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Equity Research Report

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Fluence (FLC)

Solid progress

Key Points

- FLC reported a 1H17 loss after tax of US$12.1m, however this also included FX losses and one off costs relating to the merger with RWL. Whilst not specifically disclosed, we estimate the underlying loss was ~US$8m.
- Cash on hand was US$15m, however cash inflows since balance date imply a current cash balance >US$40m.
- FLC gave a business update that implies the merger is integrating well and China appears developing to plan.
- CY17 revenue guidance of US$90m was reiterated.

Fluence

Current share price (A$)	$0.73
52-week range (A$)	$0.70-$1.12
Shares outstanding (m)	419
Market Cap (A$m)	$306
Avg. Daily Turnover (A$m)	0.5
Net cash CY17F (US$m)	US$15m
CY17F Gearing (ND/E) %	(94%)

Progressing to plan

The business update included the following new information:

- Class 1 water certification has been granted for the Wuxi Design Institute. As this is a technology institute and state owned, certification is likely to have national significance;
- The SUBRE product is due to be released Q2 2018;
- A global meat processor is installing a digestion water processing plant at one of its operations in Latin America. If successful, this could be rolled out in up to 50 plants;
- Nirobox sales are guided to increase by 300% in CY17 (they were $6m in CY16). This is a higher margin product and we expect this supports FLC guidance of +20% gross profit margin in CY17;
- Founder and former MD Eytan Levy has resigned from the board, however he remains an employee; and
- The rollout of plants in China is expected to be phased, with significant demand predicted in 18 months time. Our forecasts mirror this style of rollout.

Investment Considerations

The 1H17 reported result related to Emefcy only and did not provide proforma results incorporating RWL. Hence, the results are largely irrelevant as to the outlook of the group.

We have left our forecasts largely unchanged. Post incorporating a higher number of shares due to a recent placement and lowering our interest income forecasts our scenario based DCF valuation has changed as as follows, with the difference to the current share price (csp) as follows:

- Bear case - $1.02/share (unchanged), 40% above csp;
- Base case $2.29/share (from $2.31), 213% above csp;
- Bull case $3.80/share (from $3.85), 421% above csp.

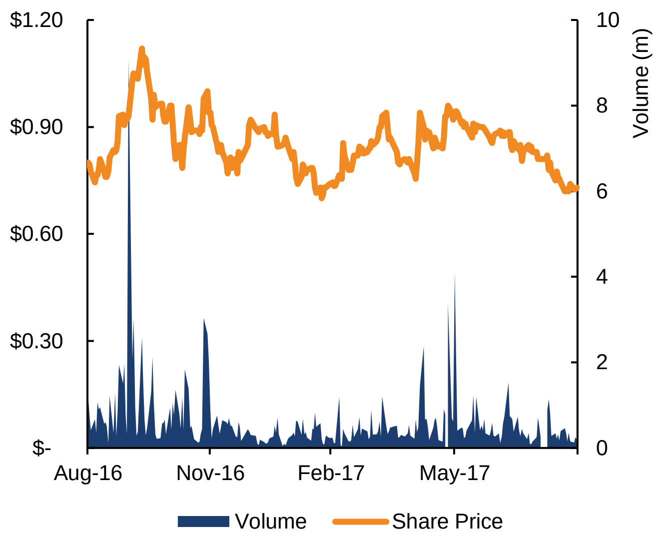
We see FLC as the only way to invest in the global water treatment market via an ASX listed company. It appears to have the team in place to give it a strong chance of succeeding.

Whilst FLC is pre-earnings, the upside (should it deliver) is high. The risk/reward equation remains compelling, in our opinion.

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)	(20.4)	(10.7)	34.4	80.8
Normalised EPS (¢)*	(5.6)	(2.4)	7.4	17.3
EV/EBITDA (x)	(10.2)	(20.3)	4.9	1.1
EV/EBIT (x)	(9.7)	(18.2)	5.1	1.2
Normalised P/E (x)	(12.9)	(30.8)	9.9	4.2

Share Price Performance and Volume



Source: Cap IQ

Results Summary

Underlying loss for half likely to be closer to US$8m

As 1H17 financials released were only for EMC and did not include pro-forma financials (i.e. they did not show the 1H17 contribution of RWL) we consider the current numbers to be largely irrelevant to investors. We expect complete pro-forma financials to be released at year end.

FLC posted a total loss of US$12.1m for the period. This includes:

- US$1.4m Foreign exchange loss; and
- Corporate consulting fees of US$3.4m (we believe a significant portion of this cost relates to the one-off fees for the merger with RWL).

On an underlying basis, the loss for the half is likely to be closer to the US$8m mark.

Cash on hand was US$15.0m but this has been significantly bolstered by further share placements after 30th June of US$31m, implying a current cash balance of over US$40m.

Progress Update

The results announcement did provide a number of operational updates as to the progress of the overall group. Our key takeaways were:

China

Wuxi plant has received class 1A certification

- The Wuxi Design Institute demonstration plant has received full class 1A effluent standard certification. As the Wuxi Design Institute is an SOE and technology centre, certification is likely to have national (as opposed to provincial) importance;
- The first commercial contract is already in place with Shanghai Winner, slated for commissioning in November 2017;
- FLC has a further three demonstration plants to be commissioned within the coming two months; and
- Early stage negotiations are underway for SUBRE plants, with three customers. SUBRE is due to be released in Q2 CY18.

The China strategy appears to be progressing to plan. Having the plant operating and securing contracts in the near term is the main focus for investors. For a graphical depiction of FLCs progress in China, see Figure 1.

Global

- FLCs containerised desalination system (the Nirobox) has a targeted year-on-year sales growth of +300% for CY17 (sales were US$6m in CY16). We see the Nirobox as one of the leading products of the group and their sales growth is a key margin driver;
- The US$44m San Quintin BOT project is still awaiting financial close but in our opinion, continues to represent a potential near-term catalyst and a strong foundation for annuity style revenues; and
- FLC have also announced a waste-to-energy solution contract with a global meat processing leader in Latin America. The food processing market appears a sizeable opportunity for the company, with this particular contract holding the potential of up to 50 plants.

Private placement

On August 8th FLC announced a combined strategic direct investment of US$11.0m from a very large US-based institutional investor and a second strategic investor. The placement was done at a premium to the closing price. In our opinion, this additional placement was unexpected and has probably contributed to the recent softness in the share price.

From Fluences perspective, the rationale for undertaking the placement (we believe that it didn't need the capital) was to:

- Introduce a US investor that is likely to continue to buy stock to build a larger position; and
- Help shape the register, noting that FLC intends to list on the NASDAQ at some point in the future.

We now incorporate the additional 16m shares issued in our valuation.

Innovation

Next-gen MABR & SUBRE to be available 2Q18

FLC intend to sell both the next-gen MABR and SUBRE in 2Q18. We see continued innovation and improvement of the MABR as imperative, this drives:

- Improved efficiencies in the product (leading to faster take-up);
- Cost optimisation, leading to higher margins; and
- Keeps FLCs products ahead of the curve, mitigating intellectual property risk.

The SUBRE is targeted at larger treatment plants and addresses nitrogen pollution in large wastewater treatment facilities, incurring low opex expenses. FLC have stated they believe the SUBRE has a protentional market of US$2bn. We understand that the Company are now beginning to generate interest in the product, albeit prior to its release to the market.

Management change

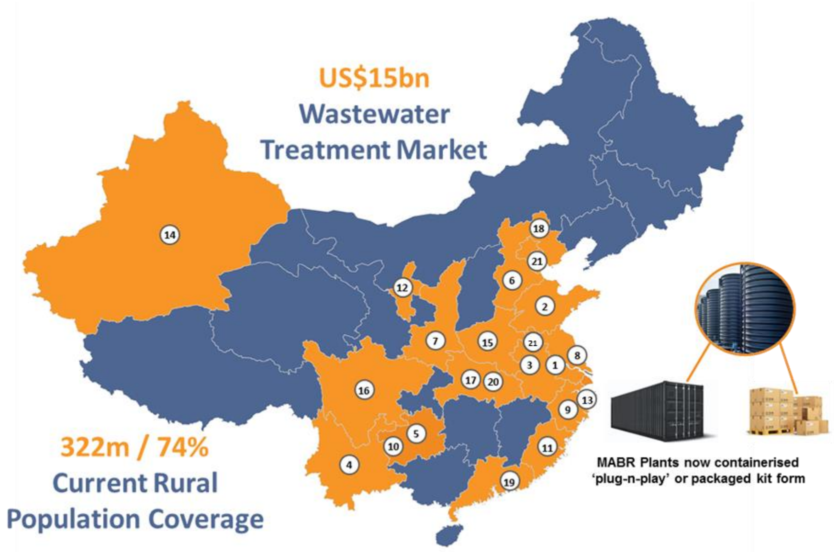
Co-founder of Emefcy and former Managing Director Eytan Levy will be transitioning to an advisory role and has left the board of directors. Fluence indicated he will continue as an employee until the end of 2018 and will be still involved in product development.

Merger update

FLC has indicated that the merger is going well, with all geographies capable of cross-selling the entire product suite. We see this as a key point, as the addition of RWL's suite of products and ability to market and sell MABR units in new geographies makes for a much stronger group.

Figure 1: China rollout progress

Partner / Facility	Locations	Progress
Manufacturing & Management	1. **Changzhou**	• Manufacturing facility due to be completed and operational in September • 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**	• 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**	• Deployed plant, with testing process complete and certification received • 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**	• 20k litre test plant commissioned, operating and being visited regularly by prospective customers • Will provide provincial certification once plant data collection is complete • US$2.5bn estimated demand for MABR product
Zhejiang Tiandi	13. **Zhejiang**	• 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**	• 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**	• 20k litre test plant installed, commissioned & operational • First year expected demand of ~10k MABR modules, with US$130m of first year deployment • Second CGGC dedicated production line expected to be built in Hubei, subject to CGGC purchasing 60k MABR modules
Shanghai Winner	20. **Hubei**	• 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**	• 20k litre test plant installed, with commissioning complete • 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)
Jiangsu Welle	22. **Anhui**	• 9th partner signed, a wastewater management, treatment and equipment engineering company, with a market cap of ~$1,281m • Holds projects for 5k m3/day of wastewater treatment, with demo plant anticipated to be commissioned in September, which is expected to lead directly to commercial contracts



Source: Company reports, CapIQ & Henslow estimates (new information in red)

2H'CY17 Guidance & Outlook

On a long-term basis the Company have targeted a +25% revenue growth rate. On a long-term basis, the Company have targeted a +25% revenue growth rate. FLC more specifically guided a gross margin of +20% for CY17, which is in line with the group reaching EBITDA break even in early CY19.

The groups guided revenue target of US$90m was reiterated.

Forecast Base Case Earnings Changes

We have updated our forecasts to include the additional shares on issue post the placement and we lowered the interest received rate. This resulted in:

- A 2.3% dilution of the previous register;
- An increase of US$11m in cash from the placement; and
- Lower interest income received, which also impacts tax and NPAT.

Our revenue forecasts, EBITDA and EBIT figures remain unchanged (see Figure 2). In our opinion, our forecast changes are immaterial.

Figure 2: Forecasts Changes

	Old				New				Difference			
$m	CY17F	CY18F	CY19F	CY20F	CY17F	CY18F	CY19F	CY20F	CY17F	CY18F	CY19F	CY20F
Revenue												
MABR	1.5	25.0	150.0	285.0	1.5	25.0	150.0	285.0	0.0	0.0	0.0	0.0
Reuse as a Service	0.0	0.5	3.5	9.5	0.0	0.5	3.5	9.5	0.0	0.0	0.0	0.0
RWL	90.1	121.6	145.9	167.8	90.1	121.6	145.9	167.8	0.0	0.0	0.0	0.0
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	**91.6**	**147.1**	**299.4**	**462.3**	**91.6**	**147.1**	**299.4**	**462.3**	**0.0**	**0.0**	**0.0**	**0.0**
Cost of sales	71.9	106.7	185.9	268.3	71.9	106.7	185.9	268.3	0.0	0.0	0.0	0.0
Gross Profit	19.7	40.4	113.5	194.0	19.7	40.4	113.5	194.0	0.0	0.0	0.0	0.0
Gross Margin %	21.5%	27.4%	37.9%	42.0%	21.5%	27.4%	37.9%	42.0%				
Overheads	38.5	43.7	50.4	60.0	38.5	43.7	50.4	60.0	0.0	0.0	0.0	0.0
EBITDA	**(26.2)**	**(12.5)**	**51.1**	**116.7**	**(26.2)**	**(12.5)**	**51.1**	**116.7**	**0.0**	**0.0**	**0.0**	**0.0**
Depreciation	(1.4)	(1.4)	(2.4)	(4.1)	(1.4)	(1.4)	(2.4)	(4.1)	0.0	0.0	0.0	0.0
Amortisation	(1.5)	(1.7)	(1.9)	(2.1)	(1.5)	(1.7)	(1.9)	(2.1)	0.0	0.0	0.0	0.0
Total EBIT	**(29.0)**	**(15.5)**	**46.8**	**110.5**	**(29.0)**	**(15.5)**	**46.8**	**110.5**	**0.0**	**0.0**	**0.0**	**0.0**
Net Interest	3.4	2.5	2.4	3.1	0.8	0.8	1.0	1.7	(2.6)	(1.7)	(1.4)	(1.3)
Tax	7.2	3.7	(13.8)	(31.8)	7.9	4.1	(13.4)	(31.4)	0.7	0.5	0.4	0.4
Abnormals after tax	(2.1)	0.0	0.0	0.0	(2.1)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reported NPAT	(20.6)	(9.4)	35.4	81.8	(22.5)	(10.7)	34.4	80.8	(1.9)	(1.3)	(1.0)	(1.0)
Normalised NPAT	**(18.5)**	**(9.4)**	**35.4**	**81.8**	**(20.4)**	**(10.7)**	**34.4**	**80.8**	**(1.9)**	**(1.3)**	**(1.0)**	**(1.0)**
Underlying EPS (cps)	**(5.2)**	**(2.2)**	7.9	18.1	**(5.6)**	**(2.4)**	**7.4**	**17.3**	**(0.4)**	**(0.2)**	**(0.5)**	**(0.8)**
Dil. shares on issue	353.0	432.6	450.2	450.9	361.2	448.9	466.5	467.2	8.2	16.3	16.3	16.3

Source: Henslow estimates

Scenario Related Assumptions

Figure 3: Key assumptions used in modelling FLC

SALES ASSUMPTIONS	--------- Bear Case --------- CY17	CY18	CY19	-------- Base Case --------- CY17	CY18	CY19	--------- Bull Case --------- CY17	CY18	CY19
China Opportunity									
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
Raas Opportunity									
No. modules sold	7	13	19	7	37	73	13	49	122

Source: Henslow estimates

The business update indicated that FLCs strategic partners are likely to undertake a phased rollout of plants, before a significant uplift in volumes. We have left our sales volumes assumptions unchanged, noting that our forecasts already reflect a phased rollout.

Investment Considerations

DCF Valuation

All DCF scenarios remain above csp

After incorporating the additional issue of shares and slight alterations to interest our DCF valuation has reduced, albeit very minimally.

- Our Bull value of $3.80 is 421% above the current share price;
- Our Base value of $2.92 is 213% above the current share price; and
- Our Bear value of $1.02 is 40% above the current share price.

All scenarios remain above the current share price.

Investment considerations

Whilst FLC remains a relatively risky investment, we see the continued integration of the merger as a strong sign that the business has been considerably de-risked. The merger has resulted in:

- A broadened product range;
- Improved production and engineering capabilities;
- Bolstered leadership; and
- Considerably larger geographical footprint and distribution channels.

Today’s announcement insinuated to us a much broader and globally focussed group, no longer leveraged so much to success in China but a diversified number of geographical markets, across several water treatment technologies.

Securing commercial orders for the MABR in China is likely to remain the main focus of investors. Once the China manufacturing plant is operational (in late September), we hope to contracts awarded. Forecasting the volume of orders has and will remain hard to predict for both us, the market and the Company.

In our opinion, FLC remains the only way to play the global water opportunity, via an ASX listed stock. We continue to believe the risk/reward scenario is favourable to investors and see the recent tapering off of the share price as a buying opportunity.

Financials

Figure 4: Scenario based forecasts for FLC (proforma for CY17)

PROFIT & LOSS (US$m)	Bear Case			Base Case			Bull Case		
Operating Revenue	90.8	134.6	222.4	91.6	147.1	299.4	92.3	160.1	375.9
EBITDA	(22.3)	(12.0)	22.8	(26.2)	(12.5)	51.1	(29.8)	(11.4)	80.3
EBIT	(25.2)	(15.1)	18.9	(29.0)	(15.5)	46.8	(32.7)	(14.4)	75.6
UNPAT pre abnormal	(17.6)	(10.3)	14.3	(20.4)	(10.7)	34.4	(23.0)	(9.9)	55.2
Abnormal Items	(2.1)	0.0	0.0	(2.1)	0.0	0.0	(2.1)	0.0	0.0
Reported NPAT	(19.7)	(10.3)	14.3	(22.5)	(10.7)	34.4	(25.1)	(9.9)	55.2
BALANCE SHEET (US$m)									
Cash	28.7	28.6	47.1	24.9	23.6	68.0	21.2	20.6	92.0
PP&E	5.5	6.8	11.3	5.5	7.1	14.7	5.6	7.3	18.0
Debtors & Inventory	15.8	22.5	36.7	15.9	24.2	47.8	16.0	25.9	58.7
Total Assets	180.9	194.7	228.6	178.3	193.9	259.4	175.8	194.5	292.1
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	86.6	91.9	110.1	83.8	88.7	127.1	81.2	86.8	146.0
CASHFLOW (US$m)									
Operating EBITDA	(22.3)	(12.0)	22.8	(26.2)	(12.5)	51.1	(29.8)	(11.4)	80.3
Interest & Tax Paid	0.8	0.8	0.9	0.8	0.8	1.0	0.7	0.7	1.1
Working Cap.	(3.4)	0.7	(0.1)	(3.3)	0.3	1.2	(3.2)	0.1	2.7
Operating CF	(24.9)	(10.5)	23.6	(28.7)	(11.4)	53.3	(32.3)	(10.5)	84.1
Maintenance Capex	(1.8)	(2.7)	(4.4)	(1.8)	(2.9)	(6.0)	(1.8)	(3.2)	(7.5)
Expansion Capex	(5.3)	(2.4)	(4.7)	(5.3)	(2.4)	(6.9)	(5.3)	(2.5)	(9.1)
Free Cashflow (FCF)	(35.0)	(15.6)	14.5	(38.8)	(16.8)	40.4	(42.4)	(16.2)	67.4
Ord & Pref Dividends	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Other	40.7	15.5	4.0	40.7	15.5	4.0	40.7	15.5	4.0
Net Cashflow	5.7	(0.1)	18.5	1.9	(1.3)	44.4	(1.8)	(0.6)	71.4
VALUATION METRICS									
Normalised EPS (c)	-4.9	-2.3	3.1	-5.6	-2.4	7.4	-6.4	-2.2	11.8
Normalised PE (x)	-15.0	-31.9	23.9	-12.9	-30.8	9.9	-11.5	-33.1	6.2
Enterprise Value ($m)	277	277	259	281	282	238	285	285	214
EV / EBITDA (x)	-12.4	-23.0	11.4	-10.7	-22.6	4.7	-9.6	-25.1	2.7
EV / EBITA (x)	-11.7	-20.7	12.5	-10.2	-20.3	4.9	-9.1	-22.3	2.8
EV / EBIT (x)	-11.0	-18.4	13.7	-9.7	-18.2	5.1	-8.7	-19.8	2.8
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)	1.3	2.4	(2.1)	1.0	1.9	(1.3)	0.7	1.8	(1.1)
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	-20.3%	-11.2%	13.0%	-24.3%	-12.0%	27.1%	-28.4%	-11.4%	37.8%
ROA (%) y/e	-16.6%	-9.1%	10.4%	-18.9%	-9.1%	24.5%	-21.2%	-8.3%	37.8%
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 (%)	(33.2%)	(31.2%)	(42.8%)	(29.7%)	(26.6%)	(53.5%)	(26.2%)	(23.7%)	(63.0%)
OPCF / EBITDA (%)	111.5%	87.3%	103.6%	109.7%	91.4%	104.3%	108.5%	92.4%	104.7%
DCF Valuation A$		**$1.02**			**$2.29**			**$3.80**	

Source: Henslow forecasts

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