injectables. At this point Clear has not moved into the Body category. Clear operates over 70 clinics across Australia and New Zealand.

Other competitors outside specialist NSA providers: In the LHR and skincare treatment categories SILK also competes against beauty salons that offer consumers a range of non-permanent hair removal solutions such as waxing and to a lesser extent, depilatory products sold over the counter. In the Injectables category, conventional medical providers (i.e. GPs, dermatologists) are also active. In facial skincare, SILK's key competitors include major physical and online skincare retailers. In the body contouring and fat reduction services market, SILK primarily competes against other specialist clinics. To a lesser extent, SILK also competes against conventional medical providers (i.e. plastic surgeons) that offer invasive fat reduction services such as liposuction.

Drivers of financial performance

What makes a good NSA business can be understood in both structural terms and with reference to specific differentiating features at the clinic level.

Some factors to consider include:

- Quality of facilities and clinical excellence: Modern, well equipped facilities involve establishment costs and ongoing maintenance capex.
- Scale and practice management systems: Larger scale enables fixed cost leverage allowing investment in centralised systems (regulatory, IT, consumables purchasing, equipment maintenance, cleaning).
- Location and opening hours: Individual clinics tend to attract a majority of patients from a 3-5km radius but can draw from a significantly larger catchment if the practitioner is excellent and word of mouth spreads the reputation.

Regulatory framework and barriers to entry

There are various federal, state and territory laws governing the NSA industry in Australia which apply to SILK and the practitioners who provide services at its clinics.

Cosmetic injectables. Clinics administering cosmetic injections must comply with state and territory legislation for the prescription and administration of cosmetic injections which are classified as Schedule 4 (prescription only) drugs under the Therapeutic Goods Act 1989 (Cth). Cosmetic injections require an "instruction to administer" from an accredited professional. Cosmetic injections must be stored and administered by Authorised Practitioners. At SILK, the minimum requirement for an Authorised Practitioner is a Registered Nurse who is registered with the Australian Health Practitioner Regulation Agency. The minimum requirement under law is an Enrolled Nurse, with supervision by a Registered Nurse. In Western Australia, only Registered Nurses or doctors can access Schedule 4 drugs and no other staff are allowed access to these.

Laser Hair Removal Laser service regulations vary in each state and territory in Australia. In Western Australia, Queensland and Tasmania operators are required to have a laser licence and radiation management plan pursuant to the Radiation Safety Act 1975 (WA), the Radiation Safety Act 1999 (Qld) and the Radiation Protection Act 2005 (Tas), respectively. Radiation management plans set out the facility and activities, the nature of radiation sources and risks, the controls to manage those risks, and the measures to achieve compliance with each applicable regulation. In the same states, individual staff members are also required to hold a laser licence to use Laser Hair Removal devices.

Skincare products Skincare products do not require registration on the Australian Register of Therapeutic Goods (ARTG) or any safety assessment unless they make therapeutic claims, in which case they would be considered "therapeutic goods". Products that do not make therapeutic claims are considered "cosmetic only" and must be safe for normal human use according to Australian Consumer Law. Most of SILK's products are considered cosmetic only. SILK's sunscreen products that do make therapeutic claims are registered on the ARTG and are approved by the Therapeutic Goods Administration (TGA).

Body contouring and fat reduction EmSculpt and Coolsculpting devices are approved by the U.S. Food and Drug Administration (FDA) and have been entered on the ARTG.

Registered Nurse (RN) availability: The NSA industry draws its RNs primarily from elsewhere in the healthcare industry. SILK and other operators offer RNs the opportunity to own franchises and grow their own businesses. RN supply is somewhat limited and expected to tighten further in Australia.

A.2 Board and management

Board

Boris Bosnich – Independent Chairman

Boris joined SILK in 2015 as a director and chairman. Following a 15-year career with a global logistics organisation, Boris jointly established Challenge Recruitment in 2001. It became one of Australia's largest privately held recruitment companies and Boris sold his interest in the business in 2008 as part of an initial public offering and listing on ASX. Boris is also chairman of Orthopaedics SA and Kid Sense Child Development. Boris holds various directorships and provides advisory services to a number of growth orientated small and medium enterprises and start-up companies in the United States and Australia and is currently managing a range of venture development projects and capital raisings to accelerate growth strategy execution.

Martin Perelman – Managing Director

Martin is a co-founder and the Chief Executive Officer (CEO) of SILK. Having worked in various national sales roles in the retail industry, Martin has acquired the relevant skills required to successfully lead a growing business, including sound financial management, brand development, innovative sales and marketing strategies and team leadership.

Brad Lynch – Non-executive Director

Brad joined SILK in 2017 as a director. Brad is a partner at Advent Partners and has over 15 years of experience as a private equity investor. He is currently a director of Mandoe Media, Junior Adventures Group and Flintfox International. Prior to joining Advent Partners, Brad worked for two years at global private equity firm The Riverside Company, seven years at ANZ Capital (a division of the Australian New Zealand Banking Group) and six years at Ernst & Young. Brad qualified as a Chartered Accountant and graduated from the University of Melbourne with a Bachelor of Commerce.

Andrew Cosh – Non-executive Director

Andrew joined SILK in 2015 as a director. Andrew is the co-founder and director of Kilara Capital, a specialist investment management business focussed on impact investment opportunities within the food, agriculture and energy sectors in Australia and New Zealand. He is also a director of two private family offices, Colindale and Clearwater Investment Co and is a director Agrinos Australia Pty Ltd, a subsidiary of NYSE listed American Vanguard Corp (AVD). Prior to his current investment and governance activities, Andrew held senior executive roles at Ernst & Young, Minter Ellison and international agribusiness trading group, Michell Australia.

Sinead Ryan – Non-executive Director

Sinead joined SILK in 2020 as a director. Sinead has over 25 years' experience with roles including company director and CEO. Sinead has held several strategic executive roles leading and driving sustainable business growth and has in-depth experience in the childcare, retail and energy sectors. Sinead has extensive experience in leading large transformational programs, specialising in M&A from due diligence through to integration. Sinead previously led large global transformation programs with EY and Deloitte.

Management

Martin Perelman – Chief Executive Officer

See biography above.

Ivan Jacques – Chief Financial Officer

Ivan joined SILK in 2019 as Chief Financial Officer (CFO). Ivan has over 20 years of experience as a CFO in listed and private equity owned companies. Ivan was previously the CFO for listed international healthcare group, Synergy Health plc, based in the UK, which listed on the London Stock Exchange during Ivan's tenure. Ivan is a graduate member of the Australian Institute of Company Directors, a Fellow of the Institute of Chartered Accountants of England and Wales and a member of Chartered Accountants in Australia and New Zealand.

Rob Garsden – Chief Operating Officer

Rob joined SILK in 2018 as Chief Operating Officer (COO). Rob has 15 years' broad experience in strategy, sales and operations including business unit transformations, post-merger integration and operations and sales management. Rob has driven fundamental changes to how SILK clinics are tracked, measured and rewarded. Prior to joining SILK, Rob gained experience in his roles at Bain & Company, Qantas, LinkedIn and Laser Clinics Australia.

Silk Laser Australia Limited (SLA)

Business description

Silk Laser Australia (SLA) is the third largest operator offering non-surgical aesthetic (NSA) products and services. SILK's five core offerings comprise laser hair removal (LHR), cosmetic injectables, skin treatments and non-surgical fat reduction.

Investment thesis

We initiate coverage on Silk Laser Australia (SILK) with an OVERWEIGHT rating and a 12 month price target of $4.15 per share. SILK is the first corporatised network of non-surgical aesthetics (NSA) clinics to list its securities on the ASX. The business operates a network of 56 branded clinics, grown primarily via greenfield expansion and franchising. The NSA industry is growing faster than conventional healthcare services sub-sectors, supporting SILK's strategy to add 6-10 clinics per year, pursuing an aspirational target of 150+. The company's thesis on winning in the NSA industry features disciplined site selection, local market share acquisition, systems investment to maximise the products available to clients and data to optimise the economics of delivering services. The sector offers M&A consolidation opportunities to open new jurisdictions and accelerate scale.

Revenue drivers

- Organic growth
- Market share
- Higher per client revenue collection and cross-selling
- Introduction of loyalty programs

Balance sheet

- FY21e net cash of $23M.

Margin drivers

- Introduction of loyalty programs

Board

- Boris Bosnich – Independent Chairman
- Martin Perelman – Managing Director
- Brad Lynch – Non-executive Director
- Andrew Cosh – Non-executive Director
- Sinead Ryan – Non-executive Director

Key issues/catalysts

- Above system organic growth
- Earnings upgrades
- Margin development via network leverage, procurement power
- Sector consolidation
- Accretive M&A

Management

- Martin Perelman – Chief Executive Officer
- Ivan Jacques – Chief Financial Officer
- Rob Garsden – Chief Operating Officer

Risk to view

- Competitive intensity
- Macro factors influencing demand for medically unnecessary services
- Wage pressure and margin stability
- M&A execution and integration

Contact details

Silk Laser Australia
Unit 5, 148 Greenhill Road
Parkside SA 5063
+61 8 7225 6489
https://silklaser.com.au

Disclaimers and disclosures

Recommendation structure and other definitions

Definitions at wilsonsadvisory.com.au/Disclosures.

Disclaimer

This document has been prepared by Wilsons Advisory and Stockbroking Limited (ACN 010 529 665: AFSL 238375) ("Wilsons"). This communication is not to be disclosed in whole or part or used by any other party without Wilsons' prior written consent.

This document is being supplied to you solely for your information and no action should be taken on the basis of or in reliance on this document. Any advice contained in this document is general advice only and has been prepared by Wilsons without taking into account any person's objectives, financial situation or needs. Any person, before acting on any advice contained within this communication, should first consult with a Wilsons investment adviser to assess whether the advice within this communication is appropriate for their objectives, financial situation and needs. Those acting upon such information without advice do so entirely at their own risk.

Wilsons has not independently verified all of the information given in this document which is provided at a point in time and may not contain all necessary information about the company or companies covered in this report ("Companies"). Accordingly, no representation or warranty, express or implied, is made as to the accuracy or completeness of the information and opinions contained in this document. To the fullest extent permitted by law Wilsons, its related bodies corporate and their respective officers, directors, employees or agents, disclaim any and all liabilities for any loss or damage howsoever arising in connection with the use of this document or its contents. Any projections contained in this document are indicative estimates only. Such projections are contingent upon matters outside the control of Wilsons (including but not limited to economic conditions, market volatility and company-specific fundamentals) and therefore may not be realised in the future. Past performance is not an indication of future performance.

This report does not constitute an offer or invitation to purchase any securities and should not be relied upon in connection with any contract or commitment whatsoever.

Wilsons and Wilsons Corporate Finance Limited (ABN 65 057 547 323: AFSL 238 383) and their associates may have received and may continue to receive fees from the Companies in relation to corporate advisory, underwriting or other professional investment services. Please see relevant Wilsons disclosures at wilsonsadvisory.com.au/Disclosures.

Neither Wilsons nor its research analysts received any direct financial or non-financial benefits from the Companies for the production of this document. However, Wilsons' research analysts may receive assistance from the Company in preparing their research which may include attending site visits and/or meetings hosted by the Companies. In some instances the costs of such site visits or meetings may be met in part or in whole by the Companies if Wilsons considers it is reasonable given the specific circumstances relating to the site visit or meeting.

Wilsons and its related bodies may trade securities in the Companies as principal.

Regulatory disclosures

Wilsons Corporate Finance Limited ABN 65 057 547 323, AFSL 238383 acted as Joint Lead Manager in the November 2020 IPO of Silk Laser Australia Limited for which it received fees or will receive fees for acting in this capacity. Wilsons Advisory and Stockbroking Limited may have a conflict of interest which investors should consider before making an investment decision. Wilsons Advisory and Stockbroking Limited, Wilsons Corporate Finance Limited and its related bodies corporate trades or may trade as principal in the securities that are subject of the research report.

Wilsons contact: For more information please phone: 1300 655 015 or email: publications@wilsonsadvisory.com.au

Wilsons contact

For more information please phone: 1300 655 015 or email: publications@wilsonsadvisory.com.au