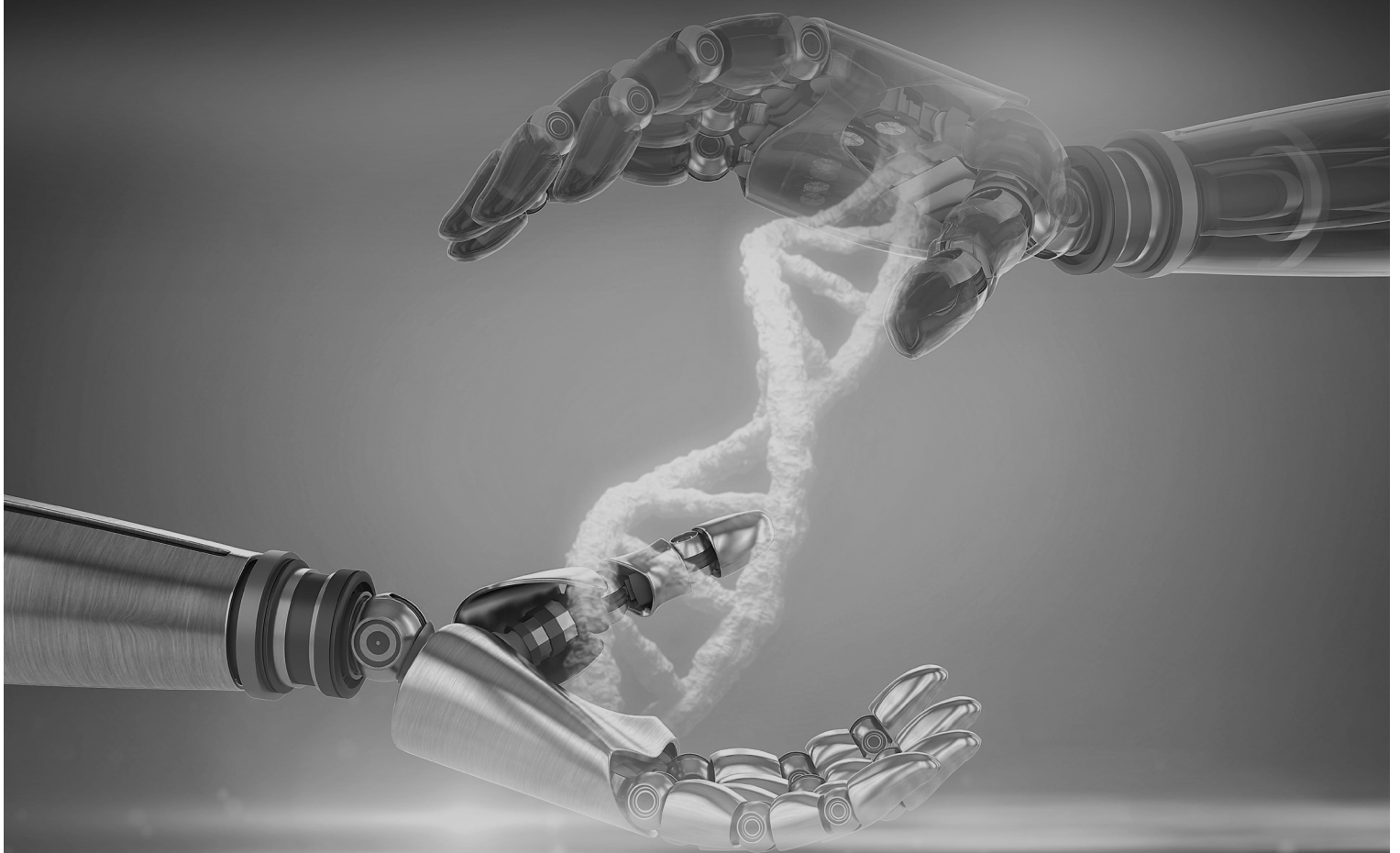




Emerging Stocks Down Under

🗉 *Every problem has two handles. You can grab it by the handle of fear or the handle of hope.* 🗉

- Margaret Mitchell (1900-1949), Author of 'Gone with the Wind'



PHOSLOCK ENVIRONMENTAL TECHNOLOGIES

New management in charge

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New management in charge

Stocks Down Under rating: ★★★★★

ASX: PET
Market cap: A\$27.4M

52-week range: A\$0.038 / A\$0.12
Share price: A\$0.04

Phoslock is one of a handful of ASX-listed companies that are trying to clean the world's waterways. It has technology that can remove excess nutrients, such as phosphates and nitrogen, from water and water bodies. This not only helps address water shortages, but also polluted waterways from impacting fish stock. The company's mission is admirable, but it has spent much of the last two years suspended due to accounting fraud. With a new management team and shares reinstated to trading, is it back to business as usual?

Share price chart



Source: Tradingview

That was then...

Long suffering shareholders will want to move on, but we should recap what has happened in the past couple of years for the sake of investors who are unfamiliar with this company. In August 2019, it forecasted its profit for FY19 (which is the calendar year) to be \$6-\$8m from \$27-\$30m revenue – the latter would have been a 55% gain. This forecast was reiterated in October. During the September quarter of 2020, four of Phoslock's directors sold down \$37.8m in shares to 'satisfy significant institutional demand'. Ultimately, the company only made \$24.5m in revenue and \$3m in profit.

In the first half of CY20, it made just \$1.2m in revenue, 78% of which came from just three customers in China and Brazil. After a \$10.8m cash inflow for 1HY19, it recorded a cash outflow of \$8.4m.

The onset of the pandemic in China - not to mention the nature of Phoslock's contracts providing for longer payment terms based on back-ended periodic payments and performance milestones - led to a significant number of customers not making payments. In September 2020, the company revealed that KPMG was investigating accounting irregularities at its Chinese operations and shares were suspended. The investigation discovered fraud, falsified revenues, improper tax reporting and misappropriation of funds and resulted in an en-masse departure of employees.

...and this is now

Phoslock was reinstated to the ASX in mid-September 2022. Naturally, shares are a fraction of their former value as investors scrambled to take tax losses. Revenues for 1HY22 were in line with the prior corresponding period at \$1.3m. It was in positive territory at the gross profit level of \$0.72m and this was a slight improvement from \$0.68m 12 months ago. But it was in the red on the EBIT level (by \$5.3m) and NPAT level (by \$6.5m). It had \$17.5m in cash at bank (down from \$30m a year ago).

The company admitted sales were relatively small, but were in line with expectations as the company sought to rebuild itself despite port disruptions and project delays. In April, the board approved a \$1m investment in its China manufacturing facility to enable a capacity of 6,000 tonnes per annum, the level of sales required to break even at current costs. It is also trying to diversify beyond China, looking to build a new manufacturing facility in the USA and securing projects in the USA as well as in Europe.

New management

Chairing the board is David Krasnostein, a former CEO of MLC Private Equity and Chief Counsel at NAB. The Managing Director and CEO is Lachlan McKinnon, a former Nufarm executive. And one other notable board member is Brenda Shanahan who has served on the boards of a number of companies, including Clinuvel (ASX:CUV). The company concluded its recent half-yearly report by telling shareholders the short-term outlook was challenging, but that the longer-term outlook was more positive as COVID impacts began to recede.

The September quarter (3Q22) was somewhat better than the June quarter (2Q22). Phoslock significantly reduced its cash outflow from \$3m to \$1.9m. It won distribution rights to phosphorus absorbing pellets made by US-based company Water Warriors, in a two-year deal that covers several global markets. It has had significant success in Chinese courts in obtaining orders for payments of outstanding receivables, but is still fighting for proceeds to be reclaimed.

The company boasted that several directors acquired shares on-market and that this represented a vote of confidence in its future prospects. Robert Prosser and David Krasnostein bought \$25k worth of stock each while Lachlan McKinnon bought \$50k.

It depends on whether or not you trust the management

Henry Ford said, 'you cannot build a reputation on what you are going to do'. We admit this is a company you are buying into primarily on that basis because the short term looks uncertain.

However, it can be accepted that the demand for solutions such as Phoslock's will continue to grow. The company's exposure to China will concern some investors due to China's COVID Zero policy. While it is diversifying its horizons, China will remain an important market for the company and it would be wrong to abandon it completely. This is not only because of the population, but also the presence it has established in the country. And remember that, unlike some companies with issues in China, Phoslock's problems are not with the lawmakers, but with the companies it has sought to do business with. We expect the new management to be more prudent in this regard.

Nevertheless, we state again that investors expecting to make money from this company will be expecting that things are smooth sailing from here on out and any short-term issues are minor. For these investors, we think this one is four stars. However, other investors may want to wait at least until the company has sorted its accounts receivables in China, maybe even until it becomes cash flow or NPAT positive.

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