Second Quarter 2019 Business Update
Conference Call
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Adam Hinckley, VP Investor Relations:

Good morning to those of you in Australia, and good evening to our US listeners. I am Adam Hinckley, Vice President of Investor Relations for Fluence. I am joined on the call by Henry Charrabé, Managing Director and Chief Executive Officer, and Francesco Fragasso, Chief Financial Officer.

To begin the call, Henry will provide some detail about operations and outlook. He will then hand it over to Francesco to cover the financials, and finally we will answer any questions you might have.

I also want to note that all financial references are in US dollars and that we will make forward-looking statements, which are protected under the safe harbor provisions of Australian securities law. Details are provided in the ASX release.

Now, let me now turn over the call to our Managing Director & Chief Executive Officer, Henry Charrabé, to provide more detail on our operating performance. Henry?

Henry Charrabé, Managing Director & Chief Executive Officer:

Thank you, Adam.

By now, you have hopefully had the opportunity to review the quarterly business update, along with the Appendix 4C, that were released on the ASX earlier today. Rather than summarize the releases, I would like to provide additional context on some of the key points.

Following a very busy and successful first quarter, Q2 was a period of consolidation for the business. Importantly, we want to reiterate our guidance and that we remain on track to achieve sustainable EBITDA profitability by Q4 this year, subject to financial close on Ivory Coast, and expect to increase the backlog of recurring revenue from our project finance operations.

While the financial performance of the business over the second quarter has not been as strong as we would have liked, our conviction that there will be strong and growing demand for our decentralised pre-engineered Smart Product Solutions has only strengthened. Our growing backlog, which now stands at $278 million, is a clear indicator that we are a leading force of this transformation, and also points to strong future revenue growth.

In the first half of the year, we experienced an unanticipated product mix shift of desalination customers selecting bespoke systems under our Custom Engineered Solutions segment rather than pre-engineered NIROBOX systems under our Smart Product Solutions segment.

We understand the reasons for this, given it is a new market segment and customers need to be educated on the benefits of this new approach. We continue to believe that the minimal engineering and design work associated with NIROBOX results in a lower cost of water delivered than a custom engineered solution, but it takes time to change an industry's ingrained way of doing business. If the only parameter for decisions would be the cost of water delivered, all our desalination work would be pre-engineered Smart Product Solutions. However, these tenders are won based on a scoring system that assigns value to non-economic criteria, which benefit custom engineered solutions over Smart Product Solutions, such as the number of reference points in the specific country. As our installed base of NIROBOX increases, we expect that dynamic to tip in favour of our Smart Product Solutions.

In addition to the sales mix shift lowering expectations for Smart Product Solutions revenue this year, the timing of signing new recurring revenue projects, where NIROBOX is currently our main product, has an impact as well. We expect to sign future recurring revenue projects in the domestic wastewater space with our Aspiral and SUBRE products, but this end market is more municipally focused and takes longer to close than commercial and industrial customers seeking drinking or process water from NIROBOX.

Recall that during construction of a recurring revenue project, under IFRS accounting, we recognize revenue on a percentage of completion basis for project costs incurred. In 2018, this amounted to $7.8 million from construction of our Bimini and Peru projects and we still expect to sign 1 to 2 new recurring revenue projects before year-end.

As a result of the sales mix shift in the first half of this year and the timing of new recurring revenue projects, you will have seen that we have lowered our guidance for 2019 for Smart Product Sales to $26 million.

The reduction in Smart Product Solutions revenue expectations from $44 million to $26 million reflects $10 million from the Brazil project, which we announced earlier in the quarter. Fluence will still recognize revenue under Custom Engineered Solutions for this project but, differently than expected, the customer preferred a traditional treatment system, rather than a Nirobox. Additionally, approximately $8 million from the lack of construction revenue contribution from recurring revenue projects this year cause us to reduce the expectation in Smart Product Solutions in 2019.

On an encouraging note, our expectation for segment revenue contribution from products containing our proprietary MABR technology, namely Aspiral and SUBRE, are unchanged and remain around $20 million – significantly higher than the MABR related revenue in 2018 of approximately $3 million.

What gives us so much confidence that MABR sales will materialize the way we expect is our core China market, which represents the bulk of our MABR revenue. We are receiving strong indications of near-term orders from existing customers, and we are working on several new multi-year agreements. These multi-year contracts would be executed with our channel partners and in coordination with provincial governments while establishing final assembly capacity for ASPIRAL systems within the respective province. Our MABR modules would still be manufactured exclusively by us in our Changzhou facility and then transported to the provincial assembly facility. The assembly capacity is extremely inexpensive, so this would not require meaningful capex and could potentially lower transportation costs and logistics by performing final assembly of our ASPIRAL solutions closer to the end user installation site. Additionally, outside of China, we are seeing growing interest in MABR, as well.

As a result of this strong demand, we are ramping production of modules in our Changzhou facility and expect to reach its full capacity of three-shift operations for one line of manufacturing by year end. MABR is a fast turn business, so we are building inventory to meet visible near-term demand.

Overall, our confidence to reach sustainable EBITDA profitability in Q4 is driven by the expectation of achieving financial close on the Ivory Coast project by the end of Q3. As we have previously stated, we expect to recognize up to $20 million of revenue from the Ivory Coast contract in Q4 primarily related to design work. Our flagship MABR-based products continue to produce a strong sales pipeline in China and our overall backlog now stands at $278 million. We feel comfortable with year-to-date bookings of $241 million or $54 million excluding the Ivory Coast project.

Now moving on to the San Quintin, Mexico recurring revenue project, it has become apparent that our minority equity partners in this project would likely be unable to meet their equity capital commitments, thus preventing the first disbursement from the North American Development Bank project finance facility. This negatively impacted revenue in Q2 by approximately US$4.5 million, and we were not able to recognise approximately US$7 million of revenue in the first half of the year due to the delays of funding contribution by our minority equity partners.

To resolve the situation, we have reached agreement in principle with the minority equity partners for Fluence to contribute the remaining equity and thereby increasing our ownership in the project from 51% to approximately 94%. This will require a cash investment of $8.5 million, which we expect to fund from a drawdown of the potential new Generate Capital term loan facility.

As you may have read, we have executed a Term Sheet with Generate Capital and are in advanced discussion regarding a term loan facility for up to $40 million with funds earmarked for specific projects, such as the aforementioned equity portion of San Quintin, and the short-term working capital needs in China and Ivory Coast. Securing the loan is subject to customary conditions, including completion of due diligence and execution of definitive documents, which we expect to occur late in Q3 or in early Q4.

This new corporate term loan facility would be in addition to the $50 million project finance facility previously secured from Generate for recurring revenue projects. We expect to meet the revised capital commitments for the San Quintin, Mexico project through this facility. By making the remaining project equity contribution, we expect to proceed with construction and draw down on the project financing facility from North American Development Bank for reimbursement for work previously completed.

Before turning the call over to Francesco to discuss Fluence's financial performance, I would like to review our policy on the disclosure of new customer orders. Under ASX Continuous Disclosure guidelines, we have an obligation to report news that could reasonably be expected to materially impact the price or value of Fluence's shares. We have set a $3 million threshold for the disclosure of individual new orders, which equates to approximately 3% of prior year revenue. However, we will continue to announce all recurring revenue projects, and other wins below this threshold, if these are of strategic significance. As a result, there will be periods of time where new contract wins are not specifically disclosed to the market given individually, they are below this threshold. Investors should know that we are constantly active on many fronts to build our backlog and grow revenues even if no announcements are being released by the company. In addition, we regularly reassess our disclosure thresholds and may make adjustments to the $3 million level as the business requires.

Please let me now turn over the call to Francesco to offer you more details on our Q2 2019 financials. Francesco, please go ahead.

Francesco Fragasso, Chief Financial Officer:

Thank you, Henry.

Second quarter unaudited revenue of $11.3 million was negatively impacted by approximately $4.5 million from the delays in the San Quintin project that Henry discussed, and timing of revenue recognition related to orders previously won.

First half unaudited revenue of $23.6 million reflected $5.6 million from Smart Product Solutions; $0.5 million from Recurring Revenue and After-market; and $17.4 million from Custom Engineered Solutions. Revenue from Smart Product Solutions increased 74% year-over-year in the first half.

Major project wins that have occurred this year, including the New Mansoura project in Egypt, the Ivory Coast project, and the Brazil project won in Q2, have not yet contributed to revenue. This strong backlog is a leading indicator for forward revenues and supports our expectations for a strong ramp in revenue over the second half of this year, and in particular, during the last quarter.

Historically, Fluence's revenue has been skewed to the second half of the year, and given our backlog, we again expect to generate a substantial amount of revenue in the fourth quarter. That revenue is expected at a higher margin than that achieved over the first half of this year.

Cash and Cash Equivalents were $15.6 million at the end of June. The cash balance was negatively impacted from the delay in revenue recognition of previously awarded contracts and the delay in the first disbursement from the North American Development Bank related to the San Quintin project. We expect to close the corporate term loan with Generate Capital by late Q3 or early Q4 and achieve first disbursement from North American Development Bank shortly thereafter, resulting in a $5 million net cash benefit.

Net cash used from operating activities in Q2 2019 was $7.8 million versus the forecast of net cash usage of $6.5 million.

Based on current contracts, we expect $26.1 million of cash receipts from customers during Q3 and cash payments of $32.1 million, resulting in an expected net operating cash outflow for Q3 of $6 million.

Let me now turn the call back to Henry for the question and answer session. Henry.

Henry Charrabé, Managing Director & Chief Executive Officer

Thanks, Francesco.

As I discussed earlier, MABR demand, which is dominated by our Aspiral product, is extremely robust; we are confirming guidance to reach sustainably positive EBITDA in Q4 and feel very comfortable with year-to-date bookings and backlog.

With water scarcity increasing, our conviction in the thesis that there will be strong and growing demand for decentralized, pre-engineered Smart Product Solutions for water and wastewater treatment has only strengthened. Our market position is strong, there is growing acceptance of our proprietary MABR technology, bookings backlog and continue to grow, with our backlog now at $278 million, and we are utilizing non-dilutive funding to capitalize on the many growth opportunities ahead of us.

Before beginning the question and answer session, I would also like to highlight that Francesco and Adam will be presenting at the Canaccord Genuity Growth Conference taking place in Boston on August 8th. You will be able to find a link to the live webcast on the Investor Relations section of our website.

Operator: Could you please repeat the instructions for how to submit questions?

Thank you for your interest in Fluence, and especially to our supportive shareholders.