Research as a Service

Fluence Corporation Ltd

Q1 2024 Update

New strategy proving up

Industrials – Capital Goods

6 May 2024

Fluence Corporation (ASX:FLC) specialises in the delivery of water and wastewater solutions in industrial, municipal and commercial industries across the globe. The company released an update on Q1 performance (note: FLC has a December balance date), that clearly validates the change in group strategy away from large construction and engineering projects, and towards smaller, higher margin, proprietary solutions, with a clear push into North America. The company has maintained full year guidance of US$90m-$100m of revenue and EBITDA of US$3.5m-$4.0m, a positive turnaround from the EBITDA breakeven position of FY23. Q1 is seasonally the weakest quarter of the year, in this case further affected by delays in the large legacy Ivory Coast project, resulting in revenue of US$10.1m and an EBITDA loss of US$1.6m for the 3 months to March. The operating cash outflow of US$7.3m was more material than we forecast, but again was affected by timing delays in projects and payments and is guided to reverse in upcoming periods. A material positive is that the core business (ex-Ivory Coast) grew revenue by 59% over the previous corresponding period (pcp) and expanded group gross margins by 14% to 33.9%. The strong project backlog and forward pipeline lends some confidence to retain our FY24 forecasts, equating to strong revenue growth and cashflow positivity over the balance of the year. Our forecasts remain unchanged and we retain a DCF-based valuation of A$0.25/share (US$0.16/share), representing potential capital upside of 47%.

Business model

Fluence is a diversified business, by product, customer profile and geography, and derives revenue from the design and sale of equipment solutions for water and wastewater treatment in municipal, industrial and commercial settings. This is complemented by the ongoing provision of parts and service, and operation and maintenance contracts.

Q1 2024 result clearly validates the strategy

The strategy has been refocused away from large construction engineering projects (such as the Ivory Coast (IVC) project)) and towards high-growth, higher-margin proprietary product solutions (SPS) and recurring revenue. Over the quarter, SPS and recurring revenue represented 96% of total revenue, at higher margins than any time during FY23. The company signed US$9.9m in new order bookings and has a contract backlog of US$91.4m, up 124% on the pcp. The company has put the pipeline of opportunities at US$940m, growing 183% since the beginning of 2023. The new team has proven it can deliver high margin SPS projects, but the conversion of the pipeline of opportunities remains key, in our view. Management however communicated its confidence on new contract wins, suggesting a strong 2nd quarter of bookings and guided to H1 FY24 order bookings of US$40m-$50m. Further cost savings of US$1m over the pcp were also delivered. After the recapitalisation in December 2023, the balance sheet remains in a solid position, in our view, to execute growth initiatives without the debt burdens of the past.

DCF valuation of $0.25/share

Our full year forecasts remain unchanged, but we forecast an increased H2 skew. Our existing discounted cash-flow valuation of A$0.25/share also remains unchanged. All forecasts and reported financials are in US$, so we have adjusted the DCF valuation and all per-share metrics at an A$/US$ exchange rate of US$0.65. Our valuation represents 47% upside potential from the current share price.

Earnings history and RaaS' estimates (in US$m unless otherwise stated)

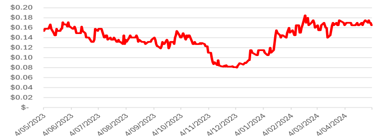
Year end	Revenue	Gross profit	EBITDA adj.*	NPAT adj.*	EPS adj.* (c)	EV/Sales (x)	EV/EBITDA (x)	PER (x)
06/22a	116.3	26.8	(2.0)	(18.8)	(1.9)	0.6	134.4	n/a
06/23a	69.4	18.4	0.2	(18.0)	(1.7)	0.9	366.9	n/a
06/24f	95.7	26.9	3.2	0.1	0.0	1.2	35.1	n/a
06/25f	114.6	33.1	7.7	4.0	0.6	1.0	14.5	29.7

Source: RaaS estimates for FY24f and FY25f; Company data for historical earnings; *Adjusted for one-time and non-cash items

Share Details

ASX code	FLC
Share price (3 May)	$0.165
Market capitalisation	$177.6M
Shares on issue	1,076M
Net debt at 31-Mar-2024	US$0.17M

Share Performance (12 months)



Upside Case

- New contract win-rate ahead of forecasts
- The emergence of a clear BOO model backed by contract wins
- Ongoing margin expansion

Downside Case

- Failure or delays in conversion of pipeline
- Margin expansion story doesn't play out
- Further Ivory Coast delays

Catalysts

- Strong Q2 contract win-rate
- Proof of strong US traction
- Ongoing evidence of margin expansion story

RaaS Fluence Initiation Report

Fluence Corporation RaaS Initiation Report

Board and Management

Doug Brown	Chair
Tom Pokorsky	CEO/Managing Director
Paul Donnelly	Non-Executive Director
Richard Irving	Non-Executive Director
Ross Haghighat	Non-Executive Director
Mel Ashton	Non-Executive Director
Nikolaus Oldendorff	Non-Executive Director

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Q1 FY24 Result Discussion

The Q1 FY24 result was weaker than we expected at group level, containing a mix of divisional-specific strength and weakness, but the core business that drives the growth strategy performed well, in our view. Exhibit 1 illustrates the divisional contributions for the quarter. Note all references to Fluence's earnings from here are in US$ unless otherwise stated.

Exhibit 1: Q1 FY24 Divisional Contribution versus pcp (US$m)

	Q1 FY23a		Q1 FY24a		% chg
	Revenue	**EBITDA**	**Revenue**	**EBITDA**	**Revenue**
Municipal Water & Wastewater	1.0	(0.6)	1.7	0.2	+70%
Industrial Water & Biogas	1.9	(0.0)	0.7	(0.4)	-63%
Industrial Water & Reuse	1.8	(0.5)	$4.6	0.8	+156%
SEA & China	1.2	(0.7)	2.2	(0.0)	+83%
BOO	0.6	0.1	0.7	0.1	+17%
IVC	8.0	1.1	0.3	(0.1)	-96%
Corporate	(0.3)	(2.0)	(0.1)	(2.2)	
Total	14.2	(2.6)	10.1	(1.6)	-29%

Source: Company data

Key discussion points:

- **Group revenue dropped from $14.2m to $10.1m**, however in Q1FY23 the Ivory Coast (IVC) project contributed $8.0m, versus $0.3m in the quarter just gone. We discuss IVC in more detail later in this report, but we believe it can be considered a legacy project that will only contribute for the next 18 months (from a capital works perspective). Excluding IVC, revenue grew 59% from $6.2m to $9.8m, with particularly strong performances from the Municipal Water & Wastewater (MWW) (+70%), Industrial Water & Reuse (IWR) (+156%) and SEA & China (+83%) divisions, all key potential growth drivers going forward.

- **Negative EBITDA quarter (as we expected)**, but an improvement of 38% over the pcp. Q1 is historically the seasonally weakest quarter of the year, so softer revenue over the fixed cost base challenges operating leverage, exacerbated in this instance by a delay in commencement of the IVC Addendum project. Management emphasised that on a trailing 12-month (TTM) basis the company was profitable to the tune of $1.2m at the EBITDA line. This gives us significant confidence going forward.

- **Four of the six divisions delivered strong growth.** Most notably IWR, MWW and SEA & China. We expect the other core division Industrial Water & Biogas (IWB) to rebound strongly over the course of the year, with a current backlog of ~$13m and a sales pipeline of $161m.

- **IVC the notable exception**. The delay in finalising the finance element of the Ivory Coast Addendum project (total project value ~US$51m over the next 18 months) was a minor negative surprise to us, but only creates a timing issue. We continue to forecast a ~$23m contribution in FY24 (now more skewed to 2H24) with the balance of the contract completed in FY25. In our view, delays in a material project such as this highlight the risks with the previous business model (particularly given the lower margins). That said, management highlighted its confidence in securing an operation and maintenance contract on the site, the assumption of which is in our forecasts. This could be a long-term opportunity but is yet to be formally secured.

- **Margin expansion across the core business.** It is clear to see the margin expansion story in a period when there was no contribution from large construction engineering projects. FLC delivered gross margins of 33.9% in the quarter and management has stated its ability to deliver margins of 35%+ in its core business going forward. Obviously this will be diluted at group level over the next 18 months as IVC contributes at gross margins closer to 15%, but we see the Q1 result as validation of the company's strategy.

- **Cash flow number was weak and worse than we forecast.** We expected a negative operating cash flow number, but the outflow of $7.3m was a negative surprise to us. Management cited the delay in commencement of the Ivory Coast Addendum and the first milestone payment, plus "delays in collections on several large projects in Egypt". Therefore, these appear to be timing issues and we would expect them to reverse over the next one to two quarters. Fluence also reduced a further $1.3m in debt in the quarter and remains net cash positive.

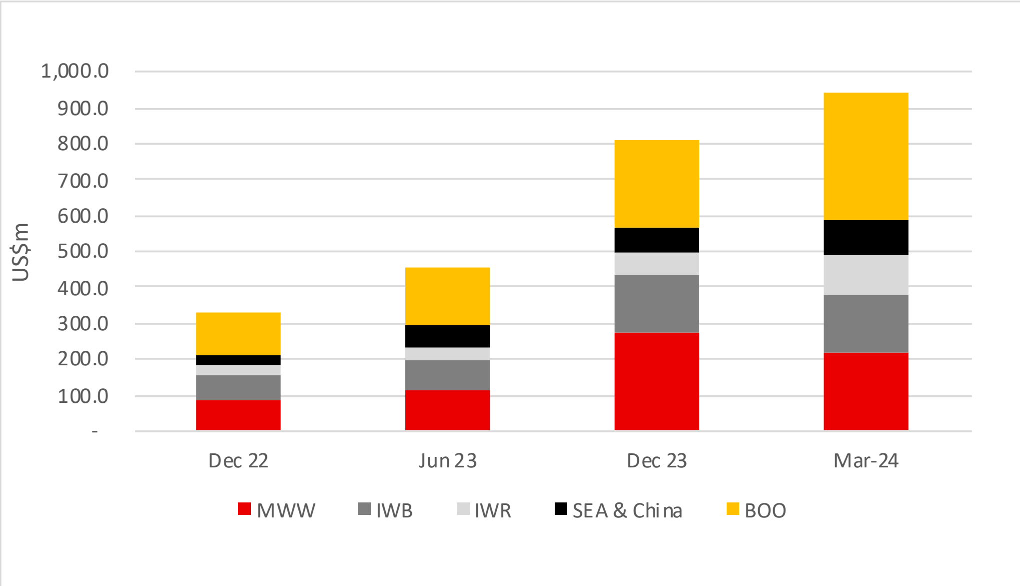
Contract Backlog And Sales Pipeline

FLC signed $9.9m in new orders in Q1, an increase of 19% on the pcp. The main divisional contributors were IWB ($4.3m) and MWW ($3.5m). The $3.5m booked in municipal work in North America is, in our view, a leading indicator to strong potential success in the region. The bookings in Q1 exceeded the total bookings for FY23, and the pipeline has more than doubled over the last 12 months.

The backlog for the total company now sits $91.4m, which has grown 124% over the past 12 months. The backlog includes the ~US$51m IVC Addendum project, but the balance appears to be well diversified by division and geography. The company has guided to $45.5m of the backlog to be recognised in Q2-Q4 2024, of which we estimate ~50% to be the IVC project. Management also communicated its confidence in the current tender pipeline, citing $30m-$40m of expected bookings in Q2 2024.

The order book also continues to grow strongly, as illustrated in Exhibit 2.

Exhibit 2: Sales Pipeline



Source: Company Data

The pipeline has more than doubled since June 2023. Four of the five divisions have stronger pipelines than at December year end, with the exception being MWW which has a reduced pipeline due to the ending of commercial operations in Israel. For clarity, the Fluence sales pipeline is loosely defined as a group of projects that have been identified as appropriate to pursue on which budgeted numbers have been constructed. The pipeline is highly diversified containing over 350 projects at an average size of $1.9m (excluding Build, Own, Operate (BOO) projects which tend to be larger in size but are not included in our forecasts). The timeline to signing varies markedly from 2 weeks to 3 years. As yet, we don't have the track record under new management for the defined pipeline definition to correlate the success rate, but we expect this to become evident over the course of the next 12 months.

Guidance And Outlook

Management has retained guidance of:

- FY24 Revenue of $90m-$100m (RaaS estimate $95.7m)
- FY24 EBITDA of $3.5m-$4.0m (RaaS estimate $3.2m)

Management also stated that of the $91.4m backlog, it expects $56m (including Q1) to be shipped in FY24, therefore requiring new orders secured and executed of ~$34m-$44m over Q2-Q4 to meet revenue guidance. This appears achievable to us given management confidence in expected Q2 bookings already discussed.

Earnings Adjustments

We adjust for timing issues experienced in Q1 FY24 but assume these are smoothed over the course of the year, resulting in a slightly increased skew towards 2HFY24 earnings whilst keeping our full year forecasts unchanged (broadly in line with guidance). Some lumpiness and seasonality can be expected in the Fluence business, so although the operating cashflow was weak we believe the timing issues, pipeline and existing backlog is strong enough for the business to still meet guidance.

Our forecasts beyond FY24 remain unchanged. Execution risk remains, but we gain confidence that the stated strategy and business model are meeting expectations and believe further evidence of traction in North American over the next 1 to 2 quarters may provide positive share price catalysts.

DCF Valuation Is A$0.25/share

Our valuation remains unchanged. We believe the discounted cash-flow methodology is the most appropriate method to value FLC. We apply a discount rate of 10.6% (beta 1.2, terminal growth rate of 3.0%). This derives a base-case valuation of A$0.25/share (US$0.16/share), as illustrated in Exhibit 3.

Exhibit 3: Base-case DCF valuation

	Parameters
Discount rate / WACC	10.6%
Beta (observed beta is 0.86)*	1.2
Terminal growth rate assumption	3.0%
Sum of Present Value (PV) (US$M)	49.2
PV of terminal value (US$M)	116.1
PV of enterprise (US$M)	165.3
Net cash at 31 Dec 2023 (US$M)	6.3
Net value – shareholder (US$M)	171.6
No of shares on issue (M)	1,076.2
NPV per share	**A$0.25**

Source: RaaS estimates

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Exhibit 4: Financial Summary

Fluence Corporation	All financials in US$ unless stated otherwise				
Profit and Loss ($m)					
Y/E 30 December	**FY22A**	**FY23A**	**FY24F**	**FY25F**	**FY26F**
Sales Revenue	116.3	69.4	95.7	114.6	112.6
Gross Profit	26.8	18.4	26.9	33.1	39.1
EBITDA underlying	0.5	0.2	3.2	7.7	8.1
Depn	(2.0)	(1.8)	(1.7)	(1.1)	(0.6)
Amort	(0.3)	(0.2)	(0.1)	(0.1)	(0.1)
EBIT underlying	(1.7)	(1.4)	1.3	6.5	7.4
Interest	(4.0)	(5.7)	(1.2)	(0.7)	(0.7)
Tax	(1.0)	(0.7)	(0.0)	(1.7)	(2.0)
Minorities	0.0	0.0	0.0	0.0	0.0
Equity accounted assoc	(0.1)	0.0	0.0	0.0	0.0
NPAT pre significant items	(9.0)	(9.1)	0.1	4.0	4.6
Significant & non-cash ite	(9.8)	(8.8)	0.0	0.0	0.0
NPAT (reported)	**(18.8)**	**(18.0)**	**0.1**	**4.0**	**4.6**
Cash flow ($m)					
Y/E 30 December	**FY22A**	**FY23A**	**FY24F**	**FY25F**	**FY26F**
EBITDA	0.5	0.2	3.2	7.7	8.1
Interest	(3.9)	(5.7)	(1.2)	(0.7)	(0.7)
Tax	(0.1)	(0.2)	(1.0)	(1.7)	(2.0)
Working capital changes	(17.0)	(13.3)	(0.6)	(5.2)	(0.2)
Operating cash flow	(20.5)	(19.0)	0.3	0.1	5.1
Mtce capex	0.0	0.0	(2.0)	(1.7)	(1.1)
Free cash flow	(20.5)	(19.0)	(1.7)	(1.7)	4.0
Capex	(0.4)	(1.8)	(1.5)	0.0	0.0
Acquisitions/Disposals	0.3	0.1	2.0	0.0	0.0
Other	10.9	6.1	0.0	0.0	0.0
Cash flow pre financing	(9.8)	(14.6)	(1.2)	(1.7)	4.0
Equity	3.7	26.6	0.0	0.0	0.0
Debt	(0.4)	(13.4)	(10.0)	0.0	0.0
Dividends paid	0.0	0.0	0.0	0.0	0.0
Net cash flow for year	(6.5)	(1.4)	(11.2)	(1.7)	4.0
Balance sheet ($m)					
Y/E 30 December	**FY22A**	**FY23A**	**FY24F**	**FY25F**	**FY26F**
Cash	30.9	24.6	13.2	11.4	15.2
Accounts receivable	49.0	35.3	37.0	43.9	49.4
Inventory	9.3	5.7	9.3	9.0	10.6
Other current assets	10.6	8.7	8.7	8.7	8.7
Total current assets	*99.8*	*74.3*	*68.2*	*73.0*	*83.8*
PPE	9.7	8.1	7.9	6.8	6.2
Intangibles and Goodwill	1.3	1.1	1.2	1.3	1.4
Investments	0.3	0.3	0.3	0.3	0.3
Deferred tax asset	0.0	2.0	3.0	3.0	3.0
Other non current assets	12.4	7.2	7.2	8.9	10.1
Total non current assets	*23.8*	*18.8*	*19.7*	*20.3*	*20.9*
Total Assets	123.6	93.1	87.9	93.3	104.8
Accounts payable	51.5	32.4	37.0	38.4	45.3
Short term debt	1.3	15.8	5.8	5.8	5.8
Tax payable	0.1	0.7	0.7	0.7	0.7
Other current liabilities	32.3	28.7	28.7	28.7	28.7
Total current liabilities	*85.1*	*77.6*	*72.2*	*73.6*	*80.5*
Long term debt	32.9	2.6	2.6	2.6	2.6
Other non current liabs	2.6	0.8	0.8	0.8	0.8
Total long term liabilities	*35.6*	*3.4*	*3.4*	*3.4*	*3.4*
Total Liabilities	120.7	80.9	75.6	77.0	83.8
Net Assets	**2.9**	**12.2**	**12.3**	**16.3**	**20.9**
Share capital	217.7	232.3	232.3	232.3	232.3
Accumulated profits/losses	(198.9)	(214.9)	(214.8)	(210.8)	(206.2)
Reserves	(13.9)	(3.3)	(3.3)	(3.3)	(3.3)
Minorities	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)
Total Shareholder func	**2.9**	**12.2**	**12.3**	**16.3**	**20.9**

Share price (3 May 2024)	All per share mettrics in A$					0.165
Interim (A$m)						
	1H23a	**2H23a**	**1H24f**	**2H24f**	**1H25f**	**2H25f**
Revenue	31.7	37.6	33.9	61.7	69.3	45.2
EBITDA (adj)	(2.0)	2.6	(1.6)	4.8	5.3	2.4
EBIT (adj)	(3.0)	1.6	(2.5)	3.8	4.6	1.9
NPAT (normalisec	(5.4)	(3.4)	(2.3)	2.4	2.9	1.1
EPS (normalised/c	(0.74)	(0.42)	(0.22)	0.22	0.27	0.10
Dividend (cps)	-	-	-	-	-	-
Imputation	-	-	-	-	-	-
Operating cash flo	(12.9)	(0.4)	(2.0)	2.3	(1.0)	1.0
Divisions	**1H23a**	**2H23a**	**1H24f**	**2H24f**	**1H25f**	**2H25f**
MWW	6.2	4.9	6.3	12.2	9.9	11.8
IWB	3.4	3.6	6.5	8.4	9.8	9.8
IWR	5.7	9.2	9.7	10.7	12.2	12.9
SEA & China	2.2	11.4	7.0	9.0	9.0	9.2
BOO	1.1	1.0	1.4	1.4	1.4	1.4
IVC	13.2	9.1	3.0	20.0	27.0	0.0
Sales revenue	**31.7**	**37.6**	**33.9**	**61.7**	**69.3**	**45.2**
COGS	(25.1)	(27.8)	(23.7)	(45.1)	(51.1)	(30.4)
Gross Profit	6.7	9.8	10.2	16.7	18.2	14.8
GP Margin (%)	21%	26%	30%	27%	26%	33%
EBITDA (normalis	(2.0)	2.6	(1.6)	4.8	5.3	2.4
Margins, Leverage, Returns		**FY22A**	**FY23A**	**FY24F**	**FY25F**	**FY26F**
EBITDA		0.4%	0.2%	3.3%	6.8%	7.2%
EBIT		(1.5%)	(2.0%)	1.4%	5.7%	6.5%
NPAT pre significant items		(16.2%)	(25.9%)	0.1%	3.5%	4.1%
Net Debt (Cash)		3.3	(6.3)	(4.9)	(3.0)	(6.8)
ND/ND+Equity (%) (%)		933.1%	34.0%	28.5%	15.7%	24.6%
EBIT interest cove (x)		n/a	n/a	1.1	8.6	9.8
ROA		n/a	n/a	1.5%	7.1%	7.4%
ROE		n/a	n/a	0.7%	28.0%	24.9%
ROIC		n/a	n/a	11.2%	53.4%	47.8%
Working capital		6.8	8.6	9.3	14.5	14.7
WC/Sales (%)		5.9%	12.4%	9.7%	12.6%	13.1%
Revenue growth		6.3%	(40.3%)	37.9%	19.8%	(1.7%)
EBITDA growth pa		n/a	n/a	1722%	146%	5%
Pricing		**FY22A**	**FY23A**	**FY24F**	**FY25F**	**FY26F**
No of shares (y/e) (m)		651	1,076	1,076	1,076	1,076
Weighted Av Dil Sl (m)		710	791	1,163	1,163	1,163
EPS Reported (A$ cps		(1.91)	(1.66)	0.01	0.57	0.66
EPS Normalised/E cps		(0.82)	(0.75)	0.01	0.57	0.66
EPS growth (norm/dil)		n/a	n/a	n/a	4921%	16%
DPS cps		-	-	-	-	-
DPS Growth		n/a	n/a	n/a	n/a	n/a
Dividend yield		0.0%	0.0%	0.0%	0.0%	0.0%
Dividend imputation		0	0	0	0	0
PE (x)		n/a	n/a	1,490.0	29.7	25.7
PE market		18.0	18.0	18.0	18.0	18.0
Premium/(discount)		n/a	n/a	8177.8%	64.9%	42.6%
EV/EBITDA		134.4	366.9	35.1	14.5	13.4
EV/Revenue		0.6	0.9	1.2	1.0	1.0
FCF/Share (A$) cps		(4.8)	(2.7)	(0.2)	(0.2)	0.6
Price/FCF share x		n/a	n/a	n/a	(71.6)	29.7
Free Cash flow Yield		(28.5%)	(16.0%)	(1.4%)	(1.4%)	3.4%

Source: RaaS estimates; Company data for actuals

FINANCIAL SERVICES GUIDE

RaaS Research Group Pty Ltd

ABN 99 614 783 363

Corporate Authorised Representative, number 1248415, of

BR SECURITIES AUSTRALIA PTY LTD; ABN 92 168 734 530; AFSL 456663

Effective Date: 26th March 2024

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