

# **Ballard Power Systems Inc. (BLDP) Q1 2024 Earnings Call Transcript**

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**Body**

Ballard Power Systems Inc. (BLDP)

Q1 2024 Earnings Conference Call

May 07, 2024 11:00 AM ET

Company Participants

Kate Igbalode - Vice President, Investor Relations

Randy MacEwen - Chief Executive Officer

Paul Dobson - Chief Financial Officer

Conference Call Participants

Rob Brown - Lake Street Capital Markets

Aaron MacNeil - TD Cowen

Saumya Jain - UBS

Mac Whale - Cormark Securities

Rupert Merer - National Bank

Jordan Levy - Truist Securities

Craig Shere - Tuohy Brothers

Vikram Bagri - Citi Capital

Presentation

Operator

Thank you for standing by. This is the conference operator. Welcome to the Ballard Power Systems' First Quarter 2024 Results Conference Call. As a reminder, all participants are in a listen-only mode and the conference is being recorded. After the presentation, there will be an opportunity to ask questions. [Operator Instructions]

I would now like to turn the conference over to Kate Igbalode, Vice President, Investor Relations. Please go ahead.

Kate Igbalode

Thank you, operator and good morning. Welcome to Ballard's first quarter financial and operating results conference call. With us on today's call are Randy MacEwen, Ballard's CEO; and Paul Dobson, Chief Financial Officer.

Given that our 2023 year-end earnings call was only eight weeks ago, we are will keep scripted remarks today relatively brief. We will be making forward-looking statements that are based on management's current expectations, beliefs, and assumptions concerning future events.

Actual results could be materially different. Please refer to our most recent annual information form and other public filings for our complete disclaimer and related information.

I'll now turn the call over to Randy.

Randy MacEwen

Thank you, Kate, and welcome, everyone, to today's conference call. In our last earnings call, in addition to providing 2024 OpEx and CapEx guidance ranges, we outlined four specific milestones that investors can expect from Ballard in 2024.

We noted the following four milestones; first, continued growth in our order backlog; second, a major order announcement from a bus customer; third, a major order announcement from a stationary customer; and fourth, the announcement of our next manufacturing facility.

In Q1, we delivered against each of these four milestones, highlighting our continuing journey to a commercial products company. I would like to comment on each of them in turn.

So, first, on continued growth in our order backlog, we're encouraged with our progress over the past six months with new order intake. After booking record new order intake of $64.7 million in the fourth quarter of 2023, we booked another $64.5 million of new orders in Q1, bringing total new bookings over the past two quarters to almost $130 million, a Ballard record for a six-month period. Our order backlog grew by 38% since the start of the year.

Second, on a major order announcement from a bus customer. Here, we announced a multiyear supply agreement and the largest order fuel cell engines in Ballard's history. The supply of 1,000 engines through 2027 to Solaris for the European bus market. This landmark agreement is a testament to our collaborative partnership with Solaris over the past decade and the progress we've made with our fuel cell engines.

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We have proven our fuel cell engines as safe, reliable, and durable. This agreement also reflects an acceleration in adoption of fuel cell buses in Europe, supported by policy tailwinds and regulations to decarbonize public urban transport fleets.

The transition to zero-emission city buses has accelerated as the value proposition of hydrogen fuel cells is increasingly understood zero-tail pipe emissions, rapid refueling, long daily range in all weather conditions, and scalable refilling infrastructure as fleet sizes increase.

Indeed, we believe we're on the road to achieving scaled deployment of fuel cell buses in the medium term, which is a critical lever to facilitate economies of scale and cost down initiatives, driving improved economics and reduced emissions for fleet operators.

Now, I'd like to linger here for a moment on the bus market. Over the past five months, we've received orders, all repeat orders from existing platform customers for a total of 1,200 engines for fuel cell buses in Europe and North America. This is very, very exciting. We see a tripling of the existing operating fleet in these markets over the next two to three years.

Now, let's move to the third milestone, the announcement of a major order in the stationary market. We announced a multi-year supply agreement and the largest order in Ballard's history for the stationary market in order for 150 engines totaling 15 megawatts of fuel cell systems from a UK-based customer specializing in renewable off-grid power generation. Again, this is a repeat order from an existing customer and reflects a scaling in their market opportunities.

Our customer is targeting the replacement of traditional diesel generators with fuel cell systems that can provide resilient, predictable, clean and quiet solutions for on-site power generation in a variety of applications, including EV charging, filming, events and construction. The customer also has an option to purchase an additional 296 engines by March 2026.

Finally, to turn to the fourth milestone, the announcement of our next manufacturing facility. As context, as part of our local for local global manufacturing strategy, we conducted a comprehensive comparative analysis during 2023 of sequenced production capacity expansion options in North America, Europe and China. Based on our review, we determined to prioritize the US as our next market for production capacity expansion. We announced our plan to build a new manufacturing facility to be located on a parcel of 22 acres of industrial land within the Rockwall Technology Park in Rockwall, just outside of Dallas, Texas.

The facility is expected to have an initial main plate production capacity of 8 million MEAs, 8 million bipolar plates, 20,000 fuel cell stacks, and 20,000 fuel cell engines per year, or the equivalent of 3 gigawatts of fuel cells. Dubbed Ballard Rockwall Giga 1, we plan to manufacture next-generation fuel cell products, incorporating the benefits of our work related to technology innovation and design changes, supply chain collaboration, and the introduction of volume production processes and advanced automation to drive down costs.

We also recently announced two separate non-dilutive funding awards to Ballard, totaling up to $94 million, consisting of 40 million in expected grants from the US DOE Hydrogen and Fuel Cell Technologies Office, and up to another $54 million in expected Advanced Energy Project Tax Credits, known as 48C, funded under the Inflation Reduction Act.

Our capacity expansion plan comes at the very time that platform customers are being clear about what they need from Ballard in the future. They're counting on us to be there for them at volume and at the right cost. The ability for us to demonstrate a clear roadmap to high production volumes at significantly reduced cost is critical to customers transitioning from demonstrations to future scaled deployments.

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With Ballard Rockwell Giga 1, we plan to bring scaled, advanced manufacturing of next-generation fuel cells online in late 2027, at the same time when we expect to reach capacity constraints of our existing North American production facilities based on our forecasted growth and production volumes. We expect to make a final investment decision on this facility later in 2024 and pending completion of certain customary conditions, including necessary approvals and definitive documentation, including with Rockwall and with the U.S. funding sources.

Accordingly, we will provide a detailed review of the plans of Ballard Rockwell Giga 1 during an earnings call later this year. We want to also provide two interesting updates on the rail market so far in 2024. First, one of our customers in the commuter rail market, Stadler, revealed its FLIRT H2 train powered by Ballard fuel cell engines has been entered in the Guinness Book of World Records for the longest distance achieved by a pilot hydrogen fuel cell electric multiple unit passenger train without refueling or recharging an impressive 1,742 miles.

Second, and importantly, on April 16, CSX unveiled its first fuel cell locomotive, developed through its partnership with CPKC where CPKC provides CSX with a powertrain conversion kit using Ballard fuel cell engines to refurbish diesel locomotives. We view this as a very exciting development. We believe hydrogen fuel cells offer the only viable zero-emission powertrain solution to replace or refurbish diesel locomotives in North America.

The total North American fleet is estimated to be around 40,000 locomotives, and notably, CPKC has approximately 2,500 diesel locomotives and CSX has approximately 3,500 diesel locomotives with high power line haul locomotives using 2.4 megawatts of fuel cells, which is equivalent of amount of fuel cells were required to power about 24 buses. We believe this represents a large and attractive addressable market for Ballard.

And before I turn the call over to Paul to review our Q1 financial highlights, I'd like to provide a headline summary of Q1 and some commentary on our setup moving forward.

In Q1, we booked $64.5 million in new orders, increased our order backlog by 38%,

announced total non-dilutive funding of up to $94 million for the planned build-out of our Rockwall Gigafactory, grew revenue by 9%, improved gross margin by 5 points, and reduced cash operating costs slightly, while continuing to invest in next-generation products and product cost reduction.

Looking forward, in the context of an increasingly constructive policy environment, growing order backlog and with sustained investments in product cost reduction in advanced manufacturing capacity expansion, we see an exciting setup for the second half of 2024 and growth in 2025. We are well positioned to enable our customers to compete in the energy transition and the adoption of hydro fuel cells to decarbonize heavy-duty mobility and select stationary power applications.

With that, I'll turn the call over to Paul to discuss our financials.

Paul Dobson

Thanks, Randy. In Q1, Ballard delivered $14.5 million in revenue, driven by strong growth in the bus and stationary verticals. Heavy-duty motive applications accounted for approximately 84% of the total and with added to stationary power, our fuel cell products as a whole represented approximately 88%, once again emphasizing our shift into a commercial products company.

As a reminder, from previous years, we see that Ballard revenue is typically weighted approximately 30%, 70% between the first and second half of the year and heavily indexed to Q4. 2024 looks to be no different.

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Even with the continued shift in revenue mix to power products and the burden of fixed production overhead costs being spread over a seasonally low revenue, gross margin of negative 37% showed a 5-point improvement compared to Q1 2023. We are still anticipating underlying gross margins will breakeven in Q4, as revenue increases and product cost reduction activities have greater impact.

We reported total operating expenses of $37.1 million and cash operating costs of $29.8 million, both relatively flat compared to the prior year comparables. Capital expenditures totaled $7.5 million in Q1. We are maintaining our guidance ranges for total operating expenses and capital expenditures for the year. Our guidance for 2024 includes capital for the initial design and scoping activities for the Rockwell Gigafactory, assuming FID. The expected US government funding for the facility would impact our net capital expenditures in subsequent years starting in 2025. We ended the quarter with a strong balance sheet with cash and cash equivalents just over $720 million.

With that, I'll turn the call over to the operator for questions

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] The first question comes from Rob Brown with Lake Street Capital Markets. Please go ahead.

Rob Brown

Good morning. I want to -- just wanted to follow up on the Solaris order, good scaling there. Are you -- can you give us a sense of sort of what the rollout schedule is and how that market is developing and sort of what the sort of size of the market is and penetration rates you get to by the end of -- kind of by the end of that contract.

Randy MacEwen

Good morning, Rob. Thanks for the question. Maybe just to step back a little bit and just remind everyone, we're really seeing the employments of fuel cell electric bus scaling up both in Europe and North America, driven largely by this transition to zero-emission bus fleets and supported by regulations and strong mandates and, of course, public funding. Just to give you a sense of kind of where we are right now, we at Ballard have about 158 fuel cell buses in operation that have Ballard engines inside in North America and about 398 in Europe. In North America, I think we're probably right at 100% to 99% to 100% market share in Europe over 80%. So we have really good visibility on what's happening in this market. And what you're seeing is that the proven operational advantages of fuel cell buses, including kind of 500 kilometers or 350 miles of range, the ability to have that range consistent for every day and every season and the rapid refueling time, kind of 6 to 12 minutes refill time. And then you add in the complexity that comes with depot electrification as you scale up, we're seeing a lot of operators really revisit their plans going forward. As you see a growing number of cities committing to what I would characterize as a larger deployment. So Bologna, for example, 127 buses, Venice, 90 fuel cell buses, Cologne, 150, Santa Cruis, 57%. You've got many other cities in North America as well, Oakland, Philadelphia, Foothill in the LA Basin area, Las Vegas, New York City and Edmonton in Canada, all kind of committing to fuel cell bus deployments.

So we see probably going from the situation where you have roughly 500 to 600 buses in North America and Europe combined today to thousands, literally in a three, four year period. And so we're tracking a very healthy pipeline and with strong market share with most of the OEMs that are offering fuel cell buses in North America and Europe are powered by Ballard. So we feel very comfortable with our position in the market and the growth opportunity we see.

With Solaris specifically, I don't want to comment on any one customer in their rollout schedule. We'll let them do that. But I would just indicate that we expect those 1,000 engines to be deployed between 2024 and 2027.

Rob Brown

Okay. Thanks for all the color there, Randy. On the Rockwell expansion or new facility what's the CapEx requirements there, I guess, obviously, impacted by the government funding side, but what's the CapEx expected on that facility?

Randy MacEwen

Yeah. Great question, Rob. So we're doing quite a bit of work in parallel right now. We are polishing our project scoping, final budget, time line. There's a lot of work going on completing the facility design, the plant layout looking at the permitting process and finalizing our land acquisition agreement and our EPC contract. There's still some more work on equipment specification procurement. So what we expect to do, Rob, probably on the Q2 or Q3 call, is actually provide a fairly comprehensive review of Rockwell once we get through FID and include a CapEx range at that point. We had kind of indicated if I would put kind of parameters on right now, I would say, in the $100 million to $150 million net of the funding is kind of the parameters, and we'll tighten that up as we get out later in the year.

Rob Brown

Great. Thank you. I'll turn it over.

Randy MacEwen

Great. Thanks, Rob.

Operator

The next question comes from Aaron MacNeil with TD Cowen. Please go ahead.

Aaron MacNeil

Good morning. Thanks for taking the time to answer questions. Randy, you highlighted the upfront incentives to build Rockwell. Obviously, that's great -- kind of step in the right direction. I can also appreciate that a larger update is forthcoming. But I guess, I'm just wondering at a very high level, are there any production tax credits that you can take advantage of? And if the capacity is 3 gigawatts, do you have any early indications of sort of what sort of sales volume you think you need out of the facility for it to break even? And then embedded in that to the extent that you can answer what sort of unit cost reductions do you assume relative to where you are today?

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Randy MacEwen

Yeah. So we've canvassed the US market fairly carefully in terms of incentives. And we actually have other opportunities for this facility beyond the $94 million that we've commented on. And of course, there's a package of incentives that comes with the Rockwell Economic Development Corporation. So I think all in, will likely be higher than $100 million in total support opportunities there, of course, all non-dilutive. So that's very powerful for us as we move forward.

In terms of like kind of unit economics, volume scale, et cetera, to get the profit, I think we'll wait until the upcoming calls to manage those. What I would say is, just to be very clear, we don't have an order book at this time that satisfies the volume of 3 gigawatts that we're talking about. Clearly, we are looking clearly at investing ahead of the adoption curve but of course, we have a sales pipeline that is showing very strong growth indicators across most of our vertical markets and, of course, both for Europe and for North America.

So as we look at our scaling over the next couple of years and basically using the production capacity -- existing production capacity and actually some capacity expansion that's ongoing here for bipolar plates in Burnaby, British Columbia, what we see is kind of meeting capacity constraints in that 2027 timeframe based on our sales pipeline and our forecasting for our financial model.

Aaron MacNeil

Makes sense, happy to wait. I don't want -- I know you don't want to get specific on customers and orders and pricing. But you've mentioned $1,000 per kilowatt in the past for these big orders? Like is that still a good barometer? Or are you giving some discounts in exchange for volume?

Randy MacEwen

Yeah, Aaron, I would say for lower volume orders 1,000 is probably a good proxy. In most cases, we're probably below that, but 1,000 is a good proxy. As you get to higher volume orders, we are seeing, of course, pricing compression there, as we should be. And so this is not -- these type of contracts are not at that level.

Aaron MacNeil

Got it. No, happy to turn it over there. Thanks, Randy.

Randy MacEwen

Great. Thanks, Aaron.

Operator

The next question comes from Saumya Jain with UBS. Please go ahead.

Saumya Jain

How do you guys see Ballard playing out in the U.S. rail market and specifically down the line? And how are you seeing the truck market growth in 2024 as well?

Randy MacEwen

Yeah. So just to clarify your question, I think you're asking about the truck market, is that correct?

Saumya Jain

Yeah and the rail market for U.S.

Randy MacEwen

Oh and rail. Okay. Yeah. So just on the rail market, we'll start rail first. I think one of the market opportunities that's probably not very well understood is the freight locomotive market.

So you have both commuter rail in Europe and I would characterize it as modestly in North America, but certainly, Europe, a larger market opportunity there. As you know, North America, the volume of commuter rail traffic is much later than it is in Europe.

But on the freight locomotive market, as I commented in the opening remarks, basically, you've got a market with about 40,000 diesel locomotives. Those locomotives are refurbished or replaced every 15 years. So roughly speaking, you have about 2,600 locomotives per year.

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If you look at each locomotive, depending on the requirement for that locomotive being up to 2.4 megawatts, let's assume it's about megawatt and half on average per locomotive. You're talking about a couple of billion dollar a year market opportunity just for that market in North America.

So it's a very exciting market opportunity for Ballard. We have, I would say, a couple of year period here over the next few years as customers like CPKC, and we're very excited with the work that CSX is doing as well, as these types of companies continue to validate, the use of hydrogen for locomotive applications, including their hydrogen storage tender solutions.

I think this is the only pathway for decarbonizing. And when you look at the emissions and the costs associated with diesel and the variability of diesel pricing, I think the number one -- Scope 1 emissions is typically around 95% of scope 1 and emissions for these operators is diesel fuel. So this is a real priority for this type of operators who are looking at the future to really look at decarbonization, hydrogen is going to play a big, big role there.

I don't think you're going to see high volume in the next year or two. This is going to take a number of years to validate, but we are very well-positioned with the solutions we have, with the partnerships that we have to play an important role in this market.

On the commuter rail market, we have a number of partners there. Siemens that we've announced for the European commuter rail market. They, obviously, have an increasing presence in the North American commuter rail market too. And then Stadler is another customer for the North American and European market as well.

So we see, I would say, growth in this market by 2030. I think we're going to see very clear validation both to the commuter rail and for the locomotive market that puts it on a very strong pathway moving forward.

For the truck market, this market is actually moving slower than I would like, and there are a variety of reasons for that. We have been focused on what I'll call the truck market opportunities we have returned to base refueling. So think about things like drayage trucks and regional haul trucks that are coming back to the same base or yard at night.

So you can avoid that distributed refilling infrastructure. And we see a number of applications in different weight ranges that will have, I think, hydrogen fuel cells as the primary solution. There will be some battery electric in some of these weight ranges as well. I think it's going to be a mixed solution.

But it is taking longer, and I think the vehicle OEMs who've been investing quite a bit in different technologies, including autonomy, including battery electric are now looking at the hydrogen fuel cell investments as well. So we see a number of opportunities that are in the, I would say, early stages of validation with these customers as they're going through their RFP and RFQ processes and we're very active on this front.

So we are seeing, I'd say, increased activity from truck OEMs, the large credible ones who are looking to bring solutions to market on the 2028 to 2030 time frame. In parallel to that, we're working with a number of what I would call the upfitters. So entrepreneurial companies that see a market gap today and are rushing to market with, in many cases, both battery electric and fuel cell electric depending on the use case and are looking to Ballard to provide them with fuel cell engines.

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And so that upfitter market is a market that we're also working on. So we have two flows of traffic, if you will, two streams of opportunity in the truck market. We're advancing both of them, but it is taking longer than we'd like.

Saumya Jain

Got it. Thank you so much.

Operator

The next question comes from Mac Whale with Cormark Securities. Please go ahead.

Mac Whale

Hi, good morning. As you noted, Randy, strong six months for new orders, I'm wondering, what are your thoughts on the variability of that going forward? I mean, you've seen in the past when you get these big orders and it draw some activity level from the next quarters? Do you think you're through that now with these big long-term sales agreements? Or do you think we're going to see some -- where we should be expecting maybe a little bit more soft on the new order side, your thoughts there?

Randy MacEwen

Yeah. Great question, Mac. What I would say is this is still very much early-stage demonstration market where some customers are earlier in their processes. But I do see that while there will be lumpiness and some of the market opportunities we are pursuing, like, for example, the back-up power market for data centers or the marine market or even the rail market, you're looking at much larger size applications, power applications. And if you get scale orders there, it's quite different than the type of orders you'd see from the bus market.

So I think we're going to see -- continue to see a lot of variability and a lot of lumpiness. It will be based in some part on seasonality and some part, based on when funding sources are available. And of course, a couple of the contracts we've signed are long-term supply agreements with fixed volumes associated with them. So that doesn't happen every quarter. So there will be some variability. But I would see the trend is towards larger order books and the trend is towards getting a smoother cadence of growth going forward. We do see a very strong sales pipeline, expect to see some additional large orders through the year. So our job is to close those out.

Mac Whale

Okay. I guess related to that, I guess as more evidence to support that is -- if you look at the 12-month backlog, it's actually, kind of back to where it was in 2021 when you had -- correct me, if I'm wrong, a lot more technology-related sales in the 12-month order book, is that correct?

Randy MacEwen

Yes. I mean I think that's one thing that's probably been misunderstood in some ways. People kind of look at the revenue as being flat and in some cases, the order book is being flat, which has been true for a number of years, but the composition has changed dramatically, and so we're going to a situation now where we're reaching almost 90% revenue and similar on the order book front and certainly, on the sales pipeline, it's heavily, heavily dominated by the sale of fuel cell engines now. So just as an illustrative example, last year, we shipped over 500 fuel cell engines, a record year for Ballard on that front. You know, in the first quarter, we shipped over 100, which is a record for Q1.

Mac Whale

Okay. And just as a second question, just switching gears on the -- you kind of addressed this a little bit on the giga factory in the US and that's up and running. I know it's still a few years out. What is the contribution margin look like? In the past, you've spoken about contribution margin as opposed to sort of the margins you're reporting. Is there any change in what you expect to see when that's up and running? Not sure you want to frame that? Yes.

Randy MacEwen

Yes. Yes. So we will see a significant reduction in our costs as we move forward on manufacturing. And so when you look at the processes for MEA, the processor for bipolar plate production, the other areas we're seeing significant cost reduction opportunity with automation and different processes that really help with things like yield and scrap rates, et cetera, that all go back to cost.

So we will see a very significant difference in material costs, direct material and direct labor costs as we scale in a high automated facility. And then as from -- as you move from contribution margin to gross margin, then it becomes a function of getting the volume and getting your fixed overhead absorption across a bigger book of business. So -- we're actually very excited about the opportunity for both contribution margin expansion and gross margin expansion, particularly as volume hits in that new facility.

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Mac Whale

Okay. Great. Thanks. That's all my question. Thank you.

Randy MacEwen

Thanks, Mac.

Operator

The next question comes from Rupert Merer with National Bank. Please go ahead.

Rupert Merer

Hi, good morning. Thanks for taking the question. I wanted to follow-up on the cost reduction and pricing strategy. With the orders you've announced recently, are the prices you've offered for larger volumes out to 2027, representative of prices that are sustainable in the long run or to put that another way, are your prices getting to a level that could be competitive with diesel buses on a TCO basis.

Randy MacEwen

Yes. I think what we'll see is that as we move forward, we're going to see -- and this happened very similarly in the solar industry and wind and happen in the battery electric market. There are some variability in those markets, particularly when depending on supply and demand balances, but also very high dependency in some thesis on rare earth metals and certain commodities.

I don't see that going forward here on the commodity front in terms of variability. But what I would say is we're going to expect to see selling price reduction on an annual basis. And our job is to make sure that our cost reduction exceed selling price erosion so that we're effectively seeing margin expansion. And so that's what we currently have in our plan is we're assuming a certain percentage, it varies by year, but there is a kind of an overall blended percentage of cost reduction that customers are expecting. And certainly, in the larger long-term supply agreements that we've been signing up recently, we have cost reduction and selling price -- we have selling price assumptions reductions in there and is supported by cost reduction assumptions that we have in our plan.

Rupert Merer

Great. Thanks. And a follow-up on that. So you've talked about some of the advantages you're going to have scaling up your Bipolar Plate in MEA. Of course, a big part of your cost is coming from balance of plan. Can you give us an update on the cost reductions you're seeing there and the commitments from your suppliers to bringing their cost down to where they need to be?

Randy MacEwen

Yes. Great question. And I think it's worth noting too. Like we're working now on our ninth generation of fuel cell engine. And we've learned a lot through eight generations as you would expect, and including eight generations operating in the field. So we have a massive competitive advantage on this front. But what I would say is we kind of -- if you look at the ninth generation, we have more of what we characterize as an open architecture, and this has enabled us to integrate the DC/DC but also reduce significantly the number of parts, reduce the volume and the weight and improve the powertrain integration and ease of service, but also significantly reducing the manufacturing time or the assembly time, so this is all going to help reduce costs and improve the total cost of ownership for customers.

What I would say is the balance of plant component is a very significant cost reduction initiative at Ballard. We have a fairly large balance of plant team that is working with the supply chain every day on making sure we're improving performance, reliability, availability and uptime, warranty terms, payment terms but importantly, moving down costs. And we've seen a step change cost reductions on a number of components that will be coming into production in 2025. So we're pretty excited about some of the cost reductions we're seeing on the balance of plant components. And we look forward to kind of unveiling the ninth generation of product, including some of the metric improvements that we're seeing there.

Rupert Merer

That's great. Thanks for the color.

Randy MacEwen

Yes. Thanks, Rupert.

Operator

The next question comes from Jordan Levy with Truist Securities. Please go ahead.

Jordan Levy

Good morning, all and thanks for taking my questions. Maybe just to start on the stationary side, as you see work and some of the momentum there with your customer in Europe, maybe if you could just talk to kind of the opportunity size over in that market near-term and then how you see that progressing over the next couple of years?

Randy MacEwen

Yes. I would say so far, we've been fairly constrained in our view on the market opportunity size for kind of the total TAM for the stationary power market. We characterize it kind of around $4 billion. I think that's dramatically understated. I think what's changed in the last year since we kind of assessed that $4 billion market opportunity is really the data center market opportunity.

Obviously, there's a lot of publications out the last six months on the growth and the expected growth of the data center market. And the number one challenge the data center operators have, particularly the hyperscalers is the access to green energy.

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And then I would say, number two, importantly, is having the opportunity to get permitted quickly. And one of the challenges with permitting is to make sure that you have total clean energy solutions, and we're seeing a number of markets that are cracking down to make sure that backup power is also clean energy solutions.

So we see a very significant market opportunity for data centers. And that's a market that I think is going to take that TAM significantly higher. So we have more work to do this year with a couple of key partners that are very large players in the data center market to kind of validate that TAM.

But I would say, this is going to be a market that we're going to see a lot of lumpiness, and we expect to see more opportunities in 2024. Obviously, we've announced this 15-megawatt opportunity orders. We expect to see more developments in this market in 2024. That will really set us up in 2025 and 2026 to make sure that we have the right partners and customers to really move forward in that market.

Jordan Levy

Appreciate that. And then as a follow-up, a separate topic, recognize the solid benefits for the FC and maybe some of the other credits that you can realize from the Rockwall plant. But maybe just talk to how important you see finalized PTC guidance to the local market opportunity for that plan and maybe more broadly the investment case for Rockwall?

Randy MacEwen

Yes. First of all, Rockwell is designed to provide us with product that we can use globally, frankly. But it's going to be used to provide products primarily for the North American and European market. And that will take us, in my opinion, likely through to at least 2030. So we have very good kind of capacity coming out of Rockwall and very cost effective and efficient additional incremental phasing if we wanted to scale that up in the future.

So in terms of the PTC, we have the guidance that was published in December. The whole industry has provided feedback. I personally have talked to the US DOE recently about the volume of feedback they've received and the kind of the nature of the feedback.

So there's a lot of work going on there with the IRS and the DOE looking at the feedback to kind of square the objectives of making sure that they have the right incentive mechanisms to support the growth they want while also trying to make sure that the hydrogen that is produced has the clean hydrogen attributes that the policy is targeting.

There's a lot of debate around the regionality, the additionality and the time matching. I think regardless of how this gets settled, there's really no major impact to us from the sales opportunities that we see through 2030 for Rockwell.

Really, I think the cost and availability of hydrogen with the PTC, even in the constrained case where they take the most onerous -- or their most restrictive interpretation of the PTC still provides us with the cost of hydrogen that is significantly lower than it is today.

I think with $3 per kilogram production tax credit for clean hydrogen as that's defined, you're probably looking at around 50% of the cost of green hydrogen being subsidized. So, for us, we view this as a really significant enabler to the market.

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Of course, we'd like to see the most flexible interpretation of PTC, but we'll see how that shapes up. We've submitted our response to the guidance and are waiting to see how that bakes out.

Jordan Levy

Super helpful. Thanks so much.

Randy MacEwen

Thank you.

Operator

The next question comes from Craig Shere with Tuohy Brothers. Please go ahead.

Craig Shere

Good morning. Thanks for taking the question. To start with, give or take, you're bleeding about $20 million cash a quarter in operating cash flow. And I understand you're saying that your margins will -- gross margin will approach breakeven by the fourth quarter on higher volume, but higher volume can have a working capital impact. And then you've already alluded to a seasonality like the first half of next year might then return to lower volumes and negative margins.

So, just in terms of this $20 million cash burn from operating cash flow, do you have any trends, color, expectations heading into the fourth quarter and first half next year about what we might anticipate.

Paul Dobson

Yes. So, thanks for the question. It's something that we look at all the time is this is still a relatively immature market and the impact on our cash flows. When we look at different scenarios all the time. What we have to factor into that, though, is balancing our -- what's in our sales pipeline and talking to customers, their expectations, they want a supplier that is going to be able to grow with them as they deploy these -- their various fleets and various applications.

Also, our investments in products and to reduce our product cost, as we talked about, not only decreased the unit costs, but increase the performance and quality and the investment in manufacturing to enable the scale benefits and grow. And you're balancing all of that against the cash on hand.

And I think we've said in the past that we're looking at our funding and seeing all of these coming together and seeing that we're going to need funding, additional funding probably in the 2026, 2027 timeframe.

And so we're looking at various ways of doing that. We are very fortunate to announce the DOE grants and the investment tax credits. As Randy alluded to, there are other things that we're looking at as well, non-dilutive financing that is going to be helpful there.

And we're also having a hard look at all of our activities across the business and our -- where we're doing business in various locations and finding ways of redirecting spending on reducing overall spending on both OpEx and CapEx and to kind of rationalize the product set and the rest of our costs. You saw in our -- in Q1, as we said in Capital Markets Day, our costs were relatively flat, lower CapEx spending and operating costs that were relatively flat. And that's bumping up against a relatively higher inflationary environment as well.

So we are looking very hard at all of our costs and focusing the company on where the market opportunities are. And we'll be able to -- as we explore these other financing options the particular emphasis on the nondilutive ones, we'll bring out more information as those become more solving.

Craig Shere

Fair enough. Just on that first question to finish this point, I mean, you had a very strong fourth quarter and sales seasonally fell and you have a working capital benefit, is it unreasonable to think that heading into a fourth quarter surge that there would be a working capital drain.

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Randy MacEwen

Yes. Yes, we would expect that as sales come up, our receivables and inventory is building throughout the year. Our receivables will be building, and then we'll see the receivable inflow in Q1 as we did in this Q1. So we expect that pattern to continue. We are, though, also as part of -- as we're looking at our cash flows and as we come up to scale, looking at all aspects of working capital, customer terms, inventory reduction, inventory management, tighter on that and payment terms with our suppliers as well. So, all of it is a big focus of mine.

Craig Shere

All right -- go ahead

Randy MacEwen

Sorry, Craig. I might just add to that, when we kind of look at 2023 last year, we really implemented a number of activities really sharpened the focus to make sure that we have this right balance of investing for the future, making sure we have competitive products, not just today, but five years from now and 10 years from now, and at the right cost structure, et cetera. And so we rationalized the product portfolio last year. We reduced the number of active product development programs. We dropped corporate development investments and discontinued certain legacy noncore activities. So we're taking a very careful look to make sure that we are investing resolutely kind of on the long term, but protecting the balance sheet.

Craig Shere

Okay. That's very helpful and it feeds right into my second question, which also digs into the answer to Rupert's first question. And that related to this multiyear contracts and providing your customers lower pricing on an annual basis and planning to kind of leg into that with even more reductions on your internal costs. It feels like that is a challenging effort.

I mean, it's very hard to predict with certainty the time lines for these things when the market will scale and if you have a growing order book with falling annual pricing, but the ultimate market scaling takes whatever, another 12 months or 18 months for various reasons beyond anyone's control, that maybe -- I'm just -- is that

very challenging in your mind? Is there a risk that if things turn dramatically different than anticipated for any macro reason that you could suddenly find yourself leaving a lot more cash in 18 months than expected?

Randy MacEwen

Yeah. So Craig, everything about the hydro fuel cell industry is challenging, right? This is not for the faint of heart. But what I would say is when we sign a long-term agreement, and we're committing to future forward pricing, we have very high probability on what our costs are. We're not taking risk on that, right? So there is some development risk, and there's some very modest volume risk, but not kind of what you're talking about. So I feel very confident, very confident that our cost reductions will exceed our selling price reductions based on the work that we're doing and based on the supply chain visibility I don't view that there's lots of risks. I think about it at night, that's not one of them.

Craig Shere

All right. Good to hear. Thank you.

Operator

Our next question comes from Vikram Bagri with Citi. Please go ahead.

Vikram Bagri

Hi, there. A couple of questions on gross margin. Could you just remind us if there are any impairments this quarter and then just looking at the Power Products backlog that was picked up this quarter. How should we be thinking about that going forward? And how does that impact your outlook for the fourth quarter for that breakeven target? Is that mix consistent with the next 12-month order book that you see?

Paul Dobson

Hey, Vikram. So just on the gross margin question. So as we said, we've had a gross margin of minus 37%, which was a 5-point improvement from Q1. And then looking underneath the gross margin, we just talked about contribution margin, so price minus the direct labor and direct materials. It was broadly the same quarter-to-quarter. But both the products contribution margin as well as TS improved. So we are starting to see some expansion in the products as we become more of a commercial products company. But it was flat overall because the mix of products. We have more products with generally lower contribution margins than our technology solutions. So overall, it was flat.

But underneath, the product contribution margin is expanding. And then looking at our fixed and other costs, including the fixed overhead warranties and other provisions, that improved by about 6 points overall. And we had a net reduction in our warranty approvals as certain warranties expired and that provided the benefit -- net benefit with -- we also had a few other very small inventory write-down in the quarter, but nothing -- nothing like what we saw in Q4 of last year.

So overall, as we continue to invest in our products, we continue to expect to deliver product cost reductions, and when combined with the increasing sales volume and spreading that sales over our fixed cost, we expect to see gross margins improving over time.

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Vikram Bagri

Got it. Okay. That's very helpful. And just one follow-up. Last quarter, there was a customer that had impacted the backlog. I think the project was being delayed. Could you just talk about if there's any update there? Could we expect to see that customer reenter the backlog at some point? Just any update would be helpful. Thanks.

Randy MacEwen

Yes. We're staying very close to that situation literally almost daily. So we have very good visibility on what's happening there. And they've made a lot of progress since December, and we'll -- we're expecting them to get resolved likely in the next quarter, let's call it, but we'll wait to see that. And we'll see at that time what the impact is to the order backlog.

Vikram Bagri

Got it. Thank you.

Operator

This concludes the question-and-answer session. I would like to turn the conference back over to Randy MacEwen for any closing remarks. Please go ahead.

Randy MacEwen

Thank you for joining us today. Paul, Kate and I look forward to speaking with you next quarter. Thank you.

Operator

This concludes the question -- and this concludes today's conference call. You may disconnect your lines. Thank you for participating, and have a pleasant day.

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