

# Fluence Corporation

Delivering on a demanding target

Q4 and FY18 results

An impressive Q4 (73% y-o-y organic revenue growth) saw Fluence deliver on its FY18 target. Demand for its higher-margin smart product solution (SPS) remains strong with revenues expected to 'at least' double y-o-y in FY19. Its target of EBITDA breakeven by Q419 is reaffirmed and our profit forecasts are largely unchanged. With \$38m of net cash and growing evidence of execution, we believe investors can now focus on the long-term growth story.

Year end	Revenue (US\$m)	EBITDA* (US\$m)	EPS* (c)	EV/revenue (x)	EV/EBITDA (x)	P/E (x)
12/17	33.2	(23.6)	(7.0)	3.6	N/A	N/A
12/18e	105.6	(17.5)	(4.0)	1.1	N/A	N/A
12/19e	149.1	(1.8)	(0.7)	0.8	N/A	N/A
12/20e	186.5	11.8	1.8	0.6	10.2	14.1

Note: \*EBITDA and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

## Q4: An impressive performance

An impressive Q4 performance saw Fluence report revenue of \$43.7m, up 51% q-o-q and 73% y-o-y, delivering on its FY18 guidance. Meeting this target represents a huge achievement in our view. FY18 revenues rose \$47m or 82% on a pro-forma basis (Fluence was created from the merger of Emefcy and RWL Water in Q317), driven by a doubling of higher-margin SPS (from \$10m to \$22m) and the first revenue from San Quintin (\$13.5m). Headline gross profit was flattered by a \$7.1m (non-cash) provision reversal in Q418 but underlying FY18 margin rose to 24% (ahead of our expectations). Cash outflow was larger than our expectations in both Q2 and Q3, but fell by \$3m q-o-q in Q4. Improved collections saw the company end the year with \$38m net cash (\$10m above our expectations).

## FY19 outlook: Profitability target reaffirmed

We see the strong momentum of Q4 maintained into FY19. The company expects SPS to at least double again (in line with our expectations) driven partly by the ramp in the ITEST contract in China. Further San Quintin revenue is also expected but predicting the timing of additional large, low-margin custom-engineered solutions (CES) remains difficult (see [Time for better treatment?](#)). We have trimmed our estimates but the impact on profits is offset by a reduction to opex so our profit forecasts are largely unchanged.

## Valuation: 98% upside on a DCF basis

We believe Q4 results could act as a catalyst for the shares. With the ITEST deal illustrating the potential of Fluence's technology, Q4 removes near-term forecast uncertainty and demonstrates the ability to meet demanding financial targets. An increasing focus on proprietary technologies should build a business with better margins and visibility (from Q120 long-term recurring revenue contracts should generate at least 20% of gross profit). A DCF approach that reflects the growth and margins of which we believe Fluence ultimately capable, suggests an A\$0.71 per share valuation and 98% upside. It is likely to take time and good execution to realise this, but with profitability in sight and funding secured, we believe formerly sceptical investors can now focus on these longer-term prospects.

General industrials

1 February 2019

Price **A\$0.36**

Market cap **A\$194m**

US\$/A\$0.715

Estimated net cash (US\$m) at end 2019 18

Shares in issue 538m

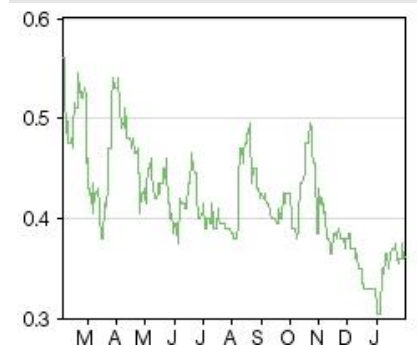
Free float 60%

Code FLC

Primary exchange ASX

Secondary exchange N/A

### Share price performance



% 1m 3m 12m

Abs 16.9 (11.6) (27.5)

Rel (local) 12.4 (11.9) (24.9)

52-week high/low A\$0.6 A\$0.3

### Business description

Fluence is a global supplier of water and wastewater treatment solutions. Its decentralised products provide municipal customers with 'plug and play' solutions that are quicker to deploy and substantially cheaper than traditional alternatives.

### Next event

Q1 FY19 trading update April 19

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## Q4 and FY18 review: Execution on a demanding target

Following disappointing performance in FY17, some investors were sceptical that Fluence could meet an ambitious FY18 target that implied at least 80% pro-forma revenue growth and was heavily H2 weighted. An exceptional performance in Q4 quashed those fears. Revenue of \$43.7m implied growth of 51% q-o-q and 73% y-o-y. Much of the sequential rise (c \$13m) was driven by the ramp up of revenue from San Quintin but the company also began recognising revenue from the ITEST contract signed in Q3 (see our recent note, [China contract catalyst?](#)). While no further high-volume smart product contract wins were announced in Q4, the company did sign an \$8.4m build-own-operate contract in Peru based on Nirobox. This should begin operating in Q319, bolstering the annual recurring revenue base by \$3m. The successful completion of an Aspiral trial with the Yiyang City government saw an extension of its contract here and in our view bodes well for future deployment of Aspiral in Hunan province.

The growth delivered by Fluence in FY18 was primarily driven by a ramp up in custom contract revenue from PDVSA and San Quintin (we estimate \$27.2m and \$13.5m respectively) combined with a doubling of higher-margin SPS revenue (from \$10m to \$22m). The greater profitability of SPS (25–40%) helped lift pro-forma gross margins from 22% in FY17 to 24% in FY18 whereas good cost control reduced the current operating cost run-rate to below \$10m a quarter.

Fluence's funding position also improved substantially over FY18, particularly in the last few months. A capital raising in Q3 (net proceeds of \$25m) and a \$3m sequential reduction in cash operating outflows in Q4 saw the company end FY18 with \$38m of net cash (\$10m ahead of our forecast). It also secured a \$50m non-recourse debt facility to provide project financing for projects (see [Debt facility in place for custom projects](#)). The current business plan now looks fully funded.

## FY19 outlook: Growth, improving mix, EBITDA +ve Q4

Fluence's momentum should continue in FY19. The company expects SPS to 'at least' double (in line with our expectations) driven in part by the ramp up in the ITEST contract in China. Further San Quintin revenue is expected (we forecast \$33m) but the company admits that predicting the timing of additional large, low-margin CES contracts remains difficult (see [Time for better treatment?](#)) and securing these deals is no longer a strategic priority. A pre-emptive \$5m cut to our CES revenue estimates trims group revenue forecasts by 3% and we also lower our gross margin assumption slightly. Our new \$149m revenue forecast implies typical seasonality in H1 followed by a substantially stronger H2. The impact on the bottom line is entirely offset by lowering our operating cost forecast from \$43m to \$39m. With the mix improving, we now see gross margins trending up to 25% and the company exceeding the revenue threshold of \$40m per quarter that will deliver EBITDA breakeven in Q419 (in line with re-iterated guidance). The company is guiding to a \$10m operating cash outflow in Q1 where we had previously assumed a \$5m cash outflow. Taking this into account and reviewing cash trends in FY18, we now conservatively forecast a total reduction in cash during FY19 of \$19m.

**Exhibit 1: Changes to forecasts**

	FY18e			FY19e			FY20e		
	Old	New	%	Old	New	%	Old	New	%
Revenue	107.3	105.6	(1.6)	154.0	149.1	(3.2)	194.4	186.5	(4.1)
Adj EBITDA	(13.4)	(17.5)	N/M	(2.0)	(1.8)	N/M	11.9	11.8	(0.6)
Adj EPS	(2.6)	(4.0)	N/M	(0.8)	(0.7)	N/M	1.8	1.8	(0.3)
Net cash	28.7	37.9	31.8	25.1	18.5	(26.3)	41.3	42.2	2.1

Source: Company data, Edison Research

## The next phase

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With FY18 numbers successfully delivered, funding secured and profitability in sight investors can now focus on Fluence's longer-term prospects. Management appears to be paying increasing attention to improving the quality of the business. Growth from its proprietary standardised technologies (Nirobox, Aspiral and Subre) should substantially improve the revenue mix, lifting both margins and visibility. The best gauge of the longer-term potential of these technologies is the volume of contract wins. However, introducing a segmentation that shows these higher-quality revenue streams will also help investors track progress. The SCS segment will directly reflect sales of proprietary products whereas recurring revenue and aftermarket will report large custom build-own-operate contracts where there is a recurring revenue element. Based only on contracts signed already, Fluence estimates annualised recurring revenue will be close to \$15m by Q120, c 10% of total sales. As these contracts are also relatively high margin they could account for 20% of gross profit. By growing this proportion Fluence believes it can substantially improve visibility for investors.

## Valuation: 98% upside on a DCF basis

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At A\$0.36 and assuming US\$18m of net cash (end FY19e), Fluence's current share price implies a US\$120m EV and 10.2x FY20e EV/EBITDA. A DCF approach, based on P&L forecasts that are largely unchanged, reflects the growth and margins of which we believe Fluence ultimately capable and suggests an A\$0.71 per share valuation and 98% upside. It will take time and further execution to realise this valuation. However, with profitability in sight and funding secured, we believe formerly sceptical investors can now focus on these longer-term prospects.

**Exhibit 2: Financial summary**

	\$m	2016	2017	2018e	2019e	2020e
31-Decemeber		IFRS	IFRS	IFRS	IFRS	IFRS
<b>INCOME STATEMENT</b>						
Revenue	0.8	33.2	105.6	149.1	186.5	
Cost of Sales	(2.0)	(27.2)	(80.3)	(112.0)	(132.9)	
Gross Profit	(1.2)	6.0	25.3	37.0	53.6	
EBITDA	(8.8)	(23.6)	(17.5)	(1.8)	11.8	
Operating Profit (before amort. and except).	(9.1)	(24.3)	(20.1)	(4.4)	9.2	
Amortisation of acquired intangibles	0.0	0.0	0.0	0.0	0.0	
Exceptionals	0.1	(1.2)	(31.1)	0.0	0.0	
Share-based payments	0.0	0.0	0.0	0.0	0.0	
Reported operating profit	(9.1)	(25.4)	(51.2)	(4.4)	9.2	
Net Interest	(0.0)	2.6	1.0	0.6	0.6	
Joint ventures & associates (post tax)	0.0	0.0	0.0	0.0	0.0	
Exceptionals	0.0	0.0	0.0	0.0	0.0	
Profit Before Tax (norm)	(9.1)	(21.7)	(19.1)	(3.7)	9.8	
Profit Before Tax (reported)	(9.1)	(22.9)	(50.2)	(3.7)	9.8	
Reported tax	0.0	(0.7)	(0.1)	0.0	0.0	
Profit After Tax (norm)	(9.1)	(22.4)	(19.2)	(3.7)	9.8	
Profit After Tax (reported)	(9.1)	(23.6)	(50.4)	(3.7)	9.8	
Minority interests	0	0	0	0	0	
Discontinued operations	0	0	0	0	0	
Net income (normalised)	(9.1)	(22.4)	(19.2)	(3.7)	9.8	
Net income (reported)	(9.1)	(23.6)	(50.4)	(3.7)	9.8	
Average Number of Shares Outstanding (m)	214	320	477	538	538	
EPS - basic normalised (\$)	(0.04)	(0.07)	(0.04)	(0.01)	0.02	
EPS - diluted normalised (\$)	(0.04)	(0.07)	(0.04)	(0.01)	0.02	
EPS - basic reported (\$)	(0.04)	(0.07)	(0.11)	(0.01)	0.02	
Dividend per share (\$)	0	0	0	0	0	
Revenue growth (%)	4.7	(10.4)	39.5	36.1	22.7	
Gross Margin (%)	(147.5)	18.0	23.9	24.8	28.7	
EBITDA Margin (%)	(1,089.3)	(71.1)	(16.6)	(1.2)	6.3	
Normalised Operating Margin	(1,126.1)	(73.1)	(19.0)	(2.9)	4.9	
<b>BALANCE SHEET</b>						
Fixed Assets	3.2	72.7	24.8	26.2	27.6	
Intangible Assets	2.1	60.2	5.8	5.8	5.8	
Tangible Assets	1.0	7.1	13.9	15.3	16.7	
Investments & other	0.1	5.5	5.0	5.0	5.0	
Current Assets	24.4	131.9	155.7	147.7	166.2	
Stocks	0.5	18.5	35.9	33.4	30.2	
Debtors	0.7	26.7	69.4	83.6	81.6	
Cash & cash equivalents	22.9	75.2	39.0	19.2	42.9	
Other	0.3	11.5	11.4	11.4	11.4	
Current Liabilities	(2.5)	(95.9)	(117.7)	(114.7)	(124.8)	
Creditors	(1.4)	(27.8)	(47.9)	(47.8)	(60.5)	
Tax and social security	0.0	(0.1)	(0.1)	(0.1)	(0.1)	
Short term borrowings	0.0	(1.1)	(1.1)	(1.1)	(1.1)	
Other	(1.1)	(66.9)	(68.6)	(65.8)	(63.2)	
Long Term Liabilities	(1.0)	(5.1)	(11.0)	(11.0)	(11.0)	
Long term borrowings	0.0	0.0	0.0	0.0	0.0	
Other long term liabilities	(1.0)	(5.1)	(11.0)	(11.0)	(11.0)	
Net Assets	24.1	103.6	51.8	48.1	57.9	
Minority interests	0.0	0.2	0.1	0.1	0.1	
Shareholders' equity	24.1	103.8	51.9	48.2	58.0	
<b>CASH FLOW</b>						
Op Cash Flow before WC and tax	(8.8)	(23.6)	(17.5)	(1.8)	11.8	
Working capital	1.7	(4.8)	(31.8)	(13.9)	16.1	
Exceptional & other	0.0	0.2	0.7	0.0	0.0	
Tax	0.0	(0.9)	(0.3)	(0.4)	(0.4)	
Net operating cash flow	(7.2)	(29.0)	(49.0)	(16.1)	27.5	
Capex	(0.4)	(3.7)	(3.5)	(4.0)	(4.0)	
Acquisitions/disposals	(1.0)	50.6	(1.8)	0.0	0.0	
Net interest	0.0	0.5	2.7	0.2	0.2	
Equity financing	22.9	31.3	23.3	0.0	0.0	
Dividends	0.0	0.0	0.0	0.0	0.0	
Other	(0.2)	1.1	(3.7)	0.0	0.0	
Net Cash Flow	14.2	50.8	(31.9)	(19.8)	23.7	
Opening net debt/(cash)	(8.5)	(22.9)	(74.0)	(37.9)	(18.5)	
FX	0.2	2.1	(4.1)	0.4	0.0	
Other non-cash movements	0.0	(1.8)	0.0	0.0	0.0	
Closing net debt/(cash)	(22.9)	(74.0)	(37.9)	(18.5)	(42.2)	

Source: Fluence Corporation accounts, Edison Investment Research. Note: these financials assume 103m additional shares from the capital raising taking place and net proceeds of \$23m.

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