Phoslock Environmental Technologies Ltd (ASX:PET)

Listed shares: *542.0 million ord fp*
10.5¢ perf. options: *20.2 million, expiring 20 Dec 2019*
Total securities: *562.2 million*

Share price: *39.5¢ as at 1 March 2019*
Market cap: *$214m on listed shares, $222m fully diluted*

Latest financials and guidance for 2019

- On 28 February PET reported for the six months to 31 December 2018 and hereafter it will report on a December year basis. Profitability was much as expected aside from the large "expense" for options issued to executives in 2017.

- I calculate that for calendar 2018, revenue was $18.9m up 130%, EBITDA was $3.6m up ten-fold, and net profit prior to options expense was $2.3m compared with a loss of $0.4m in the previous year.

- While receivables from Chinese customers were very high at the end of the year, so that total receivables were $17.8m or 94% of sales revenues in the year, the position was unwound by $9.5m in January as these customers at last paid their bills.

- Inaugural guidance for 2019 is for total revenue of $27-30m, up 55%, and for pretax profit (prior to options expense) of $6-8m, about double what it was in 2018.

- These numbers are a little lower than I had assumed so my profit projections and valuation have been revised down by some 10%, the latter now being 73¢, but the story remains highly attractive.

- The key to performance is sales revenues of course. If some of the very large projects in the pipeline come to fruition over the next several years, then my estimates will be way too low.

- PET's business in China is run by a Chinese management group with input from the company's two directors resident in China. They are also senior executives of BHZQ, a strategic partner and key customer of PET in China. BHZQ is a 70%-owned subsidiary of BEWG, the largest water treatment company in Asia, which is controlled by the Chinese government but listed on the Shanghai and Hong Kong stock exchanges. The BHZQ executives on PET's board are minority shareholders in both BHZQ and PET, but it is through their PET shareholdings that they could be rewarded best.

Phoslock Environmental Technologies Ltd (PET)

Share price 39.5¢, current issued shares 542.1 mill, mkt cap $214m

December yrs	17a	18a	19e	20e	21e	22e
Profitability ($m)						
Sales revenue	8.1	18.7	30.0	46.6	64.2	78.0
Cost of sales	3.9	9.2	14.7	22.8	31.5	38.2
Gross profit	4.3	9.5	15.3	23.8	32.8	39.8
Margin	52%	51%	51%	51%	51%	51%
Interest income	0.0	0.0	0.1	0.1	0.1	0.2
Other income	0.4	0.7	0.4	0.4	0.4	0.4
General expenses	4.3	6.6	7.4	8.0	8.6	9.2
EBITDA	0.3	3.6	8.3	16.2	24.6	31.1
Cost finance/opts	2.0	3.5	0.5	0.0	0.0	0.0
Depn/Impairmt	0.0	0.2	0.3	0.3	0.3	0.3
Pretax profit	-1.7	-0.1	7.5	15.9	24.3	30.8
Income tax	0.4	1.0	1.6	3.2	4.9	6.1
Net profit excl. mi	-2.1	-1.2	6.0	12.7	19.5	24.6
EPS (¢)			1.1	2.3	3.5	4.4
EPS (¢) fully diluted			1.1	2.3	3.5	4.4
PE			34.4	17.4	11.4	9.0
Growth in dil EPS			245%	97%	53%	26%
DPS(¢) declared for year			0.0	0.0	0.0	2.6
Cash flow ($m)						
From operating activities						
Sales receipts	5.5	6.6	22.4	37.5	54.6	68.7
Paymts to supplie	-8.6	-16.0	-21.2	-31.0	-40.5	-48.2
Other	-0.3	-0.7	-1.5	-2.3	-3.9	-5.3
Total	-3.4	-10.1	-0.3	4.2	10.1	15.2
From investing activities						
Capex	-1.2	-0.6	-0.4	-0.5	-0.5	-0.5
Other	0.0	-0.1	0.0	0.0	0.0	0.0
Total	-1.2	-0.6	-0.4	-0.5	-0.5	-0.5
From funding activities						
Debt	-0.4	-0.3	0.0	0.0	0.0	0.0
Equity	11.7	8.8	3.5	0.0	0.0	0.0
Dividends	0.0	0.0	0.0	0.0	0.0	-7.4
Total	11.3	8.5	3.5	0.0	0.0	-7.4
Cash position						
Change from abov	6.7	-2.3	2.8	3.8	9.7	7.3
Forex movements	0.0	0.1	0.0	0.0	0.0	0.0
Closing	7.4	4.9	7.6	11.4	21.1	28.4
Balance sheet ($m)						
Current assets						
Cash	7.0	4.9	7.6	11.4	21.1	28.4
Receivables	4.3	17.8	25.7	35.2	45.2	54.8
Inventories	1.5	2.4	2.9	4.6	6.3	7.6
Other	0.4	0.4	0.6	0.7	0.7	0.8
Total	13.3	25.5	36.9	51.8	73.3	91.6
Non-current assets						
Plant & equipmer	1.3	1.5	1.6	1.8	2.0	2.2
Other	0.0	0.5	0.9	0.9	0.9	0.9
Total	1.3	2.0	2.5	2.6	2.8	3.0
Current liabilities						
Payables	1.3	2.1	3.5	5.0	6.3	6.9
Debt	0.3	0.0	0.0	0.0	0.0	0.0
Provisions	0.4	0.4	0.7	0.7	0.8	8.2
Income tax	0.4	0.9	1.1	1.1	1.1	1.1
Total	2.3	3.5	5.3	6.9	8.2	16.2
Non-current liabilities						
Debt	0.0	0.0	0.0	0.0	0.0	0.0
Provisions	0.0	0.0	0.1	0.1	0.1	0.1
Total	0.0	0.0	0.1	0.1	0.1	0.1
Equity						
Issued capital	51.1	59.9	63.4	63.4	63.4	63.4
Reserves	0.7	6.0	4.0	4.0	4.0	4.0
Retained earning:	-39.4	-41.9	-35.8	-23.1	-3.6	6.2
Shareholder equit	12.4	24.0	31.6	44.3	63.8	73.6

Valuation ($m) as at 31 December 2018			
Discount rate	*5%*	*10%*	*15%*
Operations	933	400	202
Future equity raisings net of buybacks	3	3	3
Cash 31 Dec 2018	5	5	5
Debt 31 Dec 2018	0	0	0
Total	942	408	210
$ per share fully diluted	1.67	0.73	0.37

Valuation based on DCF of future cash flows.

NCF prior to dividend payments grows 10% pa beyond 2025.

Per share data based on 562.2 million shares after exercise of options.

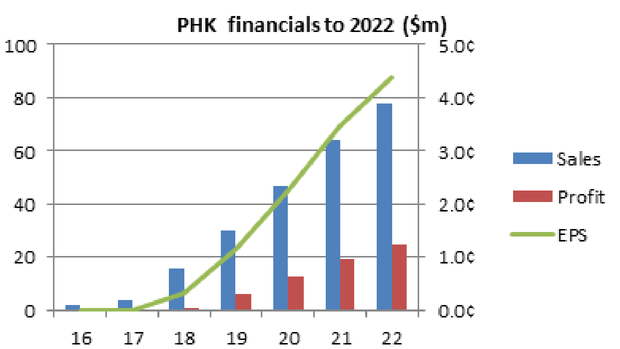
Central valn of 73¢ equates to PEs of 66.4 and 32.0 on 2019 & 2020 eps.

Increase in valuation over time at a discount rate of 10% pa and revenue growth of 10% pa beyond 2025

As at 31 Dec	*2018*	*2019*	*2020*	*2021*	*2022*
Operations	400	453	512	554	595
Future net equity raisings	3	0	0	0	0
Cash	5	8	11	21	28
Debt	0	0	0	0	0
Total	408	461	524	575	623
$ per share fully diluted	0.73	0.82	0.93	1.02	1.11

Valuation ($/share) as at 31 Dec 2018 at a range of discount rates and of growth rates beyond 2025

		Discount rates		
		5%	*10%*	*15%*
Growth rate 5% pa	*5%*	0.99	0.49	0.28
Growth rate 10% pa	*10%*	1.67	0.73	0.37
Growth rate 15% pa	*15%*	3.08	1.18	0.54



Company description

Phoslock is an environmental company specialising in engineering solutions and water treatment products to remediate impaired lakes, rivers, canals and drinking water reservoirs. Although headquartered in Sydney its key focus is in China where its factory and engineering staff are based.

One of its key products is PHOSLOCK, a clay-based product containing lanthanum which inhibits the formation of blue green algae by binding with phosphorus. This is exported from China to around the world. Other products such as zeolites (to reduce nitrogen levels) and certain bacteria are important in China.

Most revenue is derived in China which offers substantial growth potential given that State's determination to remedy its severe water problems.

The six months ended 31 December 2018

Summary

Sales revenue and gross margin were in line with previous disclosure. However, the company suffered a loss of $0.7m largely due to the cost of issued options, deemed by the auditors to be $1.8m. I have reservations about the accounting treatment of options and believe excluding this theoretical non-cash cost results in a truer picture of performance.

Figure 1: Half yearly performance ($000 except where indicated)

December half years	2017 actual	2018 actual	chge %	2018 estimate	Diff	% diff
Sales revenue						
China	3,417	7,814	+129%	7,800	+14	+0%
International	2,588	1,172	-55%	1,500	-328	-22%
Total	6,005	8,986	+50%	9,300	-314	-3%
Gross profit						
Sales revenue	6,005	8,986	+50%	9,300	-314	-3%
Cost of sales (excl. depn)	2,436	3,989	+64%	4,557	-568	-12%
Profit margin	3,569	4,997	+40%	4,743	+254	+5%
Profit margin %	59.4%	55.6%	-6%	51.0%		+9%
Other revenue						
Interest income	4	8	+100%	3	+5	
Export and R&D grants	162	308	+90%	480	-172	-36%
Other revenue	26	21	-19%		+21	
Total other revenue	192	337	+76%	483	-146	-30%
General expenses						
Employees	1,280	1,508	+18%	1,550	-42	-3%
Other (excl. depn)	1,337	2,105	+57%	1,550	+555	+36%
Total	2,617	3,613	+38%	3,100	+513	+17%
Profit						
EBITDA	1,144	1,722	+50%	2,126	-404	-19%
Financing cost	84	0		0	-	
Deemed value of options issue	114	1,782		900	+882	+98%
Foreign exchange losses/(gain	15	-39			-39	
Impairment						
Depreciation and amortisatioı	25	122	+387%	80	+42	+52%
Pretax profit	906	-143		1,146	-1,289	
Income tax expense	376	526		400	+126	
NPAT	530	-669		746	-1,415	
Excluding options expense	644	1,113	+73%	1,646	-533	-32%

Depreciation totalled $122,000 in the half year. The company included $64,000 of this in cost of sales, whereas I have removed this expense from cost of sales and included it below the EBIDA line. PET does not highlight EBITDA but I think it is a useful concept.

Source: Company reports, my spreadsheet.

Comparisons

Compared with the previous corresponding period (pcp) sales revenue increased 50%, and comprised China up 129%, much as I expected, and International down 55%. The fall in International is a concern on the face of it but revenue at this early stage of the ramp-up is lumpy and it appears that some was deferred into 2019.

Gross profit margin of 55.6% was a little lower than in the pcp but higher than my estimate of 51%, so expressed in dollar terms it was 40% higher than previously and 5% higher than I had estimated.

Other than employee costs, general expenses were 36% higher than I had thought they would be and as a result of have increased my projections for 2019 and beyond.

The result of all the above was that EBITDA of $1.7m was 50% higher than in the pcp but 14% below my estimate.

The bottom line is that net profit excluding the options expense was up 73% to $1.1m.

The 12 months ended 31 December 2018

From previous half yearly data (actuals for Dec half years, derived from June year data for June half years) I have constructed calendar year data for 2016 through 2018, to facilitate comparisons. These are shown in Figure 2. Key points:

- Sales revenue in 2018 was $18.9m up 130% on the previous year. Within that, China was up 350% and International was down 37%. The company explained to me that the variation in International is because it is lumpy. I think the main contributor in 2017 was $1.2m from treating a lake in Poland. The running has since been taken up in other jurisdictions.
- An intriguing fact is that sales revenue in the Dec H was less than that in the Jun H for both China and International.
- Gross profit was up 122% to $9.5m, reflecting a gross margin of 50.6%.
- Other revenue was up 74% to $0.7m.
- General expenses were up 52% to $6.6m, reflecting the increased scale of operations in China. This includes employee-related costs of $3.0m up 31% and other costs up 75%.
- EBITDA was up more than 10 times to $3.6m.
- Net profit (excluding options expense) improved from a loss of $0.4m to a profit of $2.3m.

Figure 2: Calendar year comparisons ($000 except where indicated)

Calendar years	2016 actual	2017 actual	2018 actual	chge %
Sales revenue				
China	120	3,504	15,765	+350%
International	2,899	4,623	2,923	-37%
Total	3,019	8,127	18,688	+130%
Gross profit				
Sales revenue	3,019	8,127	18,688	+130%
Cost of sales (excl. depn)	1,907	3,871	9,236	+139%
Profit margin	1,112	4,256	9,452	+122%
Profit margin %	36.8%	52.4%	50.6%	-3%
Other revenue				
Interest income	2	4	22	+389%
Export and R&D grants	360	345	508	+47%
Other revenue	14	48	162	+242%
Total other revenue	376	397	692	+74%
General expenses				
Employees	1,587	2,292	3,000	+31%
Other (excl. depn)	1,347	2,038	3,564	+75%
Total	2,933	4,329	6,564	+52%
Profit				
EBITDA	-1,445	324	3,580	+1006%
Financing cost	446	250	-1	
Deemed value of options issue	0	1,715	3,484	+103%
Foreign exchange losses/(gain	0	37	-13	
Depreciation and amortisatio	71	44	246	+464%
Pretax profit	-1,962	-1,722	-135	
Income tax expense	0	376	956	
NPAT	-1,962	-2,098	-1,091	
Minorities	24	45	107	
NPAT attributable to sharehol	-1,986	-2,142	-1,198	
Excluding options expense	-1,986	-428	2,286	

Depreciation totalled $246,000 in 2018. The company included some of this in cost of sales, whereas I have removed this expense from cost of sales and included it below the EBIDA line.
Source: Company reports, my spreadsheet.

Projection for 2019 calendar year

Details of my estimates are provided on page 2 of this report.

Sales revenue 2019

The company's guidance is for total revenue of $27-30m. My previous estimate of sales revenue was $34m and I have decided to drop the estimate to $30m. This would be a 61% increase on the previous year. I believe the company is being deliberately conservative and I would hope to be able to increase the estimate in coming months.

I assume China sales will be $26.0m up 65% and International will be $4.0m up 37%

Profit 2019

The company's guidance is for net profit before tax and option expense to be $6-8m.

My estimate for the above is $8.1m, whereas previously it was $10.9m. The new estimate assumes a 51% profit margin (noting that I exclude depreciation of the factory from cost of sales), other revenue of $0.4m (implying total revenue of $30.4m), general expenses of $7.4m (up 13%) and depreciation and amortisation of $0.25m (up 2%).

My NPAT estimate is $6.5m after income tax of $1.6m and an options expense of $0.5m. But the latter is just a plug – I have no idea what it will be and in any case it doesn't much matter – it is an accounting construct. Given that there will be no outstanding options at the end of the year, this "expense" won't be levied in future years.

Cash position 2019

My current estimate of the cash position at the close of 2019 is $7.6m compared with my previous estimate of $10.8m and the December 2018 figure of $4.9m. One of the key assumptions is the receivables position, noting that the position of $17.8m at 31 December equated to 94% of sales in the preceding 12 months. One reason for the build-up was that work on the second wetlands project was finished and invoiced in December, and another reason is that Chinese customers generally desire to show a good cash position at the end of the year, and thus January is when they pay their bills, not December. This proved to be the case for PET with $9.2m received from receivables in January, reducing trade receivables to $8.5m at the end of the month.

I believe a similar pattern will be seen in future. I allow for receivables to increase a further $7.9m to $25.5m in 2019, which equates to 85% of sales revenues in the year.

During the year I allow for all remaining performance options to be exercised, providing proceeds of $3.5m. Without this cash injection the cash position would actually decline over the year.

Longer term projections

Profitability

The company's profit level is determined primarily by sales revenues and to a smaller extent by its gross profit margin, and to a still smaller extent by its general costs.

I allow for sales to increase broadly by the same growth factors as I assumed previously, but of course coming from a smaller base for 2019, the estimates have declined 10%.

I have left unchanged my estimate of 51% gross profit margins (noting that I have a different definition from the company in that I exclude depreciation of the factory from cost of sales), while projections for general costs have increased by up to $1m annually.

The net result is that profit estimates have been revised down by up to 19%.

Profit growth remains impressive. It more than doubles in 2020, increases by a further 53% in 2021, by another 26% in 2022, and so on.

Figure 3: New revenue and profit projections

	2019	2020	2021	2022	2023
Sales revenue					
China	26.0	41.6	58.2	71.1	83.8
International	4.0	5.0	6.0	6.9	7.7
Total	30.0	46.6	64.2	78.0	91.6
Previous (Feb 2019)	34.0	52.1	71.4	86.4	101.2
Revision	-12%	-11%	-10%	-10%	-10%
Sales revenue growth					
China	65%	60%	40%	22%	18%
International	37%	25%	20%	15%	12%
Average	61%	55%	38%	21%	17%
Previous (Feb 2019)	82%	53%	37%	21%	17%
EBITDA					
Current projection	8.3	16.2	24.6	31.1	37.5
Previous (Feb 2019)	11.2	19.8	29.1	36.2	
Revision	-26%	-18%	-15%	-14%	
Net profit after tax					
Current projection	6.0	12.7	19.5	24.6	29.7
Previous (Feb 2019)	8.3	15.7	23.1	28.8	34.3
Revision	-28%	-19%	-16%	-15%	-13%
Growth					
Sales revenue	61%	55%	38%	21%	17%
EBITDA	132%	95%	52%	26%	21%
NPAT		114%	53%	26%	21%

All figures in $m unless otherwise indicated

Source: My estimates

Dividends and capital returns

I allow for dividend payments to commence in 2022, the year in which retained earnings turn positive, which is a year later than my previous forecast. I allow for 2.6¢ to be declared in 2022, increasing strongly thereafter, using a 60% payout ratio.

Cash flow

On my numbers cash from operations will be slightly negative this year then increase to $4m in 2020, $10m in 2021 and $15m in 2022. A projected initial dividend payment of $7.4m in 2022 would be readily accommodated.

Potential for higher profits than forecast

My current profit projections are of the vanilla variety. They could be far too conservative if all goes well with a number of very large projects in the offing.

The International project pipeline over the next two years is $20-25m, not all of which will convert to sales during the period, but nevertheless my estimate of International revenue of just $9m over the two years would appear to be conservative. Beyond that the International pipeline includes a number of lake projects which aggregate to $40-60m, and another of $50m all by itself, all of which require governmental approvals and funding. Not all of these will come to fruition and those that do will take place over a number of years, but certainly the potential is much higher than my forecasts indicate.

As for China, no figures were put forward by the company because it was thought too speculative to do so. The directors intend to get a better handle on project probabilities over the next few weeks during meetings in China. What can be said with confidence is that the potential is vast. There are many large projects in the offing. At the very large end of the scale, one is over $50m and one is over $100m. For this size of project, the company is already engaged in what could be described as Stage 1 work, wherein PET's capabilities are being tested on a relatively small scale of $0.5m to $2m. There might be four or five stages of work for each of these large projects, each stage many times bigger than the last, and securing each stage will depend on the outcome of the previous stage.

Valuation and share price target

Valuation

My central DCF-based valuation, basis 31 December 2018, is now sitting at 73¢, down 9¢ from the previous valuation. A year ago, I had a valuation of around $1 but it seems to slip a bit each time I revise it, mainly because although revenue growth is still very strong, the initial year or two has seen my expectations trimmed a little.

As was the case previously, the valuation assumes net cash flow prior to dividends will grow at 10% annually beyond 2025, and is after applying a discount rate of 10% p.a.

The valuation will increase in future years all other things being equal and for example my estimate as at 31 December 2019 would be 82¢. As at the end of 2020 it would be 93¢.

I would again caution that these valuations are sitting in a wide range of possibilities dependant on not just growth rates and long term discount rates, as is detailed on page 2 of this report, but a whole host of other factors.

But the "elephant in the room" is the possibility of much higher sales than my central forecast. My feeling is that the valuation should probably be considerably higher but it is difficult to put a number on it.

Share price target

At the current share price the forward PE's (basis 2019 and 2020) are 34.4 and 17.4. These are more than justified by the longer term growth outlook, so there is some scope for further price appreciation, but I would think perhaps not quite as much as the price suggested by the DCF valuation at this point in time.

But looking out a year and assuming for the sake of the exercise that my earnings projections are correct, the forward PEs (basis 2020 and 2021) at the current share price would be 17.4 and 11.4. These would be too low given the growth potential. I would think a share price of perhaps 80¢ could be justified, which would place the stock on forward PEs of 35 and 23. The justification would be derived not just from the valuation (it would be 92¢ by then) but also by increased investor confidence in the story and by the continued strong earnings growth outlook. The PE to growth (PEG) ratios at a share price of 80¢ would be 0.7 in both years.

As discussed elsewhere in this report, there is potential for much higher revenues than my central estimate. That of course would immediately translate to a higher share price.

Corporate

More options exercised

My previous report dated 5 February contained details then prevailing of directors, equity structure and shareholders. I would refer you to that report for those details.

Since then there have been two changes to the equity structure

1. On 12 February it was announced that the vesting conditions for the 15 million performance options issued to Australian executives had been achieved. In my previous report I had expected such an announcement any day.
2. On 18 February a further 1,150,000 performance options were exercised at 10.5¢, taking the total exercised so far this half year to 13,350,000 options. It leaves a balance of 20,150,000 options remaining to be exercised.

Given that the options were exercised just days after the Australian executives' options were vested, one would assume it was one or more of those employees who took this action. Possibly the shares were immediately sold to meet personal financial obligations.

The remaining 20,150,000 options expire on 20 December 2019. I continue to assume they will all be exercised.

Disclosure
I have not received any remuneration from any person for this report.
Associated entities own 6.2 million shares in PET at the time of writing.

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