Fairy Godmother Financiers and U.S. Government classify Molycorp as the one ‘too important to fail’

If the bulk of the Rare Earth sector had to stage a full scale retreat over the last two years the task was made exponentially more difficult for the two producers in the space (Molycorp and Lynas) as they both had nowhere to retreat to except the mothballing of their mining facilities. Molycorp has the great advantage though of having a “soup to nuts” range of production facilities ranging from the mine at Mountain Pass through to the sale and distribution of Rare Earth Oxides from its Neomaterials business.

Having it all however can be a curse as much as being a blessing, particularly when prices across the whole REE spectrum are way off their highs of the boom years. As we have noted before the Chinese let REE prices rise at the end of the last decade to allow some more non-Chinese REE mining to be undertaken. When they did this there were scarcely a handful of potential players (the likes of Avalon, Great Western etc). Little did they expect that a proliferation of companies would threaten to swamp their carefully guarded market share with indiscriminate production. When the numbers of potential projects was nearing two hundred the Chinese slammed on the brakes, torpedoed prices and in the process sent most Rare Earth wannabes in the public markets to the bottom of the ocean.

Getting Real

Molycorp and Lynas were the most advanced down the track to production and have soldiered on with both groups achieving commercial production over the last 18 months. What had largely been seen originally as equity-financed construction in the heat of the bull market ended up with a very strong debt component ($1.36bn at the end of December for Molycorp) which has led some to muse on the potential for one or both of the majors to eventually default and be subject to restructuring. We are not there yet and in any case, developments amongst Molycorp's largest shareholders give reason to believe that the company has now found itself a very powerful protector indeed.

Changing of the Guard

A key piece to understanding the new dynamic at Molycorp is to look at events at one of its largest shareholders. In mid-March 2014 it was revealed that the long and torturous process of the sale of the controlling stake in the Traxys trading group had finally been settled. Traxys likes to style itself as a physical metals and minerals commodity merchant, logistics and trading firm.

For a long while the stakes in Traxys owned by Resource Capital Funds, Pegasus Capital Advisors and Kelso & Company had been up for grabs. The buyers were the large alternative asset manager The Carlyle Group (NASDAQ: CG), together with affiliates of Louis M. Bacon (the founder of the mega-hedge fund Moore Capital Management, LP). Carlyle, Mr. Bacon and Traxys management are acquiring their stake from Resource Capital Funds. As part of the transaction, Traxys management are increasing their stake in the company.

It is a toss-up whether one could describe Traxys as being at the bottom of the first tier of trading houses or the top of the second tier. I guess it depends on your angle of approach. It definitely has some importance in some specialty metals and alloys, however in the major base metals like nickel and copper it is not a player of note and it is not known for playing in the precious metals. Turnover was reputedly around

US$6bn in 2013.

The transaction is expected to close in the third quarter of 2014.

Where It Stands Now

Molycorp came back into the news earlier this week with a bit of a damp squib of a story about an EPA fine at its Mountain Pass site. The U.S. Environmental Protection Agency that it had the company US$27,300 for improper management of hazardous waste at its Mountain Pass, California, facility. Clearly the dead news period post-Easter was taking its toll on all concerned as the violations for which the fine was issued were discovered during unannounced EPA inspections of Mountain Pass in October 2012.

Of more interest to us though was news of a competitor, China and the world's largest rare earth producer, Inner Mongolia Baotou Steel Rare-Earth Group which announced last week a first-quarter slump in profits of 72% and a 52% drop in revenues compared to last year. The company recorded profits of only $11.2 million while revenues more than halved to $160 million.

Baotou said sales volumes and realized prices for its rare earths were both weak and blamed at least in part March's ruling by the World Trade Organization against China's export quotas. This was a rather bogus excuse as the WTO ruling came at the very end of the quarter!

Essentially toeing the party line (as always) the national news agency, Xinhua, reported an executive from Baotou saying "producers were worried that the canceling of regulations on exports would compound the struggling sector with a further price slump."

What we see here is that China has scored an own goal in its management of the REE pricing environment. Usually the Chinese are rather good at this activity, but in the case of REEs they blew prices too high to the upside and then slapped them down too far to the downside, shooting themselves in the foot in the process. To remedy this, the only solution is to get their own pricing house in order and move prices for the bulk of REEs to a higher level. While they no longer have monopoly domination of lanthanum and cerium, they are definitely the axe in most of the others for the time being.

2013 – the Annus Horribilis of Molycorp

By any measure 2013 was a most unsatisfying year for Molycorp with the company reporting consolidated net revenues of $554.4 million, a 5% increase as compared to the full year 2012. The increase in revenues was largely driven by increased volume sales within its Magnetic Materials and Alloys segment, and its Rare Metals segment, slightly offset by lower realized pricing within its Resources (i.e. Mountain Pass) segment. It should be noted that the full year 2012 financial results included a partial year of contribution from its Molycorp Canada business (i.e. Neo Material Technologies), which was acquired in June 2012.

In 2013, Molycorp sold 13,118 mt of product at an ASP of $42.26 per kilogram, and generated a gross loss of $67.2 million. This compares to volume sales of 9,207 mt at an ASP of $57.00 per kilogram and a gross profit of $18.8 million for the full year 2012.

Molycorp reported a full year loss attributable to common stockholders of $385.8 million, or $2.21 per share. Adjusted loss per share of $1.09 for the full year 2013 eliminates the effect of operational expansion items, out-of-ordinary business expenses, and certain other non-cash items.

These numbers are clearly unacceptable and unsustainable. Capex requirements seem to have declined dramatically and so they should. The company has been a voracious consumer of cash for its infrastructure. This gives a salutary lesson to all those with similarly pharaonic plans that whatever they think the capex is they should probably double it…and keep some generous padding for teething problems and the ubiquitous “market conditions” on top of those.

It should be noted that capital expenditures for 2013 were $379.3 million. For the full year ending December 31, 2014, Molycorp estimates that its capital expenditures will total approximately $85-$90 million. The company had $314mn in cash and equivalents, going into 2014, with which to cover this commitment.

Outlook

The picture for the next few years is driven by Price, Price and Price. Here we have our projections for 2016 (and those of Toyota).

In most cases we are projecting that prices will be higher by then. Before one despairs of the Lanthanum and Cerium projections, the investor should note that the broadly-based Neo Material Technologies business segment is the real tail that wags the dog at Molycorp and NOT Mountain Pass. Between Neo Material Technologies and Silmet, it is the value-added segments that ultimately call the shots at Molycorp.

Conclusion

Dare we use the banking phrase “too big to fail” when describing Molycorp? Of course no mining company is too big to fail, history is littered with giants brought low. However beyond the size issue we might finesse the argument and claim that Molycorp is “too important to fail” and too strategically important to the U.S. to be allowed to disappear from the scene, or maybe even worse, end up in foreign hands. The evolution of Molycorp in recent years has seen it narrowly escape going to the Chinese when CNOOC bid for its then parent

Unocal and from there it moved on to amass the dream portfolio of Rare Earth assets, bolting on a Japanese-owned processor (in the U.S.), acquiring the ex-Soviet processing operation at Silmet in Estonia, merging with the Canadian-based processor, Neo Material Technologies (with its string of plants around the world) and finally getting its Mountain Pass mine back into production. There are more than a few that see method in this process and now the U.S. has gone from not being seated at the REE table (something that was causing many people grief) to now controlling the biggest non-Chinese player in the space. Mission accomplished.

The laurels for this achievement must go to Mark Smith, the former CEO (now at Niocorp). But putting it together is one thing, making it all work financially and operationally has fallen to the current generation of managers (mainly those that made Neo Material Technologies so successful). Molycorp has been wrestling with the tough pricing environment compounded by its preponderance (at least at the mine face) in Lanthanum and Cerium, the two throwaway Rare Earths. That is where the recent entry to the scene of Carlyle group underpins the future for Molycorp. As the unofficial “By Appointment to the US Government” private equity player it is no surprise that it has ended up in a prime position within Molycorp (via Traxys) and in Traxys itself, thus ensuring that the main non-agricultural trading house owned and based in the U.S. stays that way.

Thus those who think that the demise of Molycorp is in some way likely are failing to see the real motivations behind the accumulation of REE assets achieved in what was a rather short time frame. It remains a work in progress though. A move to profitability has to be a first goal but we would not discount the bolting on of a second REE asset in North America (Ucore for example) as the company endeavours to broaden its REE mix and right-size its business.

Having a fairy godmother in the form of the Carlyle group makes Molycorp a much safer bet than Lynas. Despite the Chinese having lost control of a sizeable chunk of REE production share in the last two years they still call the shots on price. If they resolve that higher prices would be better for all concerned then a move to profitability for Molycorp would come sooner rather than late