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Emefcy Group Limited (EMC:ASX)

Applying our theory of relativity: $E=MC^2 + RWL$

Three Key Points

- EMC has finalised the merger terms with RWL. The remaining hurdle is 50% shareholder support at an upcoming EGM. We assume the merger proceeds and see it as a very positive move.
- EMCs alliance with RWL has displayed early signs of success, with the company moving from signing MOUs for plants, to binding commercial deployments; made through three newly announced distribution partners.
- The Independent Expert's report has indicated that the deal is fair and reasonable to existing shareholders.

Merger bolsters the foundations

EMC is merging with RWL in exchange of 100.5m shares. Mr Ronald Lauder (owner of RWL) has committed to providing US\$20m of new capital at A\$0.85/share. We expect the merged group to have sufficient working capital to fund operations until it becomes cashflow positive. We don't believe the business will be raising additional capital in the near term.

We have analysed the financial information provided on RWL and incorporated RWL into our forecasts. Whilst we don't see RWL as accretive in the near term on financials, it lays the foundation of giving EMC a much better chance of commercialising its MABR product in China and elsewhere. The strategic merits of the merger makes a lot of sense.

RWL has a large BOT project (San Quintin) that it hopes to secure (subject to financial close) that would kick start the recurring earnings business model being developed.

Three new Chinese distribution partners have been secured recently and they have ordered their first commercial plants. Early success in China is becoming evident.

Investment Considerations

Post receiving detailed financial information, we revert back to a DCF based valuation (which we feel is the most appropriate method for an early stage business).

Our bear, base and bull case DCF results in a valuation ranging from \$1.06 to \$4.00/share, with our base case valuation \$2.40/share. Our base case valuation is 164% above the current share price and our bull case 340%.

Our DCF based valuation has fallen from when we first valued EMC (\$1.47 - \$4.54/share). A larger number of shares on issue, increased near term losses and a forecast slower ramp up of sales in China have impacted our valuation.

We see EMC as the only way to invest in the global water treatment market via an ASX listed company. Global peers trade on high EV/revenue multiples and this validates our DCF.

The stock currently has limited institutional investor support. With an expected much larger market cap post the merger, the stock is likely to experience increased institutional demand. In our opinion, the merger is a positive catalyst for the stock.

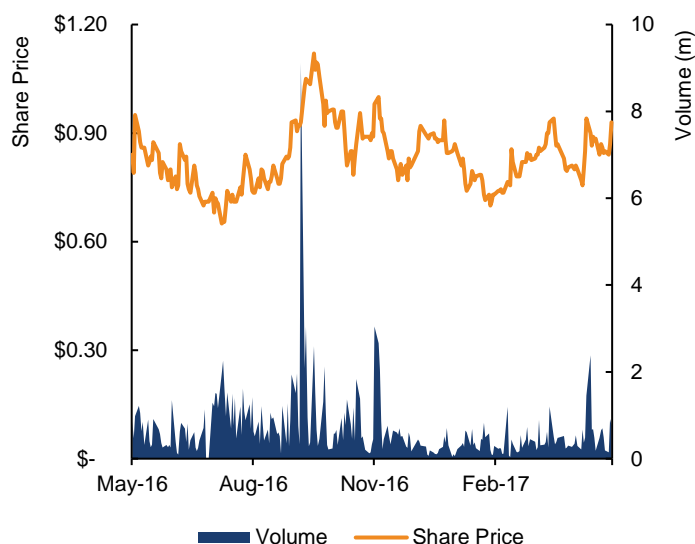
Emefcy Group Limited

Current share price (A\$)	\$0.91
52-week range (A\$)	\$0.64-\$1.18
Shares outstanding (pre-merger) (m)	257
Shares outstanding (post-merger, before options) (m)	389
Current Market Cap (A\$m)	234
Avg. Daily Turnover (A\$m)	0.5
Net cash CY16A (US\$m)	22.9
CY16A Gearing (ND/E) %	(95%)

Scenario's based on different sales volumes (base case)

Year-end Dec (US\$)	CY17F	CY18F	CY19F	CY20F
No. modules sold in a year	150	2,500	15,000	28,500
No. modules installed, RaaS	7	37	73	146
Revenue (US\$m)	91.6	147.1	299.4	462.3
EBITDA (US\$m)	(26.2)	(12.5)	51.1	116.7
EBIT (US\$m)	(29.0)	(15.5)	46.8	110.5
Normalised NPAT (US\$m)	(18.5)	(9.4)	35.4	81.8
Normalised EPS (¢)*	(5.4)	(2.2)	8.0	18.5
EV/EBITDA (x)	(7.9)	(16.4)	3.8	0.7
EV/EBIT (x)	(7.5)	(14.6)	4.0	0.7
Normalised P/E (x)	(16.8)	(40.9)	11.3	4.9

Share Price Performance and Volume



Source: Cap IQ

Terms to merge with RWL Water finalised

EMC and RWL Water have agreed to the terms of the merger and released historical financial information pertaining to RWL. An EGM has been scheduled to occur on the 12th July to ratify the merger, with 50% majority vote required. We anticipate the EGM is very likely to endorse the acquisition and the likely acquisition date would be shortly after the EGM. Whilst the deal also requires FIRB, ASIC and ASX approval, we expect these are likely.

The combined group will be named Fluence, subject to shareholder approval, with FLC as the proposed ticker.

Merger terms

EMC is offering 100.5m shares as consideration to acquire RWL, plus US\$10k. This implies an Enterprise Value of ~A\$85m for RWL and a CY17 EV/Revenue multiple of ~0.7x, which appears to be a good deal for EMC shareholders.

Mr Ronald Lauder (100% owner of RWL via his investment company RSL) has committed to subscribing for US\$20m (A\$26.7m, assuming an FX rate of \$0.75) of additional EMC shares at A\$0.85/share (equivalent to 31.4m new shares). The exact amount to issue will be calculated utilising a future FX rate at the completion of the deal, which is not yet known.

~30% of Fluence will be owned by Ronald Lauder on a fully diluted basis

Figure 1: Approximate shares on issue post the raising and deal (fully diluted)

Details	No.
Shares on issue including performance rights	257.1
Shares to acquire RWL	100.5
Shares issued in raising	31.4
Estimated shares on issue post transaction	389.0
Milestone shares to be issued	22.5
Options issued (before the transaction)	23.2
Fully diluted No. shares on issue	434.7

Source: Henslow's estimates

Post the deal, RSL (Mr Lauder) will own ~30.3% of Fluence (on a fully diluted basis) or 34% on a shares issued basis. RSL will be escrowed for two years from the transaction date.

The proforma balance sheet indicates cash of US\$34m at CY16. Adding US\$20m to this and assuming some cash burn, we estimate the combined group would have ~US\$40m – US\$50m of cash upon merger (the IER report indicates US\$56m as at 31st March 2017).

In addition, there are ~23.2m options exercisable (though not all are in the money). We estimate this will add a further ~US\$7m once exercised and gives the combined business a high cash backing. We assume half of the options are exercised in CY17 and the remainder in CY18.

We assume the cost of the merger is US\$3m combined for both companies (the other financial liabilities adjustment in the balance sheet upon consolidation), as guided in the IER.

Capital raising speculation appears unfounded

We have heard speculation that a capital raising could be forthcoming. We see the combined business as well capitalised and believe it very unlikely that EMC would look to raise additional capital when it has a large cash balance.

Based on our forecasts, we assume EMC has sufficient funds to commercialise its product range. However, if the ramp up of sales is slower than forecast, a raising cannot be ruled out in late CY18 (or if a material acquisition is made). We expect that due to likely increased sales by CY18 and an influential cornerstone shareholder, the combined group could also tap debt markets, reducing the chances of a raise.

Guidance and Independent Expert Report (IER) valuation

Previous guidance given when the proposed deal was first announced to the market was for revenue in excess of US\$90m in CY17. This guidance has been reiterated. At the AGM, management indicated that they expected the combined group to be profitable in CY19.

Previously, no guidance for EMC has been released to the market. However, the IER provided significantly more forward looking statements or details on assumptions used in its valuation methodology, including the following:

The combined group is expected to be profitable in CY19

- CY18F revenue assumption for EMC of US\$18.5m (range of US\$12 – US\$25m) was used in the valuation calculation. This is materially below our earlier expectations. We now revert to a base case revenue forecast for CY18F of US\$25m, at the top of the range in the IER. We assume the Independent Expert had access to detailed company information, hence their range has some validity. Whilst it is probably conservative, we note the difficulty in forecasting EMC revenue; hence we now reference the top end of the IER range for revenue. Recent announcements of three additional partners in China with purchase orders supports our view of being at the top end of the IER's guided range.
- The IER revenue forecasts represents only 26% utilisation of the first production lines capacity in China, we are forecasting 33% utilisation. This highlights we could be being too conservative, as the first production line is capable of supporting ~US\$75m in revenue;
- EMC on a standalone basis has been guided as expected to be profitable in CY18/19 in its own right;
- The combined group is expected to be profitable in CY19;
- Management expect some cost synergies over the medium to longer term, however profitability is expected to be mostly achieved through material revenue growth and the ability to utilise the existing management capacity. This implies that overheads are expected to grow at a significantly slower rate than revenue; and
- RWL has had US\$148m of equity contributed, highlighting that it has sunk a lot of capital already to build its global footprint and establish a suite of water treatment products. This is a process that takes considerable time and expense and EMC is able to access this platform (an asset) immediately, rather than attempt to grow it itself.

Independent experts view and valuation

The independent expert has indicated that in their opinion, **the deal is fair and reasonable for non-associated shareholders of EMC**. The IER indicated that it used an EV/Revenue approach to value EMC before the deal and EV/Revenue to value the combined group post the deal. They used:

- 5-7x revenue to value EMC, noting that it was a technology company pre-earnings, hence the high multiple. They also factored in a 30% control premium. When we conducted peer comp analysis in our previous report, we decided on a range of 3.6x – 4.6x (before a control premium, which is equivalent to 4.7x – 6.0x, close to the range used in the IER report); and
- 2-3x revenue to value the combined group, noting that the lower multiple for the combined group was recognising that RWL is mostly an Engineering business.

The IER indicated that EMC was worth between US\$0.41 – US\$0.53/share (A\$0.54 – A\$0.70/share) and the combined group was worth US\$0.49 – US\$0.68/share (A\$0.64 – A\$0.89). These values are on a fully diluted basis. The IER concludes that the value of the combined group is greater than EMC on a standalone basis.

In relation to their valuation, the IER used US\$18.5m of revenue for EMC and US\$90m for RWL as the appropriate sustainable revenue assumptions (we assume this relates to CY18). We highlight that predicting revenue for both businesses is not that easy and the revenue values used appear to be conservative, relative to what we would expect over a longer time period, particularly for EMC.

Financial Analysis

EMC has released historical financials for RWL for CY15 and CY16 (though not cashflow) and the IER provides some guidance in relation to CY18F EMC revenue and CY17F RWL revenue. Investors in EMC are more likely to be interested in the future performance of the combined group than historical information. However, it is still important to analyse historical revenue and costs, as it gives a guide on how to forecast RWL.

Figure 2 only shows RWL historical and forecast earnings (we forecast RWL separate to EMC in our model). The basis for reporting divisional results going forward has not yet been announced and RWL may not be reported separately in the CY17 accounts.

The merger is likely to occur in mid CY17 and would only include ~6 months contribution from RWL. We provide proforma CY17 forecasts (with 12 months contribution from RWL) to allow for more meaningful analysis.

Figure 2: RWL Profit and Loss statement

Details US\$m	CY15A	CY16A	CY17F	CY18F	CY19F	CY20F
Revenue	54.9	60.9	90.1	121.6	145.9	167.8
Revenue growth		11.0%	47.8%	35.0%	20.0%	15.0%
Cost of Sales	51.0	49.3	71.1	94.2	110.9	125.8
Gross Profit	3.9	11.6	18.9	27.4	35.0	41.9
Gross Margin	7.1%	19.1%	21.0%	22.5%	24.0%	25.0%
Overheads	41.5	28.7	31.0	33.7	35.4	37.2
EBITDA	(37.6)	(17.1)	(12.1)	(6.4)	(0.4)	4.7
EBITDA Margin	(68.4%)	(28.1%)	(13.5%)	(5.3%)	(0.3%)	2.8%
D&A	(3.6)	(1.6)	(1.6)	(1.6)	(1.6)	(1.6)
EBIT	(41.1)	(18.7)	(13.7)	(8.0)	(2.0)	3.1
Interest / Other	15.6	13.2	6.7	2.4	1.7	1.7
PBT	(25.6)	(5.5)	(7.0)	(5.6)	(0.3)	4.8
Tax	(0.2)	(2.8)	2.1	1.6	0.1	(1.5)
UNPAT	(25.7)	(8.3)	(4.9)	(3.9)	(0.2)	3.4
FX gains/losses	1.1	(6.8)	0.0	0.0	0.0	0.0
Reported NPAT	(24.6)	(15.0)	(4.9)	(3.8)	(0.2)	3.4

Source: Company reports and Henslow forecasts

RWL could grow its revenue much faster than forecast

The key points from our analysis of the P&L for RWL are:

- It is historically and currently loss making and materially so. The historical losses have been exacerbated by building a global presence, as highlighted by CY15 overheads being a lot higher than CY16 overheads (on lower revenue). We believe the CY15 overheads also incurred additional costs associated with securing a very sizable contract with PDVSA Agricola in Venezuela, which did not reoccur in CY16;
- A key factor in the P&L is the gross margin (19.4% in CY16 vs. 7.1% in CY15). As products like the Nirobox represent a higher portion of sales in the future, we expect the gross margin has further upside;
- Overheads represent a significant portion of costs. In our opinion, much of the overhead structure is in place to support higher revenue. As the top line grows, RWL looks well positioned to expand its EBITDA margin. We forecast overheads to grow at a much slower rate than sales and the overheads of RWL replace much of the overheads we previously forecast for EMC (providing significant sales synergies and potential EBITDA margin expansion);
- Interest income has historically been a key factor. This represents earnings achieved on monies prepaid (represented by short term investments in the balance sheet). Our understanding is that the timing of when the prepayments will be converted to revenue is uncertain at this stage. We forecast a material reduction in interest income in our forecasts; and
- We forecast RWL to be around breakeven in CY19.

RWL is a business that is leveraged to growth at the top line and improving the sales mix to increase the gross margin. Whilst we are forecasting high revenue growth rates, CY14A - CY17F revenue has grown at 31% CAGR. Given the size of the global water industry, RWL could grow its revenue much faster than forecast, noting the revenue base is not large relative to its footprint and product range.

RWL is also building a build own and transfer (BOT) model, which is similar to RaaS. We have increased our RaaS related forecasts primarily as a result of RWL having already developed the model and providing customers more certainty that installations will be maintained over the long term. BOT forecasts are not shown in Figure 2 and penalises RWL forecasts to the benefit of EMC. The IER indicates RWL is close to securing a significant BOT contract in Mexico.

Profit and loss forecasts of the combined companies (base case)

Figure 3: Revised P&L post merger and earnings changes

\$m	Old				New				Difference			
	CY17F	CY18F	CY19F	CY20F	CY17F	CY18F	CY19F	CY20F	CY17F	CY18F	CY19F	CY20F
Revenue												
MABR	15.0	100.0	330.0	500.0	1.5	25.0	150.0	285.0	(13.5)	(75.0)	(180.0)	(215.0)
Reuse as a Service	0.1	0.1	0.5	1.5	0.0	0.5	3.5	9.5	(0.1)	0.4	3.0	8.0
RWL	0.0	0.0	0.0	0.0	90.1	121.6	145.9	167.8	90.1	121.6	145.9	167.8
Eliminations	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating Revenue	15.1	100.1	330.5	501.5	91.6	147.1	299.4	462.3	76.5	47.0	(31.1)	(39.2)
Cost of sales	7.5	50.0	165.0	250.0	71.9	106.7	185.9	268.3	64.4	56.7	20.9	18.3
Gross Profit	7.6	50.1	165.5	251.5	19.7	40.4	113.5	194.0	12.1	(9.7)	(52.0)	(57.5)
Gross Margin %	50.3%	50.0%	50.1%	50.1%	21.5%	27.4%	37.9%	42.0%				
Overheads	10.1	40.0	92.4	98.0	38.5	43.7	50.4	60.0	28.4	3.7	(42.0)	(38.0)
EBITDA	(3.0)	9.9	73.0	153.5	(26.2)	(12.5)	51.1	116.7	(23.2)	(22.3)	(21.9)	(36.8)
Depreciation	(0.2)	(0.4)	(1.0)	(1.8)	(1.4)	(1.4)	(2.4)	(4.1)	(1.2)	(1.0)	(1.4)	(2.3)
Amortisation	(0.4)	(0.6)	(0.8)	(1.0)	(1.5)	(1.7)	(1.9)	(2.1)	(1.1)	(1.1)	(1.1)	(1.1)
Total EBIT	(3.5)	8.8	71.2	150.3	(29.0)	(15.5)	46.8	110.5	(25.6)	(24.4)	(24.3)	(39.8)
Net Interest	(0.0)	(0.1)	0.1	0.6	3.4	2.5	2.4	3.1	3.4	2.6	2.2	2.5
Tax	1.0	(2.5)	(20.0)	(42.3)	7.2	3.7	(13.8)	(31.8)	6.2	6.1	6.2	10.5
Abnormals after tax	0.0	0.0	0.0	0.0	(2.1)	0.0	0.0	0.0	(2.1)	0.0	0.0	0.0
Reported NPAT	(2.5)	6.3	51.3	108.7	(20.6)	(9.4)	35.4	81.8	(18.1)	(15.7)	(15.9)	(26.9)
Normalised NPAT	(2.5)	6.3	51.3	108.7	(18.5)	(9.4)	35.4	81.8	(16.0)	(15.7)	(15.9)	(26.9)
EPS (cps)	(1.0)	2.5	20.0	42.3	(5.4)	(2.2)	8.0	18.5	(4.4)	(4.7)	(11.9)	(23.8)
Dil. shares on issue	257.1	257.1	257.1	257.1	341.6	421.9	440.9	440.9	84.5	164.8	183.8	183.8

Source: Henslow forecasts

We now include RWL estimates in our forecasts on a proforma basis. In this section, we focus on our base case forecasts to avoid too much complexity. We include scenario analysis later in the report.

Figure 3 details our original base case earnings for EMC and our revised forecasts for the combined group (we assume the merger proceeds) and the difference. We show our forecasts to CY20, as that is when we forecast the group to have material scale in MABR sales.

We have also taken the opportunity to change some of the key assumptions supporting our base case EMC forecasts as follows:

- We have increased the number of shares on issue to reflect the increased number of options issued and have incorporated the additional shares being issued due to the proposed merger. We include an additional 22.5m shares to be issued to employees on achievement of a milestone (US\$2m of sales within EMC), which has been guided as likely to occur in CY17. We use diluted EPS and assume all of the existing 23.2m options on issue are exercised over a two-year period. Our original forecasts did not include all of the existing options and as a result of including them, our valuation is diluted;
- We assume that operation of the first production line for China is late Q3 2017. In our original forecasts we had assumed early Q3 2017, reducing CY17 sales. Customers are likely to install several plants and see how they operate before ordering in large volume. As a result, we assume that the ramp up in sales in CY18 of the MABR product is a lot slower than originally forecast. This also reflects the forecasts in the IER, which uses a lower revenue value than our forecasts. This has led to material near term revenue reductions for the EMC side of the business;
- With RWL in advanced discussions for a large BOT contract, we increase the take up speed of RaaS (which we assume is similar to BOT);
- We assume that CY19 is the first year where sales really start to ramp. This is the point whereby there will be enough EMC plants installed that either validates or disproves the MABR, as sufficiently more technically advanced (with lower operating costs) and making better returns for its distribution partners than competing technology. We assume orders start to compound in CY19. If this doesn't occur, EMC will have missed the China opportunity. In our opinion, this is the key risk to the stock;
- We assume that the sales of MABR products into China last longer (our assumed market share has not changed). Peak sales are lower than previously forecast but are higher in outer years; and
- A difficult component to forecast is overheads. We separately forecast COGS and assume that overheads grow at a significantly lower rate than revenue. We assume that RWL's overhead base

can be leveraged for MABR sales. RWL is providing a CEO, CFO, COO and multiple BDM's around the globe. This saves EMC from introducing these overheads.

Overall, we expect the combined group to become profitable in CY19, mostly driven by increased sales of the higher margin MABR product. We note that RWL is likely to play a very significant role in the success of selling the MABR product and we may not have properly incorporated installation revenue available to RWL, due to being uncertain as to whether this will be material or not in China. If our FY19/20 forecasts are achieved, the market cap of the combined group is likely to be significantly above where it is currently.

Combined group balance sheet

In this section, we show the proforma balance sheet as published by EMC in the IER as at CY16A, with adjustments relating to the merger. We also show our balance sheet forecasts to CY19F, see Figure 4.

Figure 4: EMC, RWL and the consolidated balance sheet at CY16 and forecasts

(US\$m)	CY16A EMC	CY16A RWL	Adjust- ments	Proforma Consolid.	CY17F	CY18F	CY19F
Cash	22.9	10.9	20.0	53.8	16.1	6.8	48.6
Receivables	0.8	12.5		13.2	12.3	19.7	42.2
Short term investments	0.0	51.9		51.9	51.0	51.0	51.0
Inventory & WIP	0.5	10.3		10.8	9.5	12.4	15.8
Work in progress							
Property Plan & Equip	1.0	2.0		3.0	5.5	7.1	14.7
Intangibles	2.1	6.5	58.0	66.7	59.6	60.4	61.4
Prepayments / Other	0.3	6.8	1.1	8.2	15.1	18.8	5.0
Total Assets	27.6	100.9	79.1	207.6	169.1	176.1	238.6
Payables	2.4	11.6	1.4	15.5	18.3	27.9	53.9
Borrowings	0.0	1.7		1.7	0.0	0.0	0.0
Deferred revenue	0.0	36.1		36.1			
Provisions	0.1	38.0		38.1	38.0	39.1	40.3
Other	1.0	2.1	3.8	6.9	38.1	38.1	38.1
Total Liabilities	3.4	89.6	5.3	98.2	94.4	105.2	132.3
Total Equity	24.1	11.3	73.9	109.2	74.5	70.7	106.1

Source: Company reports and Henslow estimates

Key factors in the balance sheet are:

We forecast that there is enough cash available to see the combined business through to being cashflow positive

- We assume US\$20m is being raised in CY17 upon completion of the merger and that US\$3.5m is raised via options, exercised in both CY17 and CY18, which exhausts existing options in the money;
- We estimate a cash balance of US\$6.8m at the end of CY18, implying there is enough cash available to see the combined business through to its cashflow positive generation point (assuming it achieves our base case target forecasts). We do note that with an influential backer, the company should also be able to access debt markets in the future;
- RWL has short term investments and customer deposits of \$51.9m. This has been invested and is earning interest income. Until work orders are received for the pre-payments, the short-term investment is expected to continue to generate earnings, albeit at a materially lower rate than previously;
- The goodwill generated on the deal is guided as \$58m;
- Receivables and payables are more or less in line with each other. With some work being prepaid, these accounts are in line with expectations;
- Deferred revenue is offsets against short term investments and represents a portion of the monies prepaid, that are not yet able to be invoiced (though work is likely to be mostly complete). Once able to be invoiced, this will turn into revenue. Our understanding is that none of this is included in the US\$90m revenue guidance and should add upside; and
- Provisions of \$38m imply that should RWL incur any claims, the combined group has a large buffer factored in. It is likely that having a large provision has resulted in an increase in the amount of goodwill generated with the transaction.

We estimate that there is another ~US\$7m of cash available to EMC from options, implying it has the equivalent of ~US\$54m of cash available to the business upon merger (as at 1st Jan 2017).

Combined cashflow statement

Very little cashflow information on RWL has been published. As a result, we assume that EBITDA (historically negative), plus investing capex is a good proxy of the cash burn of RWL. Although, prepayments from the PDVSA Agricola contract is probably the exception to our assumption. We show forecast cashflow details of the combined group in Figure 5.

Whilst the combined group has a high cash balance, we estimate that the cash burn is high initially. Overall, we forecast that the group has enough cash to commercialise its product and become cashflow positive.

Should the commercial rollout of MABR be a lot slower than assumed in our base case, then the combined group may still require capital or debt. However this would not be until late CY18, at the earliest and the share price is likely to be materially different to what it is now.

Figure 5: Forecast cashflow for the combined group

(\$m)	CY17F	CY18F	CY19F	CY20F
EBITDA	(26.2)	(12.5)	51.1	116.7
Net interest	3.4	2.5	2.4	3.1
Working capital / one off costs	(6.6)	0.4	1.2	2.4
Operating Cashflow	(29.4)	(9.6)	54.7	122.1
OPCF / EBITDA %	113%	77%	107%	105%
Maintenance Cap-ex	(1.8)	(2.9)	(6.0)	(9.2)
Expansion Cap-Ex	(5.3)	(2.4)	(6.9)	(5.4)
Dividends	0.0	0.0	0.0	0.0
Free Cash Flow	(36.6)	(14.9)	41.8	107.4
Capital introduced	29.7	5.6	0.0	0.0
Net cashflow	(6.9)	(9.4)	41.8	107.4

Source: Henslow forecasts

Key points from our cashflow forecasts are:

- Due to high accumulated tax losses, we assume that the combined group does not pay tax until CY21;
- Working capital outflows for CY17 are impacted by ~\$3m of one off costs relating to the merger;
- We assume no dividends are paid until CY21;
- We include US\$3.5m capital inflow from options exercised in each of CY17 and CY18; and
- We are forecasting EMC's cash burn to be -US\$36.6 / -US\$14.9m / +US\$41.8m for CY17/18/19 respectively, with CY19 being the year that the combined group is forecast to generate material positive free cash flow.

If the combined group is able to achieve the level of sales forecast and due to the high gross margin predicted, cashflow generation in the medium is predicted to be strong.

Scenario analysis

Figure 6 details our core EMC assumptions for each of our bear, base and bull case scenarios. The core difference is lower assumed module sales in CY18, which flows into CY19, as well as detailing the key financials of our scenario analysis. Each scenario has varying degrees of success for RaaS and BOT factored in.

Figure 6: Scenario analysis assumptions

SALES ASSUMPTIONS	----- Bear Case -----			----- Base Case -----			----- Bull Case -----		
	CY17	CY18	CY19	CY17	CY18	CY19	CY17	CY18	CY19
<u>China Opportunity</u>									
No. modules sold (Units)	75	1,250	7,500	150	2,500	15,000	225	3,750	22,500
Predicted China market share		5.0%			10.0%			15.0%	
No. China production lines	1	1	2	1	1	3	1	1	4
<u>RaaS Opportunity</u>									
No. modules sold	7	13	19	7	37	73	13	49	122

Source: Henslow forecasts

Figure 7: Scenario analysis forecasts

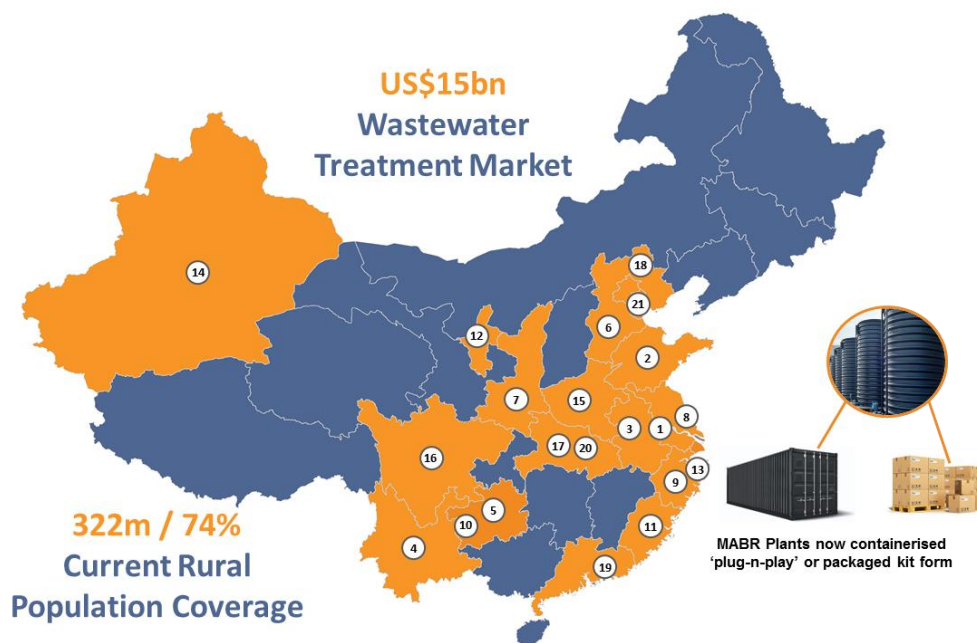
	----- Bear Case -----			----- Base Case -----			----- Bull Case -----		
PROFIT & LOSS (US\$m)									
Operating Revenue	90.8	134.6	222.4	91.6	147.1	299.4	92.3	160.1	375.9
EBITDA	(22.3)	(12.0)	22.8	(26.2)	(12.5)	51.1	(29.8)	(11.4)	80.3
EBIT	(25.2)	(15.1)	18.9	(29.0)	(15.5)	46.8	(32.7)	(14.4)	75.6
UNPAT pre abnormal	(15.6)	(8.9)	15.1	(18.5)	(9.4)	35.4	(21.3)	(8.7)	56.3
Abnormal Items	(2.1)	0.0	0.0	(2.1)	0.0	0.0	(2.1)	0.0	0.0
Reported NPAT	(17.7)	(8.9)	15.1	(20.6)	(9.4)	35.4	(23.4)	(8.7)	56.3
BALANCE SHEET (US\$m)									
Cash	20.1	12.1	27.9	16.1	6.8	48.6	12.4	3.5	72.5
PP&E	5.5	6.8	11.3	5.5	7.1	14.7	5.6	7.3	18.0
Debtors & Inventory	16.1	22.7	36.9	16.2	24.4	47.9	16.3	26.1	59.0
Total Assets	171.9	177.1	207.9	169.1	176.1	238.6	166.5	176.5	271.3
Borrowings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trade Creditors	18.2	25.6	40.0	18.3	27.9	53.9	18.5	30.4	67.7
Total Liabilities	94.3	102.8	118.5	94.4	105.2	132.3	94.6	107.7	146.1
Shareholder Equity	77.6	74.2	89.4	74.7	70.9	106.3	71.9	68.8	125.1
CASHFLOW (US\$m)									
Operating EBITDA	(22.3)	(12.0)	22.8	(26.2)	(12.5)	51.1	(29.8)	(11.4)	80.3
Interest & Tax Paid	3.6	2.7	2.1	3.4	2.5	2.4	3.2	2.4	2.7
Working Cap.	(3.7)	0.8	0.0	(3.6)	0.4	1.2	(3.6)	0.2	2.7
Operating CF	(22.5)	(8.5)	24.9	(26.4)	(9.6)	54.7	(30.2)	(8.8)	85.7
Maintenance Capex	(1.8)	(2.7)	(4.4)	(1.8)	(2.9)	(6.0)	(1.8)	(3.2)	(7.5)
Expansion Capex	(5.3)	(2.4)	(4.7)	(5.3)	(2.4)	(6.9)	(5.3)	(2.5)	(9.1)
Free Cashflow (FCF)	(32.6)	(13.6)	15.8	(36.6)	(14.9)	41.8	(40.3)	(14.4)	69.0
Ord & Pref Dividends	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Other	29.7	5.6	0.0	29.7	5.6	0.0	29.7	5.6	0.0
Net Cashflow	(2.9)	(8.0)	15.8	(6.9)	(9.4)	41.8	(10.6)	(8.9)	69.0
VALUATION METRICS									
Normalised EPS (c)	-4.6	-2.1	3.4	-5.4	-2.2	8.0	-6.2	-2.1	12.8
Normalised PE (x)	-20.4	-43.9	27.1	-17.2	-41.8	11.6	-14.9	-45.1	7.3
Enterprise Value (\$m)	220	228	212	224	233	192	228	237	168
EV / EBITDA (x)	-9.9	-18.9	9.3	-8.6	-18.7	3.8	-7.6	-20.9	2.1
EV / EBITA (x)	-9.3	-17.0	10.2	-8.1	-16.8	3.9	-7.3	-18.5	2.2
EV / EBIT (x)	-8.7	-15.1	11.2	-7.7	-15.0	4.1	-7.0	-16.4	2.2
DPS (c)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net Debt / EBITDA (x)	0.9	1.0	(1.2)	0.6	0.5	(1.0)	0.4	0.3	(0.9)
KEY RATIOS									
EBITDA Margin (%)	-24.6%	-9.0%	10.2%	-28.6%	-8.5%	17.1%	-32.3%	-7.1%	21.4%
EBIT Margin (%)	-27.7%	-11.2%	8.5%	-31.7%	-10.6%	15.6%	-35.4%	-9.0%	20.1%
ROE (%) y/e	-20.1%	-12.0%	17.0%	-24.8%	-13.3%	33.4%	-29.6%	-12.7%	45.1%
ROA (%) y/e	-16.6%	-9.1%	10.5%	-19.0%	-9.2%	24.6%	-21.2%	-8.4%	38.0%
Eff Tax Rate (%)	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%
EBIT Interest Cover (x)	nm	nm	nm	nm	nm	nm	nm	nm	nm
Gearing ND/ND+E (%)	(25.9%)	(16.3%)	(31.2%)	(21.6%)	(9.5%)	(45.7%)	(17.2%)	(5.1%)	(58.0%)
OPCF / EBITDA (%)	100.7%	70.7%	109.4%	101.1%	76.5%	107.1%	101.3%	77.1%	106.7%
DCF Valuation A\$	\$1.06			\$2.40			\$4.00		

Source: Henslow Estimates

Our scenario analysis also includes our DCF valuation for each scenario. We believe this allows investors to decide which scenario best represents the market share gained in China, the ramp up of module sales and RaaS/BOT sales to best represent their view on the outlook.

China Progress

Partner / Facility	Locations	Progress
Manufacturing & Management	1. Changzhou	<ul style="list-style-type: none"> Manufacturing facility due to be completed in Q3 and operational in Q4 2017 Currently being tested in Israel 1st line will support US\$75m of revenue with ability to add 3 further lines supporting US\$300m of revenue in total for global manufacture and distribution of MABR product Hired China Based GM, Plant Manager, Customer Support and BDM & Sales leader
Tianjin Caring	2. Shandong 3. Anhui 4. Yunnan 5. Guizhou 6. Hebei 7. Shaanxi	<ul style="list-style-type: none"> Submerged MABR treatment technology to be retrofitted to 1 of 5 existing water treatment plants, all owned and run by Tianjin Caring 20k litre treatment capacity with installation scheduled for Q3 2017 Roll out of further treatment plants to total of US\$100m revenue
Wuxi Guolian	8. Jiangsu	<ul style="list-style-type: none"> Deployed plant 'performing within specifications' data collection to be completed Q2 2017 5 year plan to provide 22m rural population with wastewater treatment, US\$1bn potential market
Jiangsu Jinzi	9. Zhejiang 10. Guizhou 11. Fujian 12. Ningxia	<ul style="list-style-type: none"> 20k litre test plant currently being shipped, due Q3 2017 Will provide provincial certification once plant data collection is complete US\$2.5bn estimated demand for MABR product
Zhejiang Tiandi	13. Zhejiang	<ul style="list-style-type: none"> MOU to develop a 500k litre commercial plant for deployment in Q4 2017 Agreement assisted by Wuxi Plant success, without provincial certification US\$1bn or 100k module demand for MABR product within Zhejiang Province



QSY	14. Xinjiang 15. Henan 16. Sichuan	<ul style="list-style-type: none"> Commercial agreement to provide 500k litre MABR plant in Xinjiang Agreement includes work in Henan province, with potential to expand to Xinjiang and Sichuan provinces Market value of US\$2.6bn over 5 years
CGGC	17. Hubei 18. Hebei 19. Guangdong	<ul style="list-style-type: none"> 20k litre test plant currently being shipped, due in Q3 2017 Demand of around 10k MABR modules, with US\$130m of first year deployment
Shanghai Winner	20. Hubei	<ul style="list-style-type: none"> VOSS (owned by Beijing based Reignwood Group) currently building new water factory in Shiyan Reignwood own exclusive rights to Red Bull 40k litre MABR plant to be commission by Q4 2017
Sinorichen Corp	21. Beijing	<ul style="list-style-type: none"> 20k litre test plant currently being shipped, due Q3 2017 3 - 5 year plan of 50m+ rural population with wastewater treatment 100k MABR Modules or 3.5bn litre treatment per day Potential revenue of US\$75m (Beijing) & US\$1.3bn (Adjacent Provinces)

EMC has announced three additional selling partners in China in the last month. We note that none of the new partners required a demo plant and ordered modules for commercially operated plants. This is also before any plant has received certification in China. In our opinion, this implies there is likely to be demand for their product and the marketing team in China are starting to gain traction.

If the plants operate as expected, it bodes well for the ramp up of sales forecast for CY19.

Merger advantages and disadvantages

We believe there are advantages and disadvantages of merging with RWL.

Advantages:

There are several significant advantages to merging with RWL

- **Strategic expansion and growth.** RWL's current international footprint will instantly expose Emefcy to an established global distribution network, across more than 70 countries. The increased scale of the company will allow it to focus on markets outside of China that present additional opportunities. Entry into additional markets derisks EMC from being mostly leveraged to the success of the China opportunity;
- **Larger market cap.** Assuming the share price does not materially fall post the merger, the combined group will have a much larger market cap, due to there being more shares on issue. This has several implications:
 - EMC becomes a much larger company (it becomes a candidate to enter the ASX300 index, though the shareholding by RSL is likely to be excluded from the free float market cap), which should make it more relevant to institutional investors; and
 - The register is under represented by institutional fund manager ownership. We believe this is likely to change and we could see strong demand for EMC shares, which would be positive for the share price.
- **Immediate cash injection to fund expansion and growth.** The US\$20m of additional capital will allow the company to continue to expedite the commercialisation of its MABR and subsequent additional EMC products;
- **Introduction of a strategic and financially robust cornerstone investor.** Mr Ronald Lauder (RSL) brings strong financial backing and gives the company an elevated status globally. It also is likely to open doors much faster, via increased connections;
- **Access to engineering expertise.** In order for EMC's customers to buy the MABR product in scale, it needs to be reliable and generate higher returns for its customers over competing technology. In our opinion, RWL materially derisks this component and increases the likelihood of securing a high volume of sales;
- **Enhanced product range.** Many water treatment solutions require several treatment technologies to provide the desired water treatment solution. The combined group is able to offer comprehensive solutions, rather than one component of a solution. This should result in cross selling sales synergies; and
- **Highly experienced board and management teams.** RWL is providing three experienced global water experts to the management team, an experienced water company non-executive board member, a number of experienced BDM's, international manufacturing facilities plus a global customer base. This should be a material factor in assisting the commercialisation of EMC products and we believe it would have taken EMC by itself a long time (and significant cost) to build these.

Disadvantages:

- **Dilution of current shareholdings** via an increased amount of shares on issue;
- **Near term losses are likely to be larger in the combined group** than with EMC as a standalone company. Due to likely larger losses, the combined group may not support the current share price, though this will hinge on how the market views the merits of the merger;
- **Potential for RSL to exercise significant influence on the operations of the Company.** Whilst 30% ownership is not a controlling interest, it is material. We note two representatives of the board have connections into RWL and five with EMC, implying the board is still independent;
- **The Company may become a less attractive takeover target.** This depends on the intentions of RSL, as owning a blocking stake does not necessarily equate to the combined group being less of a takeover target. Although on the surface it would appear harder to acquire; and
- **Assumption of RWL's potential liabilities.** RWL has performed jobs in countries considered challenging to work in and could be subject to claims. We note there are 20.1m shares held back as part of the merger terms and a \$38m provisions in the accounts that mitigates this risk.

Our view of the merger

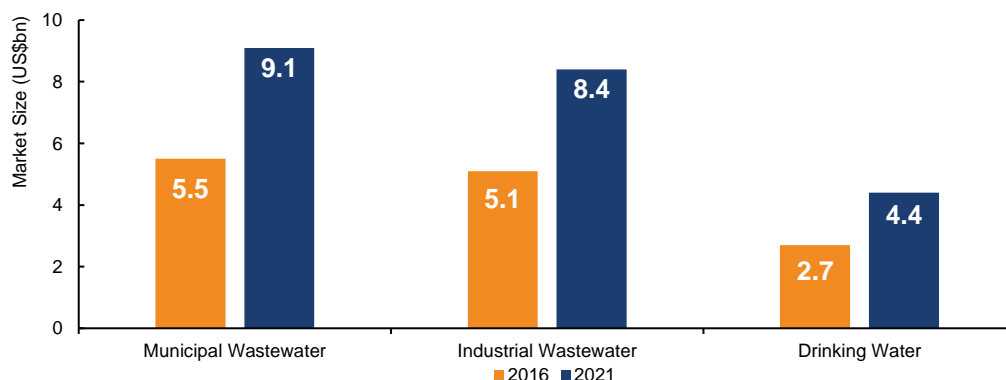
We are of the opinion that RWL’s engineering, installation and distribution capabilities will assist EMC in executing its aim of commercialising MABR in China and gaining entry into other markets.

We believe the two companies are very complementary, in that one offers a distribution platform, experience in fine tuning solutions and one offers I.P. that can potentially improve the gross margin of the other, as well as helping deliver high top line growth.

In our opinion, the combined group makes a lot of commercial sense and is likely to materially increase the chances of both companies being successful in penetrating the global water treatment market. We believe the benefits of the merger strongly outweigh the disadvantages. **We recommend that investors vote in favour of the merger.**

The size of the water treatment opportunity

Figure 8: Global pre-packaged water and wastewater treatment markets 2016 - 2021



Source: MarketsandMarkets Analysis

Figure 8 shows that the global packaged water and wastewater treatment market is currently valued at ~US\$13.3bn and is forecast to expand at a CAGR of 10.4% to 2021, resulting in a US\$21.8bn industry.

We break the water industry into three segments:

- The top end of the market is made up of large multinational corporations, capable of installing large centralised desalination plants and infrastructure, that treat an entire cities body of wastewater.
- At the bottom end, SMEs (generally restricted by their geography and likely small product offering), provide limited products and services and are generally low tech.
- In the middle is the pre-packaged water treatment market, which is the market that Fluence will be targeting.

Decentralised packaged plants such as the MABR and Nirobox, allow the company to offer products that are effectively off the grid but capable of small to medium scale municipal and commercial water treatment. The advantage of decentralised packaged plants to the combined group are:

- An ability to be deployed quickly (delivering what the customer wants);
- Significantly less water pipeline infrastructure is required compared to centralised plants, making them attractive in terms of capex for the customer;
- Less NIMBY issues, as the plants are less obtrusive than centralised plants;
- There are high barriers for small companies to enter, as packaged plants have more I.P. and require manufacturing facilities. Unique I.P. in the water industry is hard to find. The big players are not focusing on this market; and
- There are very few global competitors in this middle market, albeit being a large market.

We see the available product range making Fluence a one-stop-shop for pre-packaged middle market water treatment solutions. Its established international footprint could make it a significant player, whilst still operating well below the project scale of companies like Veolia or Suez.

The Global Water Intelligence magazine in May 2017 released an article titled, “RWL Water and Emefcy combine in Fluence”. The article included the following quote from Henry Charrabe (RWL MD):

“The decentralised middle market that we’re focusing on is a \$15 billion market which will grow to \$20 billion by 2021. There is no other company that has the global footprint that we do in that market, and we will hopefully play the number one role in decentralised water, wastewater, and waste-to-energy. We strive to make the world our backyard.”

The merged groups opportunity lies in the middle-market of water treatment

Contracts in the pipeline

RWL has two significant contracts in the pipeline that it has disclosed. Both appear very material in size.

San Quintin Mexico BOT project

The San Quintin project could be an upcoming catalyst for the combined group

This is a build, operate and transfer (BOT) desalination project that is expected to deliver 22k m³/day for 30 years. The remaining approval is financial close, with environmental approvals already in place. RWL has signed a PPP document and has an SPV already in place for the project. Implying that once the project is funded, it appears the contractor to build (1.5 - 2 year construction time frame) and operate the plant.

Given the volume of water guided to be treated, this appears a sizeable plant, that could be in the tens of millions to build. As it is a BOT, we believe RWL would receive revenue (and a margin) to build the plant, then receive recurring revenue to operate the plant for 30 years.

Financial close is expected in Q3 2017. We highlight that should the project secure funding, it could be an upcoming catalyst for the combined group. It could also act as the first major BOT / RaaS project and kick start this model by providing significant operating reference site.

PDVSA Agricola projects

PDVSA (Petroleum of Venezuela) is a state owned company that is the world's fifth largest oil exporter, according to Wikipedia. It has several subsidiaries, Agricola is the agriculture related arm.

In June 2014, RWL entered into an agreement to design and manufacture products for the treatment of wastewater and US\$95.5m was received as a prepayment in advance. Judging by the amount of deferred revenue (\$36.0m), we assume that this represents the amount of work completed that PDVSA is still to agree to as being invoiceable.

The contract is subject to Venezuelan law and courts jurisdiction.

The \$51m short term deposit mostly represents the balance of the \$95.5m that has not yet been performed and the time frame for this to commence/complete is not known. This could represent future revenue (best case) or could be returned to the client (with no earnings impact).

We note that the provision of \$38.0m probably covers the deferred revenue, should this amount fall into dispute and RWL be somehow forced to repay this.

Whilst this contract has elements of risk, it appears fully provisioned. As RWL hold all the money in US\$ (prepaid), they are in a position of strength, in our opinion. There is unlikely to be any negative P&L impacts from this contract. We understand it is not part of RWL's guided revenue of US\$90m and could offer upside if the parties agree to a work schedule to complete the contract.

Investment considerations

The crux of investing in EMC

An investment in EMC is not without risk and we assume existing and potential shareholders are aware of this. The key to the success of the merged group remains the same, even with the RWL merger, being:

- Successful in ramping sales of the MABR product in China. The MABR product should drive the top line and also materially increase the gross margin of the combined group, leading to strong leverage at the bottom line. Whether this occurs depends on gaining widespread appreciation that the MABR product generates superior returns for its Chinese partners (as compared to installing cheaper and available MBR technology).

We highlight it is too early to be able to accurately forecasting the sales penetration in China. We do however have data points that indicate things are progressing, being:

- Confirmed orders for three plants (before certification approvals have been achieved), indicating a willingness of partners to install before trialling it (presumably based on visiting the operating Wuxi plant and achieving US EPA approval in the Virgin Islands);
- A demonstration plant (Wuxi) operating in China that is producing output to the expected standard;
- Improvement in the design of the MABR product to make it more plug-and-play, reducing installation risk; and
- A manufacturing plant being under construction in China that should be operational in CY17.

Other factors to consider that add to the investment case (whilst important but are secondary to the reason above, in our opinion) are:

- Other products of the combined group such as the EBR, Nirobox, Anaerobic digester and SUBRE could also generate significant growth;

- The addressable market for the combined groups products is forecast to grow from US\$13bn in CY16 to US\$22bn in CY21. The combined group is expected to predominantly compete against small companies;
- The recurring earnings model from RaaS or BOT, both of which are still being developed but offer longer term recurring earnings streams; and
- A global footprint, with a highly influential cornerstone investor, a very strong management team and board.

Valuation methodology

In our previous note, we were unable to generate a valuation using DCF for the combined group, due to insufficient financial information. We used EV/Revenue, however we feel DCF represents a much better method to assess the value of a start-up company, that is currently in the commercialisation phase. We revert back to DCF in this note now that additional financial information is available, though do reference EV/Revenue as a check to our main valuation methodology.

DCF valuation

We have made some changes to our core DCF assumptions being we have:

- Increased the long term growth rate to 3% (from 2%). This is to better reflect the large growth opportunity in global wastewater treatment market; and
- Lowered our Beta to 1.3x (from 1.5x). In our opinion, the likely merger with RWL increases the chances of commercial success for the group, not just in China but in other continents that RWL operates in. It also adds a supportive cornerstone investor. We see the merger as lowering the risk, hence the decline in the Beta. This results in the WACC falling to 12.0% (from 13.0%).

Several significant assumption changes have lowered our valuation from our original DCF valuation, being:

- A significantly increased number of shares on issue, from additional options issued, the US\$20m raise and the RWL acquisition (100.5m shares), diluting our valuation;
- Reducing the speed of the ramp up of sales in China for the MABR product in our forecasts (i.e. our base case CY19 revenue forecasts has been cut by \$180m (55%)), though over a 10 year period, total sales are more or less the same. We recognise this is a very large cut, and has been driven by:
 - The CY18 revenue range used in the IER being materially below our original expectations; and
 - We push back the timeframe for the operation of the manufacturing plant in China by ~3 months from the time used in our original forecasts.

Figure 9 contains our bear (A\$1.06/share), base (\$2.40/share) and bull case (\$4.00/share) scenario DCF valuations. Our original scenario based valuation ranged between \$1.47 - \$4.54/share, with a base case valuation of \$2.93/share.

Whilst DCF valuation is lower, it still offers material upside to the current share price, particularly in the base and bull case scenario's (158% / 330%), see Figure 9. It also sets the bar lower in terms of what the combined companies need to achieve to meet expectations.

Figure 9: Scenario based DCF valuation

Present value of cashflow	Bear	Base	Bull
Present value of cashflows CY17 to CY25 US\$	107	252	413
Present value of terminal year cashflow US\$	192	457	787
Net Cash at CY17F US\$	20	16	12
Present value of equity US\$	319	725	1,212
FX Assumption	0.75	0.75	0.75
Present value of equity A\$	426	967	1,616
Diluted Shares on issue CY17F	403	403	403
Present value per share A\$	1.06	\$2.40	4.00
Current share price A\$	0.91	0.91	0.91
Difference %	16%	164%	340%

Source: Henslow estimates

EV/Revenue analysis

Deciding what revenue multiple the combined group should trade on is not easy. There are many water treatment companies globally, some are:

- Water tech exposed (high multiple);
- Construction exposed (low multiple); and

- Exposed to recurring earnings streams or have long term contracts (high multiple).

The question is where does the combined group sit. It has intentions to build its recurring earnings, but this is immaterial at present. RWL is being acquired at ~0.7x CY17F revenue, implying it is mostly construction exposed, though this is changing as sales of products like the Nirobox increase. EMC has water tech, but little revenue at this point in time. We could also argue that RWL is worth more combined with EMC than on a stand alone basis, but this relies on the owner knowingly selling for less than could be achieved to create a more meaningful company (which may or may not be the case here).

The IER indicated a EV/Revenue multiple of 2-3x for the combined group (on an assumed US\$108.5m of FY18 revenue). This implies a EV of US\$217 – US\$325m (A\$289 – A\$434m). Assuming a share price of A\$0.91 post merger, implies an EV of A\$354m, around the middle of the IER valuation range and supports the current valuation of the company.

In our prior note titled “Fluence in motion”, we looked at the EV/Revenue multiples of several peers, which were trading at an average multiple of 4.1x FY18F revenue. In our opinion, this could represent future upside.

We see it possible that the combined group could be materially re-rated and also trade at an EV/Revenue multiple of 4x (or higher). We believe that this would require catalysts and proof of delivery on several of the following items:

- High take up of its MABR product in China;
- Take up of MABR products in other jurisdictions;
- Meaningful sales volume of products under the RaaS/BOT model; and
- Commercialisation of other products like the SUBRE.

Should this occur, the combined group will be seen as more tech and recurring in nature, and at that point should be re-rated.

Valuation conclusion post merger

Post the introduction of a recognised cornerstone investor and an injection of additional experienced management into the business, the stock has more appeal for institutional investors, in our opinion. As the register is light on institutional investors, we could see higher demand for EMC shares in the near term that could drive the share price (particularly given its likely much larger market cap post merger).

In our opinion, EMC remains the only way to play the rapidly growing global water treatment market, via an ASX listed stock. As a result, it could trade on high EV/Revenue multiples and price in more of the potential upside of successful commercialisation of its products than it currently enjoys. We continue to believe it has near term upside and is likely to continue to announce further progress in China (pending catalysts). Our base case DCF based valuation indicates significant upside from the current share price.

In our opinion EMC remains a high risk investment at this point in time but the level of risk is much lower than prior to the proposed merger.

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