STOCKS DOWN UNDER

25 FEBRUARY 2022

ASX Small Caps Stocks Down Under

Behind every stock is a company. Find out what it's doing.

- Peter Lynch (b. 1944), Investor

FLUENCE

We'll drink to it

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Stocks Down Under rating: ★★★★

ASX: FLC
Market cap: A$121.9M

52-week range: A$0.15 / A$0.26
Share price: A$0.20

When we last covered Fluence Corporation, at the back end of the Corona Crash on March 20, 2020 , we used the phrase "Immune to Corona" as a title for the report. Indeed, demand for Fluence's products was not affected by the pandemic, but this has not been reflected in the company's share price. It has been a tough time for shareholders, but we still believe their patience will pay off. We are encouraged by the company's restructuring in late 2020 that shifted focus towards high margin products and China's continued embracing of the company despite investor fears to the contrary.

Share price chart

Source: Tradingview

Water: An urgent need

Fluence is an industrial company specialising in wastewater treatment. Fluence was born from the merger of Emefcy and RWL Water back in 2017. Fluence's largest shareholder is Estee Lauder's son Ronald Lauder, who owns over 20% of the shares. Second is current CEO Richard Irving, who co-founded Silicon Valley venture capital firm Pond Venture Partners, an Emefcy investor.

Fluence has three key segments. First, a water treatment project in Cote d'Ivoire. Second, desalination solutions in the Middle East and Southeast Asia – Nirobox. And third, wastewater treatment solutions and plants, which utilise a technology known as Membrane aerated biofilm reactor (MABR). MABR delivers oxygen to the wastewater allowing 'helpful' bacteria to grow.

Fluence is not the only water treatment stock on the ASX but is a pure play company and has a unique focus on developing markets, such as China, Egypt and Brazil. It generates revenue from selling its technology and plants and is increasingly selling the treated wastewater separately.

Water as a Service

Humanity needs clean water to survive and this need grows more urgent as the world's population continues to rise. There are over 2 billion people facing water shortages and this number is forecast to rise as the global population heads towards 9.7 billion by 2050. Developing countries are investing heavily in water sourcing technologies, including wastewater treatment. To be clear, 'treated' wastewater isn't reused for drinking water, but secondary purposes such as irrigation and toilets. Wastewater is also treated because untreated water is a petri dish for several diseases.

Countries are deviating towards decentralized systems, such as Fluence's, which treat wastewater at the point of need, rather than centralized systems. This is because they achieve superior results, but with far less space, odour and noise, while being faster and cheaper to install. These also achieve higher gross margins for operators – Fluence estimates its portfolios achieve a margin of at least 25%.

OK, so why is the share price down?

Long term shareholders might be forgiven for being fatigued with the company given its underperformance relative to the market since it listed – and the past couple of years since we last covered Fluence has not been an exemption. We think investors have over-estimated the impact of COVID-19 travel restrictions and lockdowns on their business. And while the company has become EBITDA positive, it has taken a few years. But we also think Fluence was a victim of the 'China sell off' on the ASX.

Many ASX companies with substantial business with China have suffered from deteriorating relations at the government level and their share prices have followed. Prominent examples include **A2 Milk (ASX: A2M)** and **Treasury Wine Estates (ASX: TWE)**. But Fluence is in a different boat to those companies. For a start, those companies' goods are discretionary items, produced in Australasia and exported to China. But Fluence produces its products in China and it is addressing a societal issue that is urgent for Beijing. China only treats 25% of rural wastewater and is ramping up spending to increase that number. China's most recent Five-Year Plan committed US$50bn towards wastewater treatment systems through to 2025.

Furthermore, China is not Fluence's only market. In the December quarter, it sold more MABR capacity outside China than within it – including in Cambodia, the United States, UAE and the Caribbean. The order from Cambodia was particularly noteworthy, because it will ultimately become the largest MABR plan in the world, treating wastewater from 160,000 people.

More expensive than its peers, but is it worth it?

In CY2022 , Fluence expects $3m in EBITDA, although consensus estimates are for $5.7m in EBITDA and $181.4m in revenue. With an EV/EBITDA ratio of 17.6x, Fluence isn't cheap for a company with modest EBITDA, but we believe it deserves a premium to its peers, such as Purifloh (ASX: PO3) and Sunrise Energy Metals (ASX: SRL) considering it is earnings positive. We are also bullish about the global demand for clean water over the coming decades and think it is a positive tailwind the company can benefit from.

So, four stars from us.

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