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23 February 2016

Market Briefing

Integral Diagnostics MD on 1H16 results and outlook

Interview with John Livingston (Managing Director & CEO)

In his first Market Briefing interview, Integral Diagnostics' Managing Director & CEO, John Livingston, discusses the company's maiden half year results as a listed company, and its outlook, including:

- *Growing revenues over H1 FY16 despite industry headwinds*
- *Subdued revenue growth reducing pro forma NPATA only 3.9% reflecting the resilience of Integral Diagnostics' business model*
- *The impact of the Government's announcements and proposed changes to bulk-billing and the Medicare Benefits Schedule on the company*
- *Expectation that the company's second half performance will be above that achieved in the first half, with industry headwinds making it unlikely that the company will achieve its FY16 Prospectus forecasts.*

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Integral Diagnostics' first half result showed top line growth with lower pro forma earnings. What underpinned the growth in revenue and why did it not translate into increased profitability?

John Livingston

On a statutory basis, revenue was up 16.6% to \$82.1 million. On a pro forma basis, which includes South Coast Radiology in the 2015 first half, revenue was up 3.8%. In light of the challenging operating environment given the industry uncertainty created by the Federal Government's MYEFO and Medicare Benefits Review announcements, achieving top line growth reflects the strength of the company's business model. All three of our businesses grew revenues over the half.

Over the past 18 months we have built out our staffing levels to ensure delivery of high quality radiology services, accommodate expected growth and to enable the business to function effectively. This necessary investment in staff was fully included within our Prospectus.

The softer revenue growth, combined with the planned expenditure, is the reason why earnings reduced over the half when compared to the prior period.

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How can we interpret the half year result with respect to the company's ability to meet Prospectus forecast?

John Livingston

The Government's MYEFO and Medicare Benefits Review announcements have had an impact on the industry overall, in particular to diagnostic imaging referrals given the uncertainty that currently exists.

These industry headwinds mean that Integral Diagnostics will be unlikely to achieve the company's 2016 financial year Prospectus forecasts. However, we continue to expect that the company's performance over the second half of this financial year will be above that achieved in the first half.

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How is the business performing so far in the second half?

John Livingston

It is difficult to judge how the second half will perform based on the first seven weeks of the period. January has historically been one of the quieter and more unpredictable months of the year. Nonetheless, over the first seven weeks of the second half referrals, patient examination volumes and revenues are recovering towards budget.

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You mentioned earlier the Government's Mid-Year Economic and Financial Outlook that proposed changes to the Medical Benefits Schedule to reduce the benefit paid for some bulk-billed diagnostic imaging services. If implemented, how will these changes impact Integral Diagnostics?

John Livingston

These changes are still yet to be ratified by Parliament, but if implemented will commence on 1 July 2016, that is in the 2017 financial year. Based on analyses we have previously prepared, we believe that should the proposed changes come into effect, they would have the potential to reduce revenues by approximately 2-3% [based on last 12 months] if we did not undertake any actions to mitigate the impact of those proposed changes.

Our revenues are diversified with bulk billing comprising only 52% of revenues in the first half. If there were changes to the bulk bill incentives, we would look to adapt our billing model to introduce co-payments on a wider range of services to mitigate the impact.

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Medicare data indicates a slowing growth in the number of diagnostic imaging examinations and payments over the last two quarters. Is this a good indicator of market growth and how does the Medicare data compare to what Integral Diagnostics is experiencing in its businesses?

John Livingston

Medicare statistics are one of a number of sources of information we use to predict patient visits and plan for growth at our facilities. It is a useful indicator as the majority of diagnostic imaging services involve Medicare to some degree and so are picked up in this data. Looking at this data, it is clear that Integral Diagnostics has been growing faster than the market.

Medicare data indicates that diagnostic imaging patient examination volumes in the States we operate in grew by just over 2% over the first half. This is below the historic Medicare growth rate, which over the last five years has been over 6% nationally. While our facilities have seen a decline in the growth rate of patient examinations recently, Integral Diagnostics' growth rate is 3.9%, still above that represented in the Medicare data across all of our services.

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What has caused growth to slow and do you expect growth across the sector to remain lower in the near or medium term?

John Livingston

Diagnostic imaging relies on referrals from other medical professionals. There have been a number of factors that have disrupted referral patterns, including a Government sponsored "Choose Wisely" campaign, the ongoing MBS review, media attention focused on claims of potentially unnecessary testing, referrals or procedures and the proposed changes to bulk billing incentives. These have all contributed to a slowing of industry growth over the period.

We do not see this as a permanent adjustment to a lower growth environment for the industry. The long term fundamentals for the diagnostic imaging industry have not changed and remain attractive. Australia has a growing ageing population requiring greater healthcare support, and patient expectations for accurate diagnosis are high. Diagnostic imaging is a necessary element to improving patient outcomes and saving money through early detection of disease.

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You have 12 locations in Queensland, 9 locations in Western Australia and 23 locations in Victoria. Is this geographical divide a benefit or a risk? Do you plan to enter New South Wales?

John Livingston

This diversification does provide some benefits, for instance currently Queensland is growing at a faster rate than other States. Exposure to faster growing areas allows us to allocate our resources more effectively across the group. It also provides options for our doctors and staff to work in different locations.

While we recognise New South Wales as a large market, we would only enter this market if an acquisition was a good fit for our company and delivered shareholder value. Greenfield expansion outside of an existing company owned catchment area would be too risky and not something we are currently considering.

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What is the outlook for the company in the second half of this financial year?

John Livingston

The key factors to be considered when looking at the second half of FY2016 are:

- Continued short term industry uncertainty created by Government announcements and media coverage relating to the Medicare Benefits Review and Mid-Year Economic and Fiscal Outlook.
- The long term demand thematic remain:
 - Contemporary evidence-based preventative health care for an increasingly ageing population
 - Utilising state of the art technology to drive optimal patient outcomes
- Financial performance in 2H16 is expected to be better than 1H16, however, we are unlikely to achieve FY16 Prospectus forecast given the industry headwinds:
 - Volumes in January and February recovering towards budget
 - IDX's diverse revenue base with bulk-billing comprising only 52% of revenue in 1H16
 - Additional revenue from Toowoomba and Sunbury, plus extra MRI at SJOG Geelong
- IDX's business model and diverse revenue base can be adapted to mitigate impacts should Government proposals be ratified.

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Thank you, John

For further information, please contact +61-3 5339 0704, or visit www.integraldiagnostics.com.au.

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