Colts

A research initiative by Canaccord Genuity

Fluence Corporation

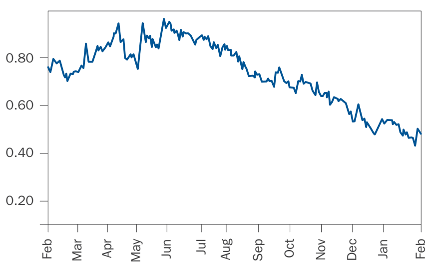
Fluence Quarterly report and updated guidance

Key Facts	
Company Code	FLC
Closing Price (31/1/18)	$0.50
Date of Report	1/02/18
Company Website	fluencecorp.com
Analyst	Johan Hedstrom

Company Statistics	
12-Month Range (A$)	$0.425-$0.96
Market Cap (A$Mil)	$208
Issued Shares (Mil)	415
Issued Options (Mil)	53
Cash (A$Mil)	41

Major Shareholders	%
RSL Investments	33%
Pond Ventures Nominees	7.7%

Share Price Performance



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Short term revenue delay - Long term growth appeal remains

Water treatment company FLC has reported weaker 4Q 2017 revenues than we had estimated, largely due to timing issues. While we have reduced our near term growth assumptions, growth prospects continue to look good, leading to a $1.24/share Target Price, down 7% from $1.34. We maintain a Buy recommendation as we believe FLC offers smarter, lower cost water treatment technologies to a world with an increasing need of clean water.

Revenues

Annual revenue of US$58m compared to our estimate of US$77m, with the difference largely due to the US$14m delayed revenue recognition of the St Quintin project in Mexico. This project is anticipated to reach financial close in 1Q 2018. The backlog of contracted revenues is estimated US$95m at the end of 2017, with US$75m anticipated to be recognised this year. Revenue guidance for 2018 is provided at US$105-115m, a near doubling on 2017, weighted to 2H18.

Profitability improving and a strong balance sheet

FLC also indicates likely gross profits of US$22-25m in 2018, representing a margin of 24-26%, up from 19% in 2016. The company is still guiding to positive EBITDA in 2019. Effective cash of US$33m and no debt shows that the balance sheet remains in a strong position.

Business operations

The MABR business has commissioned its first plant onshore US at Stanford University, and the important market opportunity in China is developing well. FLC has also sold its first SUBRE units, which reduces nitrogen discharge while expanding treatment capacity in existing plants. A positive surprise is that the Venezuelan contract with PDVSA has been re-started, which is the company's largest contract to date, totaling >US$90m. Growing water shortages has led to further sales of the company's desalination product Nirobox, with more to come, with Africa a key area of demand.

We have reduced our near term forecasts, and increased our overheads, but this does not change our positive investment opinion of the stock. A recent award by Frost & Sullivan indicates that FLC is getting more recognition in the industry.

Fluence Corporation
Financial Summary

PROFIT AND LOSS US$

Year ending December	Unit	2016A	2017E	2018E	2019E	2020E
Revenue	$m	60.9	57.0	100.6	147.0	267.0
Operating Expenses	$m	(49.3)	(45.5)	(79.1)	(112.8)	(197.8)
Admin and Other Expenses	$m	(28.7)	(35.0)	(35.9)	(36.8)	(37.7)
EBITDA	**$m**	**(17.1)**	**(23.5)**	**(14.4)**	**(2.5)**	**31.5**
Depreciation	$m	(1.6)	(2.5)	(3.5)	(4.4)	(6.3)
EBIT	$m	(18.8)	(26.0)	(17.8)	(6.9)	25.2
Net interest (expense)	$m	6.5	0.2	(0.1)	(0.9)	(1.7)
PBT	**$m**	**(12.3)**	**(25.8)**	**(17.9)**	**(7.8)**	**23.5**
Tax expense	$m	(2.8)	-	4.5	2.0	(5.9)
NPAT (pre-abnormal)	**$m**	**(14.9)**	**(25.8)**	**(13.5)**	**(5.9)**	**17.6**
Abnormal items	$m	-	-	-	-	-
NPAT (reported)	**$m**	**(14.9)**	**(25.8)**	**(13.5)**	**(5.9)**	**17.6**

CASH FLOW US$

Year ending December	Unit	2016A	2017E	2018E	2019E	2020E
OPERATING CASHFLOW						
NPAT	$m	(14.9)	(25.8)	(13.5)	(5.9)	17.6
Add: non-cash items	$m	1.6	2.5	3.5	4.4	6.3
Change in working capital	$m	(7.3)	(11.5)	(0.8)	(7.0)	(18.0)
Operating cash flow	**$m**	**(20.6)**	**(34.8)**	**(10.8)**	**(8.5)**	**5.9**
INVESTING CASHFLOW						
Net PP&E	$m	(0.4)	(3.0)	(2.4)	(4.9)	(3.9)
Evaluation	$m	(0.2)	-	-	-	-
Other	$m	(3.8)	-	-	-	-
Investing cash flow	**$m**	**(4.4)**	**(3.0)**	**(2.4)**	**(4.9)**	**(3.9)**
FINANCING CASHFLOW						
Share capital	$m	3.3	31.0	-	-	-
Interest bearing debt	$m	4.3	4.5	17.6	18.0	10.0
Financing cash flow	**$m**	**7.7**	**35.5**	**17.6**	**18.0**	**10.0**
Change in cash	$m	(17.3)	(2.3)	4.4	4.6	12.0

BALANCE SHEET US$

Year ending December	Unit	2016A	2017E	2018E	2019E	2020E
ASSETS						
Cash	$m	8.0	5.7	10.1	14.7	26.7
Accounts receivable	$m	3.1	20.0	25.2	36.7	66.8
Property Plant & Equipment	$m	0.6	1.1	0.1	0.6	(1.8)
Inventory	$m	-	-	-	-	-
Other	$m	3.8	3.8	3.8	3.8	3.8
Total assets	**$m**	**15.5**	**30.6**	**39.1**	**55.9**	**95.5**
LIABILITIES						
Accounts payable	$m	0.4	5.7	10.1	14.7	26.7
Deferred tax liablities	$m	-	-	-	-	-
Borrowings	$m	3.4	7.9	25.5	43.5	53.5
Provisions	$m	4.2	4.2	4.2	4.2	4.2
Total liabilities	$m	8.0	17.8	39.8	62.4	84.5
SHAREHOLDER'S EQUITY						
Share capital	$m	15.8	46.8	46.8	46.8	46.8
Retained earnings	$m	(10.5)	(36.3)	(49.7)	(55.6)	(38.0)
Reserves & outside equity	$m	2.2	2.2	2.2	2.2	2.2
Total equity	**$m**	**7.5**	**12.7**	**(0.7)**	**(6.6)**	**11.0**
Weighted average NoSh	m	228.6	336.1	415.1	415.1	415.1

FINANCIAL RATIOS

Year ending December	Unit	2016A	2017E	2018E	2019E	2020E
VALUATION						
NPAT (adjusted)	$m	(14.9)	(25.8)	(13.5)	(5.9)	17.6
EPS (adjusted)	c/sh	(6.5)	(7.7)	(3.2)	(1.4)	4.2
EPS growth	%		18%	-58%	-56%	-401%
PER	x	-7.7x	-6.5x	-15.4x	-35.4x	11.8x
DPS	c/sh	-	-	-	-	-
Yield	%					
EV/EBITDA	x	-11.8x	-8.9x	-15.5x	-92.8x	7.4x
PROFITABILITY RATIOS						
Gross margin	%			27%	30%	35%
EBITDA margin	%			-14%	-2%	12%
Return on assets	%	-64%	-112%	-39%	-12%	23%
Return on equity	%	-147%	-255%	-224%	160%	792%
LIQUIDITY & LEVERAGE						
(Net debt) / cash	$m	5	(2)	(15)	(29)	(27)
ND / E	%	45%	62%	-3518%	-661%	485%
ND / (ND + E)	%	31%	38%	103%	118%	83%

ASSUMPTIONS

Year ending December	Unit	2016A	2017E	2018E	2019E	2020E
PRICES						
MABR modules	#	100	100	200	2,000	8,000
Nirobox units	#	10	22	55	100	200
Custom Revenue growth	%	8%	-17%	50%	5%	5%
RaaS agreements	#	-	-	4	5	10

MARGINS		2016A	2017E	2018E	2019E	2020E
MABR	%	35%	35%	35%	35%	35%
Nirobox	%	20%	20%	20%	20%	20%
Custom Projects	%	19%	20%	20%	20%	20%
RaaS	%	-	-	50%	50%	50%

CURRENCY					
USD/AUD	0.75	0.78	0.76	0.75	0.74

A$ SOTP VALUATION AT WACC

11.1%	Risked			Unrisked	
	NPV ($m)	A$/sh	Risking	NPV ($m)	A$/sh
MABR	311	0.75	100%	311	0.75
Nirobox	139	0.33	100%	139	0.33
Custom Projects	105	0.25	100%	105	0.25
RaaS	50	0.12	100%	50	0.12
Net asset value	**604**	**1.45**		**604**	**1.45**
Corporate overheads	(96)	(0.23)		(96)	(0.23)
(Net debt) / cash	9			9	0.02
Equity value	516			**516**	
# Shares	415			415	
Value per share ($/sh)	**1.24**			**1.24**	

Guidance for 2018 and impact on our forecasts

The preliminary results for 2017 and management's guidance for 2018 were both below our expectations, but not to the extent of causing us any real concern.

The major difference in revenues for 2017 was that US$14m of revenue recognition for the St Quintin desalination project in Mexico could not be booked, as the project has not reached Financial Close. This is expected to occur in 1Q 2018, although further delays are possible.

On the positive side, the guidance for calendar 2018 has been provided at US$105-115m, a near doubling of the US$58m achieved in 2017. A substantial US$75m part of this revenue prediction is from the backlog of agreed projects totaling US$95m. This year's revenue also includes US$18m for an agreement with PDVSA Agricola in Venezuela, which was a project that was very much in doubt. The situation in that country remains unstable, but it's good to hear that the project has been reactivated.

> "On the positive side, the guidance for calendar 2018 has been provided at US$105-115m, a near doubling of the US$58m achieved in 2017."

We have reduced our revenue estimates as a result of the 2017 result, and the guidance provided. We have also increased our forecast of Staffing costs and Administration from US$30m to US$35m/year. However, we have not changed our long term volume or margin assumptions as we believe this potential remains very attractive. Nevertheless, the Target Price has reduced from $1.34/share to $1.24/share. This still represents significant upside from the share price, which has been weak in the last few months.

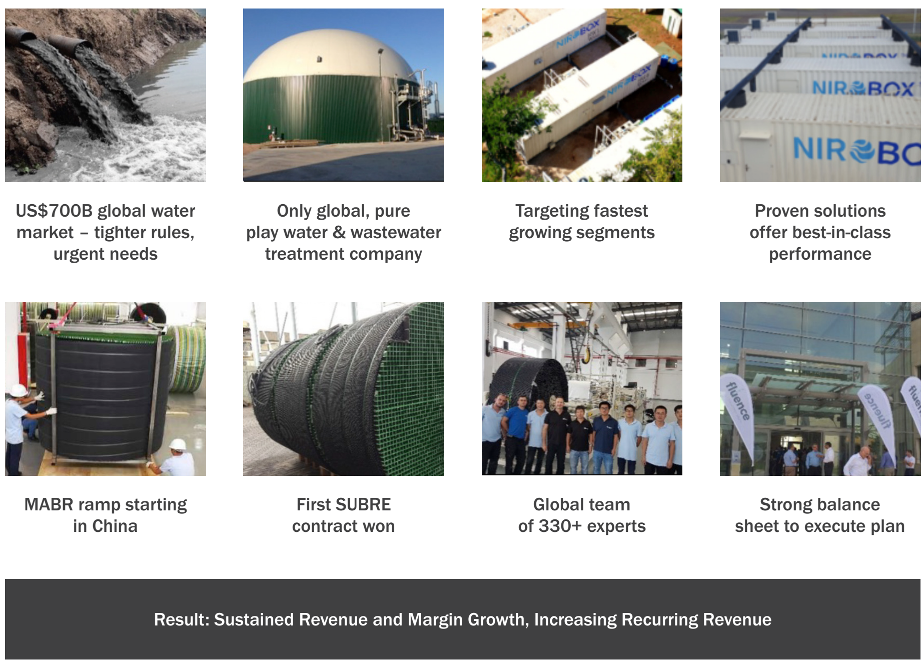
Figure 1. Revision to estimates

Revisions to estimates	Old	New	Change	Old	New	Change
	2017	2017		2018	2018	
Revenues	77	57	-26%	125	101	-20%
EBITDA	(14)	(23)	64%	(1)	(14)	927%
DCF Valuation	$1.34	$1.24	-7%			

Source: Canaccord Genuity estimates

As noted in our Initiation Report from the 6 November 2017, the valuation is highly sensitive to different long term scenarios, with a range from a low of $0.40/share to $2.46/share using more optimistic assumptions.

Figure 2. FLC is a diversified water treatment company



Source: Company reports

Business Updates

Custom Projects
This is essentially the existing base business of RWL Water, which represents the bulk of current revenues. The St Quintin and PDVSA projects mentioned above are within this business unit, as are all the existing water treatments across a range of industries such as industrial, municipal, mining, oil & gas, power and the food and beverage sectors.

The company's recent success in the food industry is particularly noteworthy, including US$6m of new contracts with food processors in Argentina and Ecuador, while the company is the dominant water treatment supplier to the poultry industry in Italy. A new manufacturing plant is set to open in Argentina in 2Q 2018, in order to meet growing demand in South America.

> "The company's recent success in the food industry is particularly noteworthy, including US$6m of new contracts with food processors in Argentina and Ecuador."

The company has not yet closed the deal with an un-named African country for a US$100m contract, so this remains a significant upside not included in the guidance or our estimates.

MABR
FLC's flagship water treatment product Membrane Aerated Biofilm Reactor (MABR) is making promising progress in China, the USA and elsewhere.

The company has signed nine strategic partnership agreements in China, and there are now five plants either operating or in construction. These are effectively test runs, ahead of much bigger orders anticipated in 2019 and beyond. As a reminder, the 13th Chinese Five Year Plan (FYP) has a target of introducing water treatment to at least 70% of the 100,000 villages currently without any treatment. Objectives set by FYP's tend to be delivered at the back-end, so FLC anticipates a significant ramp-up ahead of 2021, when the current FYP concludes.

The USA is also a very big market, with significant interest from buyers. The installation of an MABR plant at Stanford University, California is the first installation onshore US, and an important step to show the technology at work for the domestic market.

SUBRE
SUBRE is a submerged version of the MABR technology, and specifically designed to be retrofitted into existing water treatment plants, with two key benefits: Reduced nitrogen content in water treated, and a 15-20% capacity expansion.

FLC has been awarded its first contract for SUBRE, to a large water treatment plant in Israel.

As high nitrogen content in water causes excessive algal growth, water authorities around the world are tightening regulations to reduce this problem. FLC sees a big commercial opportunity for its SUBRE technology, as it is low cost, doesn't use toxic chemicals like methanol, energy efficient, and the modules can be retrofitted into existing plants.

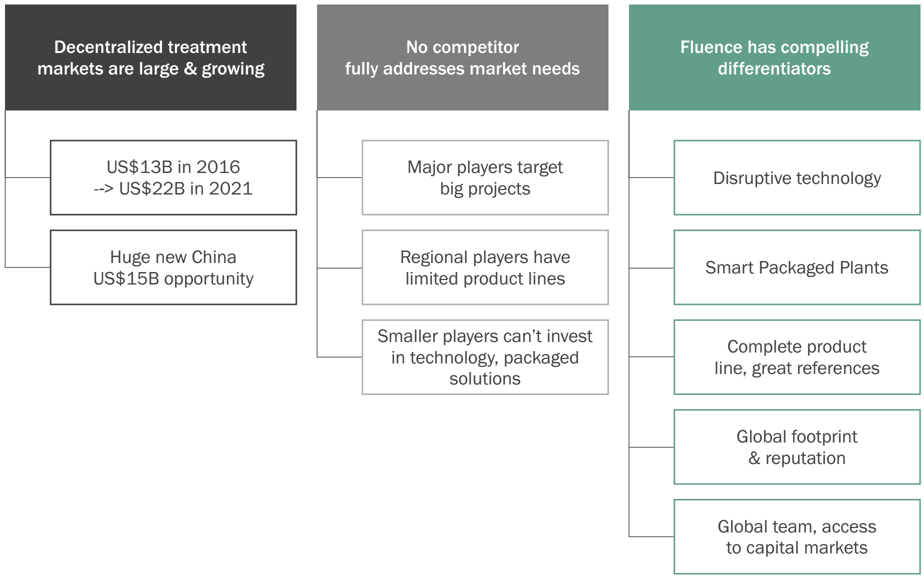
We do not include any contribution from SUBRE, until we see some sales traction, which is a conservative approach.

Nirobox
This business unit offers smart-packaged desalination plants developed by FLC. A number of plants have been commissioned around the world, and the company won a US$4.1m tender in Africa during the 4Q 2017. Further contracts are under negotiation, particularly in Africa. The current water shortages in Cape Town South Africa is a good illustration of the potential demand.

RaaS
Revenue-as-a-Service remains a key objective for the company, whereby FLC offers a financing package for customers, to reduce their up-front capital costs, and locks in a longer term annuity style income stream for FLC. The company hopes to conclude negotiations with financing partners this year, in order to offer customers attractive packages.

Risks
In our view, the two main uncertainties, and therefore risks of the FLC business are the difficulty in predicting product sales, and at what margins these products will be sold. The company is undoubtedly poised to grow product sales strongly, but it is difficult to predict the outlook accurately. Investors need to consider that the actual results may in fact be much higher or much lower than what is shown in our forecasts.

Figure 3. FLC is competitively positioned in a huge market opportunity



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