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SmileDirectClub

Third Quarter 2021 Earnings Call

November 8, 2021

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PRESENTATION

Operator

Greetings. Welcome to the SmileDirectClub Third Quarter 2021 Earnings Call.

Please note this conference is being recorded.

I will now turn the conference over to your host, Tripp Sullivan, Investor Relations. Thank you. You may begin.

Tripp Sullivan

Thank you, Operator.

Good afternoon. Before we begin, let me remind you that this conference call includes forward-looking statements. For additional information on SmileDirectClub, please refer to the Company's SEC filings, including the risk factors described therein. You should not rely on our forward-looking statements as predictions of future events. All forward-looking statements that we make on this call are based on assumptions and beliefs as of today. I refer you to our Q3 2021 earnings presentation for a description of certain forward-looking statements. We undertake no obligation to update such information, except as required by applicable law.

In this conference call, we will also have a discussion of certain non-GAAP financial measures, including Adjusted EBITDA and free cash flow. Information required by Regulation G of the Exchange Act with respect to such non-GAAP financial measures is included in the presentation slides for this call, which can be obtained on our website. We also refer you to this presentation for a reconciliation of certain non-GAAP financial measures to the appropriate GAAP measures.

I'm joined on the call today by Chief Executive Officer and Chairman David Katzman, and Chief Financial Officer Kyle Wailes.

Let me now turn the call over to David.

David Katzman

Thanks, Tripp, and good afternoon, everyone. Thank you for joining us today.

SmileDirectClub was founded seven years ago with the mission to democratize access to a smile each and every person loves and deserves by making it affordable and convenient for everyone. Each decision we've made since then has been to support and expand this mission, which will enable us to achieve our long-term growth potential. That's the same approach taken with every company that I have founded and led. I will get into why that matters in a moment, but I first want to highlight what these decisions at SDC have led to so far.

We've had 30 patents issued for innovations that enable the treatment of more complex cases, automated manufacturing, new types of aligners, smile scanning technologies, our proprietary telehealth platform, oral care products, and a variety of other areas to continue our disruption. The most recent patent was granted for our SmileBus concept, and there are many more pending and in the pipeline in the U.S. and abroad on various technologies relating to data capture, 3D image capture, treatment planning, intraoral scanning, monitoring, manufacturing, and consumer products. We've enabled treatment for over 1.5 million customers with affordable and convenient teeth straightening.

We built the only vertically integrated medtech platform for straightening teeth at scale, enabling us to provide an unparalleled customer experience. This includes a state-of-the-art FDA-certified and registered facility that is home to one of the largest fleets of 3D printers and one of the largest clear aligner manufacturers in the U.S. We created a dental partner network and have 735 global practices that are live or pending training. We created oral care products that are now available at over 12,900 retail stores nationwide and serve as a highly efficient lead source and brand building opportunity.

Our ancillary product portfolio is available through every retail channel, including drug stores, grocery stores, club stores, mass retailers, and through e-commerce. We have entered 14 countries and counting. That's a long list, but here's why those achievements and differential assets matter.

The global orthodontics market is large and underserved, and the total addressable market is expanding. Between the U.S. and rest of world, there are approximately 500 million people for whom clear aligners would be an appropriate means to treat malocclusion and who can afford treatment using our SmilePay program.

Within that, there are approximately 15 million worldwide orthodontic case starts annually, and the penetration of clear aligners within that is still less than half. It's a tremendous global opportunity. It's been my direct experience in building businesses like ours that you need these unique assets and innovation to disrupt. You need the agility and flexibility to adjust to the needs of the customer and marketplace. You need to invest in multiple channels of customer acquisition.

You also need to never lose sight of the bigger prize, which is building a sustainable brand that is always top of mind with consumers, as demonstrated through both aided and unaided awareness to efficiently and profitably capture their attention. We have done all this in the face of consistent adversity over the past six-plus years. It's only natural that those who have benefited from traditional teeth straightening with high prices and three time markups would try to prevent challengers and disrupters such as SmileDirectClub from participating in this market opportunity.

For example, we've seen teledentistry intentionally misrepresented as DIY, or do it yourself. Dental boards and trade associations have engaged in conduct to try to prevent teledentistry. Other market participants have engaged in marketing practices and have made statements that the FTC and The National Advertising Division of the Better Business Bureau had to investigate and curtail. We anticipated the pushback and we've responded. The regulatory and legal wins to allow customer access to the convenience and affordability of teledentistry have been numerous, and in many cases propelled the rest of the industry forward. We expect more of these wins to come.

We've also been able to convert and join many of the leading industry organizations, such as the National Dental Association, the American Telemedicine Association, American Association of Dental Boards, Women in DSO, and many others. Even the American Academy of Clear Aligners has turned from actively campaigning against us to asking us to become a member of the organization, as demonstrated by their recent retraction.

As I said earlier, we've been entirely incremental to the orthodontic space with our 1.5 million cases and counting. These are customers that historically could not afford the $5,000 to $8,000 price tag for clear aligners. From day one, these customers have been a massive tailwind to our business in the Americas and rest of the world. This is a customer base we will continue to support and grow with over time.

That said, as 2021 has progressed, and as we discussed last quarter, our core demographic has been challenged by the current macroeconomic environment. As our Q3 results and revised outlook would indicate our core demographic continues to be impacted. We expect this to remain throughout Q4. That said, we still believe this macro impact is transitory, and we continue to make changes to minimize the near-term impact.

Just one of multiple campaigns we are launching this week is our deferred monthly payments till 2022 with SmilePay. We tested this campaign during holiday time 2019, and will now be rolling it out in November. This campaign and others we plan to launch in Q4 will help ease the burden of record inflation on our customers. Last quarter, we outlined some of the headwinds our core demographic is facing. The data backed us up then and does so now. What third-party economic research has shown is that a combination of factors are likely contributing to the headwinds, constraining discretionary spending for our core demographic. As a reminder, our core customer has a median household income of $68,000.

The first impact is inflation. The increased cost of non-discretionary goods and services is likely limiting the ability to spend on discretionary goods and services. This inflationary headwind appears to have accelerated since the Q2 earnings release. Inflation averaged 6.1% in Q3 for the $50,000 to $69,000 income demographic versus an increase of 5.8% Q2. This increase is larger relative to other higher income demographics such as those served by our largest competitor.

Second is preferences. The reopening of the economy has been more focused on goods over services. So when choices are being made, goods are being prioritized in the wallet over services, especially with a $68,000 income customer. In that same vein, our demographic is also finding it difficult to pay household expense. In Q3 44% of household surveyed by the Census Bureau reported difficulty, up from an already high 42% in Q2.

Third is underemployment. While employment trends have improved since the end of Q2, the recent series high of quits in August could suggest disruption in household finances. We know that when customers are considering straightening their teeth, they typically might do one or all of the following. One, they might search online to understand their options, two, they might ask a dentist, and three, they might ask a friend or family member which option they would recommend.

Based on our research, our product and customer experience is competitive with Invisalign and 60% less expensive. But we have to continue to change perception across these three channels to continue to gain market share. Changing perceptions, habits, and beliefs is critical to the next phase of our growth in these tougher macroeconomic times for our core demographic. That's why our efforts in marketing with our Challenger campaign and building out our partner network are key initiatives to the next wave of our growth.

Our marketing will be focused on helping support our core demographic while at the same time continuing to move upstream with our income demographics through the Challenger campaign. We launched this campaign early in the third quarter to target Invisalign's end users with our value proposition and ramped up the ad buys throughout the quarter. The early results all from the campaign have been encouraging and we expect to continue to do well into 2022. This is not an all or nothing campaign, given that we have not previously focused on this end user base, which is the majority of the 15 million annual orthodontic case starts. A fractional percentage could be very material to us.

We've also only begun to scratch the surface on the opportunity in our partner network. Our network now has approximately 735 signed practices in the United States that are active or pending training. We have begun an aggressive hiring program to grow our rate of new office signups. We're also having success with referrals into our clinical partners for them to increase and introduce new patients to their practice. They're finding our value proposition very compelling because we can increase practice revenue with minimal chair time by using our teledentistry platform, so it's highly profitable, and also provide the added benefit of new customer leads into the practice as well.

In addition to being a little ahead of the game on the macro impacts, we were also the first in our space to call out the impact of Apple's iOS 14 and privacy changes to digitally native brands, such as ours. In the past three months, there have been no fewer than 20 companies noting this change as a substantial headwind in Q2 and Q3. Facebook and Snapchat's earnings last month reinforced just how material this change has been to their business. Similar to all of these companies, the privacy changes required us to pivot quickly to different lead strategies.

Historically, the Facebook platforms were a large portion of our sales and marketing spend, and were also highly effective in terms of conversion in our sales funnel. We've not only been shifting marketing spend away from these platforms to more TV, but we've also changed our lead strategy. We are now focused on higher funnel leads to more efficiently and effectively drive long-term growth. By carrying a stronger TV weight, we will drive greater aided and unaided awareness.

This is also a longer-term strategy focused on building our base of consumers, including the higher income customer, rather than paying for each sale we get. When we drive stronger awareness of our brand, we are less focused on optimizing to acquire the smaller percentage of consumers who are already aware of SDC.

The last but likely the most consequential topic I want to cover is where our brand sits in the eyes of our consumer. We recently commissioned a study from a third-party market research firm with significant expertise in oral care on customer satisfaction with SDC, other teledentistry players and Invisalign. This survey included over 1,200 respondents, and what we found was that SDC and Invisalign are frequently tied statistically in many categories, especially in the important categories, such as, "Has a network of dentists and orthodontists to provide the best possible care to its customers," or as a brand that I can trust.

Overall, it seems that patients are claiming an identical experience between SDC and Invisalign, yet we charge 60% less in price and are more convenient. Our NPS score was 55 and Invisalign's was 54 compared to an average of 22.5 for other teledentistry players. For other teledentistry platforms, the study also showed that significantly fewer customers would recommend those brands compared with SDC customers. They were also significantly less satisfied with the customer support received from them as compared with the SDC's customer satisfaction.

Q3 results for the U.S. brand tracker consumer survey of the general population for clear aligners, oral care and whiteners highlight our continued separation as a brand. Unaided awareness for SmileDirectClub increased significantly from Q2 to Q3. We moved from 8% to 11%, and that's significantly higher than other teledentistry competitors. By comparison Invisalign's unaided awareness is 39%.

Aided awareness for SmileDirectClub is also improving: 54% in Q3 up from 52% in Q2. This is also significantly higher than teledentistry competitors, while Invisalign's awareness for the quarter is 66%. I would also call out a sizeable shift from Q2 to Q3 where consumers perceive SDC and Invisalign would equally deliver on "Helps transform individuals through competent smiles they love." In Q2 Invisalign held an advantage: 69% viewed SmileDirectClub as a legitimate orthodontic option for straightening teeth, 74% for Invisalign; 66% believe SmileDirectClub is a brand they can trust, closing in on Invisalign at 69%.

We've made a lot of progress in a short amount of time, but we have more work to do. I'm a fiercely competitive executive who has fought similar battles in other disruptive industries, and I know how to win. We have assembled the best team I've ever seen who will execute on our initiatives, who remain laser-focused on our mission and have fully bought into what we need to accomplish success. I'd like to thank our Club members for their support as we continue to work to capture this massively underserved market.

Now I'll turn the call over to Kyle, who will provide more detail on our Q3 financial results and our outlook.

Kyle.

Kyle Wailes

Thank you, David.

I will jump right to our results for the quarter. Please be sure to review our supplemental materials posted to our Investor website, which provide additional details on everything I will cover.

Revenue for the quarter was $138 million, which is a decline of 21% sequentially and a decline of 18% on a year-over-year basis. This was driven primarily by 70,000 initial aligner shipments at an ASP of $1,900, the latter of which is up 1% sequentially and up 6% year-over-year. For the nine months ending September, revenue was $511 million, which is up 8% versus the prior year. The Q3 decline is primarily due to the macro factors that David mentioned earlier. These results were below what we have baked into our full year forecast shared last quarter as the macro headwinds continued to accelerate.

We'll have more to say on that front later regarding how much of this headwind we have factored into our new outlook for 2021. We have outlined the economic data in our earning supplemental deck, supporting the macroeconomic trends that we are seeing. In particular, inflation has had even more of an impact on our customer's wallet than it did last quarter. That has shown up in the number of kits and scans requests.

We also continue to work through the changes in our lead strategy that require investment and more brand awareness at the top of the lead generation funnel. We expect these efforts that David noted earlier over the long-term will be more efficient and profitable compared with utilizing lower funnel tactics such as retargeting on social media.

Recall, the top of funnel means everything prior to a requesting a kit or scan and middle of funnel means from requesting a kit or scan to returning the kit or showing up for the scan. As you can see from our Investor deck, rest of world aligner shipments were down slightly from Q2. We typically see some seasonality in Q3, particularly in EMEA due to vacations, but the re-launch in Spain and Germany helped offset some of that shift.

Based on our early results, we believe these markets will be strong performers for us as they are two of the largest in EMEA, but given the prevalence of competition currently in those markets, in particular Germany, it will take time to reach the level we've previously achieved in the U.K. and Australia.

Providing some details on the other revenue items, implicit price concessions were 9% of gross aligner revenue, up from 7% in the second quarter. We maintain separate reserves for IPC and cancellations. We analyze and regularly rebalance those reserves based on current trends. The net effect in the current quarter versus the previous quarter was a higher IPC reserve amount that was offset by lower cancellation reserves.

Reserves and other adjustments, which includes impression kit revenue, refunds, and sales tax, came in at 10% of gross aligner revenue, which is flat to Q2. Financing revenue, which is interest associated with our SmilePay program, came in at approximately $11 million, which is slightly down relative to Q2 primarily due to the lower revenue. Other revenue and adjustments, which includes net revenue related to retainers, whitening, and other ancillary products, came in at $19 million and is flat to Q2.

Now turning to SmilePay. In Q3 2021, SmilePay purchases came in at 59.5% of initial aligner purchases. This is down relative to Q2 due to the decreases in the U.S. and slightly below historical levels. Since we view SmilePay customers as more price sensitive consumers than full pay customers, we believe this decline in the U.S. SmilePay rates is an additional indicator of financial strain on our core customer.

Overall, SmilePay has continued to perform well and our delinquency rates in Q3 and to date in Q4 were consistent with prior quarters. While admittedly our core customer has had difficulty with the macro environment, the fact that we keep a credit card on file and have a low monthly payment gives us the confidence that SmilePay will continue to perform well.

Turning to results on the cost side of the business. Gross margin for the quarter was 71%, representing a 230 basis point sequential decline. This performance is primarily attributed to the revenue decline, with the continued streamlining of our manufacturing helping to offset the impact. Our second generation automation machines are now producing approximately 89% of aligners, up from 84% at the end of Q2 2021, and on pace with the target we set for 90% of aligners by the end of the quarter. This streamlining is helping with turnaround time, productivity, reduction in scrap, and a more consistent and superior product for our club members.

The financial benefit of these investments can be seen when looking at the 90 basis point improvement versus Q3 2020, even though Q3 2020 had 25% higher shipment volumes. Marketing and selling expenses came in at $96 million, or 70% of net revenue in the quarter compared to 55% of net revenue in

Q2 2021. The sequential increase as a percentage of revenue is primarily attributed to the decline in revenue, but is also the result of increased marketing spend to re-launch Germany and Spain, as well as increased pressure we're seeing with marketing efficiency from the challenges associated with Facebook targeting and the macroeconomic environment.

On SmileShops, recall that they function primarily as fulfillment centers instead of sources for demand generation. We had 164 permanent locations as of quarter end and held 201 popup events over the course of the quarter for a total of 365 location sites. That total is up from 288 at the end of Q2 and 218 at the end of Q4. These popup events have been an efficient way to meet our demand and enable us to fully leverage our SmileShops resources in order to fulfill demand that is coming through aided awareness, referrals, and marketing.

They have also been critical in supporting our partner network. We now have over 735 partner network locations globally that are active or pending training and an active pipeline of approximately 1,600 locations. As referenced earlier, our marketing and selling expenses in the quarter reflect significant investment in brand building to support our long-term growth in international markets, and this quarter's results bear out that emphasis.

Sales and marketing as a percentage of revenue was 94% in rest of world markets compared to 64% in the U.S. and Canada. The rest of world sales and marketing investment is consistent with what we signaled last quarter with the need to invest up to a 100% of revenue in those regions to launch the brand. While up as a percentage of revenue in the U.S. and Canada, our absolute dollars were down $6 million sequentially. Recall that with our changes to the lead strategy, we do not expect much of an increase to our overall spend in the U.S. and Canada, but we do expect our emphasis on investing in TV and the partner network will change the composition and timing of that spend.

We believe this high funnel, lead capture strategy will be more effective and efficient long-term at building improved customer consideration through greater aided and unaided brand awareness. Over time, this approach will also result in our business being less sensitive to the volatile performance of our direct response marketing with platforms such as Facebook because we will have increased the pool of prospective club members aware of SDC. As expected, early indicators in the U.S. and Canada are showing increases in lead capture per visit to our website, and we expect this trend to continue as we lean into the strategy through Q4 and into 2022.

General and administrative expenses were $86 million in Q3 compared to $85 million in Q2 2021. After adjusting for the one-time impacts from Q2, Q3 expenses were flat quarter-over-quarter. Other expenses include interest expense of $1.8 million, of which $1 million was deferred loan costs associated with the convert we issued earlier in the year; $450,000 was associated with long-term lease accounting, and $300,000 was associated with capital leases. Additionally, other expense was $4.2 million related to $1.5 million of one-time facility closure costs of our Cartago, Costa Rica, office and $2.7 million of unrealized currency re-measurement loss. All of the above produces Adjusted EBITDA of negative $54 million in the quarter with an all-in net loss of $90 million.

Breaking it out regionally, Adjusted EBITDA came in at negative $33 million for the U.S. and Canada, which aligns with the under-performance of this region due to the macro factors. For rest of world, Adjusted EBITDA was negative $21 million due to the over investments in sales and marketing to launch in key markets in these regions.

Moving to the balance sheet, we ended the third quarter with $308 million in cash and cash equivalents. Cash from operations for the third quarter was negative $38 million. Cash spent on investing for the third quarter was $25 million, mainly associated with capitalized labor and software, manufacturing, building and automation, and shop lease hold improvements. Free cash flow for the third quarter, defined as cash from operations less cash from investing, was negative $53 million.

Turning to our updated guidance for the year, I would point to our earning supplemental deck for the key assumptions underlying the forecast. There are a few points to note. We believe the macro environment will continue to affect our customer throughout Q4. Given this, we expect full year revenue to be between $630 million and $650 million. The improvements to our lead strategy to emphasize more efficient and profitable leads will take time to have the impact we expect, and we will continue to update you each quarter as we start seeing the impact.

There are still a number of potential benefits that could occur during Q4 and that we were driving toward, but not factoring these contributions into our outlook at present. This includes the normal seasonality improvement in Q4 versus Q3 around the holiday retail calendar, greater partner network adoption, success with our Challenger campaign and accelerated success in Germany, Spain, and France. We're also making operational changes and we expect the deferred payment program to have an impact in Q4. We're also working on additional financing changes to help our SmilePay customers, to make it more affordable, and we'll update you as they're released throughout Q4 and Q1.

We've also adjusted our margin outlook. Gross margin as a percentage of total revenues of approximately 70% for Q4 2021, reflecting potential deleverage from revenues. Sales and marketing as a percentage of total revenues in the range of 80% to 90% for Q4 2021, reflecting continued near-term rate headwinds expected from our lead focused marketing strategy in the U.S. and Canada, accelerated marketing investments to support relaunching, ramp-up and expansion of international markets. Lastly, added selling investment to support planned growth in partner network.

G&A dollars are expected to be flat to Q3, but experiencing rate pressure with continued top-line headwinds. While we were disappointed in our current results, they do not yet reflect the investments we were making in the brand and success we anticipate in mining a long-term opportunity available in the clear aligner space. The rapidly evolving macro environment for our core demographic is not something we could have anticipated, but we have responded quickly by pivoting our lead strategy and moving upstream with higher income demographics.

With over 500 million people globally who fall into our market opportunity and affordability being one of the biggest barriers to care, we fully believe that our business, which has a product and service offering that is on par with Invisalign at a much more competitive price, is well positioned to grow across the world. Liquidity on our balance sheet and the strengthening of our brand perception and brand credibility among consumers provide a solid foundation to help us return to our long-term growth targets and provide the best Club member experience.

Thank you to everyone for joining today. With that, I'll turn the call back over to the Operator for Q&A.

Operator

Thank you.

Our first question comes from the line of John Kreger with William Blair. Please proceed with your question.

John Kreger

Hi. Thanks very much.

Kyle, with the updated guidance for 2021, just can you clarify does this sort of change the long-term model that you've got? Could you give us any kind of early thinking on 2022? I guess, the final one related to that, how many years do you think it'll take to get to the kind of long-term model EBITDA margin that you guys have articulated? Thanks.

Kyle Wailes

Yes. Thanks, John.

I would say, overall, 2022 just given where we sit today and some of the macro impacts that we're seeing on the business is really too early to predict. So for now, I would say let's focus more in and around Q4 and how we're thinking about that. I think from a long-term perspective, nothing has changed, right. I mean, we believe the macro environment that we're in will continue to impact our customers throughout Q4. That's what we've guided to, but we fully believe that that's a transitory impact on our core demographic and at some point that will return back to normal as well.

With that, there is no changes to the long-term targets that we've outlined. I think when you look at the profitability, again, as we get back to more normalized top-line growth, as the macro impact passes from us, I would expect similar trends to what we've outlined in the past, which is ramping to that 25% to 30% Adjusted EBITDA margins over a five-year period.

I think you've seen some of that come to light here in the P&L. So if you look at gross margin in particular if you normalize for volume and you look at sort of where we are today by adding back our depreciation and amortization, we're right on top of that longer-term 85% target that we've outlined. So I think we've made really good progress against that.

I think if you look at the sales and marketing line, clearly in the short term, there's some headwinds from macro perspective, but if you look on the G&A side as well, I think we've demonstrated a lot of leverage there historically, with the ability to control that cost and get to profitability pretty quickly. So we still have high conviction in those longer term top-line numbers as the macro environment returns. I think from a bottom-line perspective, the timeframe would be about the same over that five-year period as we get back to that growth.

John Kreger

That's helpful. Thanks. Maybe one just quick follow-up. Are you thinking with your international strategy, are you sort of tapping the brakes here as you wait for a sign of a healthier core customer? Or should we think about the international strategy as even more aggressive in the next year or two?

Kyle Wailes

Yes. I would say, it's a very similar strategy to what we've outlined historically. I think if you look at the business overall, it was about 20% of revenue in the quarter. I would expect it to be about the same as you look at Q4 in particular. As you look at next year and beyond, just given the sheer market opportunity representing about 75% of our total business and rest of world markets and the ramp up that we've seen in the markets that we've got into, our strategy there remains the same.

We think it's the right time for us to continue to penetrate and gain a foothold in newer markets, which is going to support overall longer-term growth. We expect to see a good return on the cash as we invest in these newer markets.

We've got France that we're ramping up right now. We've relaunched Germany and Spain, which are performing well, and we're getting some traction there. We've got a handful more countries that we're expecting to launch into next year as well.

John Kreger

Okay. Thank you.

Operator

Thank you. Our next question comes from some line of Robbie Marcus with JPMorgan. Please proceed with your question.

Lilia-Celine Breton Lozada

Hi, this is actually Lili on for Robbie. Thanks for taking the question.

On the fourth quarter guidance, I was hoping you could just dive a little bit deeper into how some of these headwinds have trended so far into fourth quarter relative to what you saw exiting the third quarter. How much visibility and confidence do you have in where guidance is for fourth quarter as of now? Thanks.

Kyle Wailes

Yes, look, I think if you take a step back and look at sort of where we exited Q2, the pervasiveness of the macro factors and just overall sustained impact on the business were not entirely clear, given that we did give annual guidance over the course of the year at that time rather than quarterly because of that. But we certainly were not anticipating sort of a worsening on our core demographics from a macro perspective in Q3 or in Q4.

That said, if you look at sort of the ranges that we've outlined here, given that we're about four weeks into the quarter right now, we've looked at sort of the macro environment and assumed that we see more of the same as you look between now and the end of the year. We've tried to put ranges around that. As we talked about on the call, and also outlined in the deck as well, there are several potential benefits that could occur during Q4 that we're clearly driving towards, but we're not factoring those contributions into the outlook at present.

Generally, we see some seasonality improvements in Q4 over Q3 around the holiday, in particular Black Friday, Cyber Monday and the calendar there. We're making good progress with the partner network, and we've got good hiring plans there for the Q4. We're not assuming any additional sort of material ramps from that. Same thing on the Challenger campaign as well. We're not assuming that really starts to take off within the quarter.

We think there are some upsides to what we've outlined to that, but we haven't included them in the $630 million to $650 million that we've outlined here. We're also making a lot of operational changes as David and I talked about in the script as well with the deferred payment program that we're launching right now, which we think will have a nice impact. We saw a nice impact back in 2019 when we launched that as well.

Lilia-Celine Breton Lozada

Great, thank you. Just a quick follow-up on the Challenger campaign. In the past, obviously, you haven't really viewed them as much as a direct competitor, but that's obviously shifted a bit with this strategy that you're taking. So can you talk to us a little bit more about why it's the right time to be going up against Align, and are there any early metrics you can share on how successful this has been? Thanks.

David Katzman

Yes, I can take that one, Kyle.

Ultimately, down the road, it's all about aligner orders and as we start to measure where those aligner orders are coming from based on income demographics. Currently today, there's very little overlap, the 1.5 million customers that we've served really were incremental to the category. So we started looking at this. It's a natural kind of progression going from a disruptor to a challenger. We started looking at this earlier in the year. We rolled out some TV spots in July and spent very little money against it. We're now ramping it up as a total spend against our marketing budget.

In the short term, we're looking at brand trust, credibility with consumers, and GPs as one example of a KPI. We're also measuring brand recall and awareness with our TV spots that are centered around the Challenger campaign. So there's companies like Phoenix and YouGo that are giving us indicators as to how memorable the spots are, do customers understand them. Then we're now tracking, as we mentioned in the script, where we actually just did a survey of 1,200 customers that completed treatment in the last three months.

What it's telling us is that these consumers—we're tracking very well to Invisalign. Our NPS score is actually higher. We were at 55 versus 54. The other teledentistry players were half of that at 22.5. Also, how consumers view us as a trusted brand, our network of doctors, will we deliver the results that they want. So all those things are tracking very favorably. That's not just the Challenger campaign. That's a lot of the work we're doing in our treatment planning, customer service, and all those other things.

As we start to track where these aligner orders are coming from, and success ultimately to us is that we're going to start taking market share, it doesn't take a whole lot of market share. When you look at the 15 million case starts, or that case starts worldwide that Align plays in, we really don't play in that sandbox. So our 1.5 million has been incremental. So if we can start to continue to focus on our core demographic, we've got some solutions in place for this macro effect with our SmilePay financing, and then slowly start to chip away and let customers know that we have a safe and effective treatment. It's 60% less. That's what a disruptor does and intermediary. There's no reason to pay that markup. We believe overall it's a superior platform, especially if you want to be treated in the comfort of your home. So we'll continue to report on metrics as we start together.

Lilia-Celine Breton Lozada

That's helpful. Thank you.

Operator

Thank you. Our next question comes from the line of Jon Block with Stifel. Please proceed with your questions.

Jonathan Block

Hi, guys, good afternoon.

Maybe two for me. Kyle, the first one, I think I saw long-term EBITDA margin of 25% to 30% in one of the slides. I just want to make sure is that intact? Because when the Street was around $850 million this year, it implied over $2 billion in revenues in 2025, and we took prior 20% to 30% of revenue growth and extrapolated it out. So can you just help us with if the 25% to 30% EBITDA margin is intact, how are we thinking about revenue growth? Because if I sort of run it at 15% annually instead of your prior 25%, you're getting a 2025 revenue number that's cut in half. Just curious how you're able to garner the same EBITDA margins. Then I'll ask a tighter follow-up.

Kyle Wailes

Yes. Look on the long-term targets in terms of what I said before being impacted, it really goes back to the macro environment that we're in right now passing first, right. Obviously that's difficult to predict when that's going to be. But fundamentally nothing has changed in the business. We believe the market environment that we're in is transitory. So I think as that does pass, there's no changes to the targets that we've outlined, being top-line 20% or 30% growth per year and no change to the unit economics that we we've outlined for 25% to 30% Adjusted EBITDA.

If anything, I think we've gotten there from a gross margin perspective ahead of plan, being sort of right on top of that right now with normalized volume. That was more of a five-year target, and we made very good progress against that in the short period of time. So obviously it's difficult to predict when this macro environment does pass, in particular from an inflation perspective. But as that does pass, we see no changes to the long-term targets that we've outlined.

Jonathan Block

Okay, thanks. That was helpful. Then just a second question, David, you mentioned navigating the regulatory environment, that's what disruptors need to do. But with all due respect, it's not really the regulatory environment that's preventing SDC from competing in these states. I think that's what's almost a little bit more scary, quite honestly. I mean, you guys have been able to compete it, doesn't seem to be regulatory. Seems to be an LTV to CAC that for now does not work. I don't think a lot of Investors have conviction that it works. So can you help us out with that?

What abates in that regard? Because iOS is just getting more difficult. So when we think about that LTV to CAC that's fallen short so far, how do you rectify that? Is that the LTV going higher? Is that the CAC going lower? Because right now, just the numerator denominator doesn't seem to be working itself out. Thanks.

David Katzman

Yes. Jon, well, I think prior to Q2, which is only a short quarter ago, we were demonstrating that. We had brought down coming out of or into COVID in Q2 of 2020, in the remainder of 2020, we talked about our sales and marketing being at 45%, which is part of the plan to get to 25% EBITDA margins. We were hitting those. We were hitting those targets. We were even profitable a quarter ahead of the Q4 2020 goal. So, we achieved that in Q3. We had a nice Q4. Q1 was a really nice quarter for us. We actually invested a little bit higher than the 45% in sales and marketing.

We're in a tough situation right now between the iOS 14 and the macro trends where customers just aren't responding; they're worried about putting fuel in their car and food on their table. All of the staple items have gone up in price, and to a $60,000 a year person, it's much more material than it is to a $200,000. I mean, we're not in a recession, we're in an inflationary environment, which most people haven't seen. So I'm not worried about the long term, especially some of the things that we are doing and gaining traction on with our brand awareness, aided and unaided, in our referral.

We're hyper-focused on the customer experience. We have a better product today with our Gen 2. We're also going to be announcing—I'll give you a little preview later this week, probably early next week. I can't remember the timing, but it has to do with our Treatment Planning 2.0, which we've been working on for several years now. We expect the same kind of big impact that we did when we announced Gen 2 in the automation, in our manufacturing. This new treatment planning that we've been working on is all AI-driven. It gives us capabilities to do a lot more with staging molar movements, without attachments, all kinds of stuff for Teams, as far as virtual geometry and mixed dentition.

This is actually all of our techs and Costa Rica had been trained on it, all new treatments coming out of there this week and into next week. We'll be on our new Treatment Planning 2.0, more to come on that, but those kinds of things are all designed to have a better customer experience, to have more referrals. If you have more referrals, you can look at it—it will lower your CAC.

I think we proved that we were there. I think we'll get back there with the strategies that we've implemented in marketing to combat some of the iOS 14, some of the macro trends. So I'm confident that we'll get there.

Jonathan Block

Got it. Thanks, guys.

Operator

Thank you. Our next question comes from the line of Chris Cooley with Stephens. Please proceed with your question.

Chris Cooley

Good afternoon, and thanks for taking the questions.

Maybe just bigger picture for me first, and then I want to come back on the long-term margin profile for my follow-up. But can you just maybe elaborate a little bit more when you think about the patient acquisition channels that you are in now internationally here in the United States through your partner networks and the straight direct-to-consumer channels, just the relative rates of growth you're seeing in those respective channels and the stickiness of those leads? Just kind of curious if anything is changing there as you see those consumers as they come through the various channels back into the pipeline, either from a growth rate or a conversion rate. Then I have a quick follow-up.

David Katzman

Yes, I think from a conversion perspective, we're seeing trends as you would expect, just given the macro impact. So that is an impact that we've seen throughout the funnel around conversion over the past couple of quarters. But look, I think it's important to kind of take a step back and look at sort of the long-term strategy that we've outlined along that. It really goes back to the lead generation strategy, right.

If you think about it, it's a highly considered purchase, as we've always talked about. This has been a lifelong problem for people who want to straighten their teeth. It's just a matter of when, right, why now is the right time that I want to do it. So we believe that focusing on leads, and then winning once they're in consideration through CRM or partner network or other tactics, is the most efficient and profitable long-term approach.

Once someone is in consideration, and we talked about this in the script, and we talked about this in the past lot as well, consumers are really looking at three things, right. One, they're going to look online. Two, they're going to ask their dentist. Three, they're going to ask a friend or family member.

I think when you look from a lead perspective and driving those leads to convert, for us it really goes back to winning across those three channels. I think online we've made really good improvements in big investments in brand credibility with the Challenger campaign, you can see that in some of the data points that we've provided.

On the partner network side, that really goes back to building credibility with dentists and making sure we win there and that's a good reaction. Then all the investments that we've put into friends and family and improving our customer experience there. So I think that's how we're thinking about it from a lead gen and conversion perspective over time.

Chris Cooley

Thanks. I appreciate that. Then not to be redundant, but when we think about the long-term objectives, I realize you're not giving guidance for 2022 yet. But if we just think about, again, what you've laid out in the deck, a little bit slower uptake, and similarly, higher spend outside of the U.S., clearly continuing to invest in the U.S., and also from a marketing perspective, having to do more TV versus Facebook and other ad based media, at least in the shorter term, have the company's costs structurally increased? I realize that you think you can leverage those over time. But as we think about the current macro environment, is this is a cost structure that we think should be maintained until you can see that lift in the top one? Thanks.

David Katzman

Yes, absolutely. I think when you look at it from a cash perspective on the cost side. So we've got over $300 million in cash as at quarter end. We also have another $200 million in AR or liquidity on the balance sheet that we can either sell or factor. So if you look at that in total, over $500 million in total liquidity. I think we've also demonstrated in the past as well that we have the levers to control our burns. If you look at Q2 of 2020, we got the cash flow positive very, very quickly. But for now just given the liquidity that we have and where we sit within the market, our belief is the right approach is to continue to optimize and invest for future growth.

When we think about it from that perspective, certainly in the near term, as a result of some of the macro factors that we're seeing, we expect to see, on the cost side, performance that is ahead of the longer-term targets that we've outlined. So if you look at that for Q4, it'd be about a 70% gross margin, approximately for Q4, we'd expect sales and marketing to be 80% to 90% of revenue in Q4 of this year. Then just overall G&A dollars to be relatively flat. But given the liquidity that we have and our overall position in the marketplace, and continuing to invest for longer-term growth, we believe that's the right decision.

Chris Cooley

Understood. Thank you.

Operator

Thank you. Our next question comes from the line of Michael Ryskin with Bank of America Securities. Please proceed with your question.

Michael Ryskin

Right. Thanks for taking the question, guys.

I want to start on the economic macro discussion again, sorry to harp on that, but I really want to revisit it given it seems to be so pivotal to flagging what happened in 3Q and your forward outlook. I mean, there's no doubt inflation continues to tick higher, but we've been tracking consumer discretionary spending, especially in some of the lower income, even $50,000 or below consumers in United States. The latest data is pretty resilient.

I mean, there's some fluctuation week-to-week, but it hasn't seen anything like what you're indicating in terms of what happened in 3Q and the outlook for 4Q. So any additional color you can provide on why you think services and particularly the dental business, your business, is being affected to such a magnitude. I mean, if you look at inflation 5.8% to 6.1%, uptick and difficulty paying bills, these are really minor changes, 1%, 0.1%, 0.2%. We're seeing a 30%, 40% swing in volumes. So why is the model so sensitive to relatively a small sequential deterioration?

Kyle Wailes

Yes, I think you've got to look at it from our core demographic. So the core demographic we have is a median household income of $68,000. As we look at the data, this is coming right out of the Bureau of Labor Statistics and economic analysis. If you do the math on a $65,000, $68,000 household income and do the math on the inflation at over 6%, it's several thousand dollars impact to their bottom line, right. So given most of their spending is going to be on non-discretionary goods, it's almost 85%, 90% of spend is on non-discretionary goods, a 6% to 7% impact on that is $4,000 to $5,000. Right?

That's clearly more than the cost of our aligners and has a direct impact on that customer. So inflation is real for this demographic in particular. It's not as big of an impact for someone who makes $150,000 above. But for our core demographic, that's about $65,000 to $70,000 of household income. It is a big impact and there's a variety of other factors in there as well.

I think if you look at spending preferences, there's a lot more focus on goods over services from the economic data that we're looking at. If you look at household surveys, the ability to pay bills continues to get tougher on a quarter-over-quarter basis. Quits we're at an all-time high. If you look at quits as of August, it's the highest they've been since January of 2020.

I think from a macro perspective, when you look at all the data that we pulled together there, it really supports what we're saying here.

David Katzman

Yes. Kyle, I'll add too, and I think we had a slide in the deck—we had a graph in the deck about large purchases. I mean, this is a $2,000 purchase, and the consumer confidence index in there for those large purchases just fell. I mean, it's just a sharp fall starting in Q2 and continued falling into Q3. So I think from a confidence standpoint, even if you're saying, well, it's only 6% inflation, so that it's $2,000 to $3,000 more for basic items, but it's also that confidence in next. Where's this going? Should I be doing this right now, spending $2,000 to straighten my teeth when I'm not sure where prices are going?

I mean, it's all over the news. You can't turn on the news and not see the supply chain issues. Gas prices are double to fill up your tank than it was a year ago. So there's escalating prices everywhere, and there's a shortage of supply of goods. So I think, listen, we know it's real. If you listen to Dentsply's earnings call last week, they talked about it as well. The macro effect and Byte in Q3 and the potential miss on their

2021 guidance with respect to their Byte acquisition. So those guys spent quite a bit of time talking about it in the earnings call. I think they were a little surprised to see it. But it's real, it's here, and we're doing everything we can to combat it.

I think that's part of the advantage that we have of being a vertically integrated company in all aspects, especially with financing. We are the only company that controls our finance. So we have real good experience at it. Some of the stuff we're going to be doing, not only with the late billing that's out there on our website and in the market today, things that we're going to be announcing in December that we think will really help this core demographic customer overcome some of these concerns.

Michael Ryskin

Yes. I appreciate that. Thanks. I just mean that the 6.1% in 3Q, it was 5.8% in 2Q. So I was just looking at it on a sequential basis, but that's fine.

Real quick, just a quick follow-up for me. Can we drill in a little bit on U.S. versus OUS? You've talked about international expansion for a while, and from where we can tell, that's still trending pretty well as we think about continued investment priorities for 4Q next year, as you sort of remain in this challenged environment, how are you allocating, U.S. versus OUS dollars given much bigger revenue base in the U.S. but seemingly much better return on investment OUS given the growth opportunity?

Kyle Wailes

Yes, I would expect revenue, if you look at Q4, to be a similar split. So still approximately 80%, 20%. From a margin perspective, obviously international has been a little bit lower with some additional shipping costs between country, and then also local cost for final assembly. So I would expect a similar trend there on average between if U.S. and the rest of the world about 70% for Q4 but still a little bit lower than that for international.

If you look at sales and marketing in total, as I said before, about 80% to 90% of revenue. If you break that down between U.S. and rest of the world, I would expect U.S. to be 75% to 85% and rest of world to be a 100% to 115% as we continue to invest in new markets like France and get that market off the ground as an example. Then overall G&A dollars, relatively flat on a quarter-over-quarter basis for both U.S. and rest of world.

Michael Ryskin

Great. Thanks.

Operator

Thank you. Our next question comes from the line of Nathan Rich with Goldman Sachs. Please proceed with your question.

Nathan Rich

Hi, thanks for the question.

I just wanted to go back to the shift in marketing strategy. It sounds like you talked about moving more to the top of the funnel leads. But it sounds like given the macro environment, your customer can maybe benefit from more help at point of purchase. David, you talked about the extended financing program, but do you need to do more or make any changes to price to really kind of help the core demographic in this macro environment?

David Katzman

Yes, I don't think it's a matter of lowering the price on the single pay, our $1,950 price point. It's more about—and what we've seen, like Kyle mentioned earlier was that, we're at a low here on our SmilePay per centers. We're down under 60% for the first time in a long time, because that's the customer that's affected in this macro environment. So most of the stuff that we're talking about doing this month and into December is around helping that customer make it even more affordable, more creative financing, looking at the monthly payment, $89 a month, how can we make that more affordable for them without hurting our delinquency rates.

I think we've got some pretty creative ideas that you'll be hearing about that's going to help with that. So as far as leads, listen, all of us faced and we were one of the first ones to come out and talk about it in Q2, the iOS effect being a digitally-oriented marketer, the signal strength which is gone.

I mean, most people opted out of or opted into the privacy. So that really hurt that lower funnel conversion, optimizing to sales, retargeting, because you really can't follow these people around the internet. So we're fortunate that we have a lead strategy. A lot of e-commerce companies that rely on that conversion, that sale conversion were kind of stuck because they weren't getting signal strength. So we can get that customer over a longer period of time. We have a great CRM platform, both SMS and e-mail. So we're going for quality of leads. We're going to educate these customers, and we're going to use all the other mechanisms that we have to convert them.

Nathan Rich

Got it. Kyle, maybe a follow-up for you, the guidance implies a pretty meaningful step up in the marketing and selling expenses in the fourth quarter. Is that the new base that we should think about into 2022 as we go forward? Or are there some one-time investments that you're making in 4Q that might not continue as we head into 2022? Thank you.

Kyle Wailes

Yes, I think as we look at 2022, again, just given the macro perspective, it's a little bit early to start looking at it from that perspective, but look, we're making investments top of funnel, as we've talked about, to continue to build the lead tunnel. We expect to continue to do that in Q1, which is a very good time for us. So for now, I would think about that as an overall runway, but we'll continue to update you in sort of future quarters as we get more insight into the overall macro environment.

Operator

Thank you. We've hit the top of the hour, ladies and gentlemen. That concludes today's earnings call. Thank you for your attendance today.