CRITICAL STRATEGIC METALS

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Your monthly guide to the latest information on the world's strategic metals

Rare Earths Free Fall From Dizzying Heights

The soaring prices of rare earth metals and uncertain supply forecasts due to Chinese quota restrictions dominated discussions in the first half of 2012. Since then, the rare earths market has been in free fall. Experts predict that the current scenario could play out for a year before we see a turnaround of fortunes.

Falling prices and poor demand for rare earths have forced many producers to halt production. The current scenario has affected all rare earth producers. Even China is feeling the slump. Steep prices, Chinese quotas and supply uncertainties earlier this year, sparked off many new rare earth ventures besides forcing downstream industries to look for alternatives. The drop in rare earth prices is attributed to the continuing euro zone crisis and new rare earth production coming online. Some analysts even suggest that the softening demand is also because rare earth consumer industries have adjusted their production in line with the rare earth quotas announced earlier this year.

Molycorp Inc., whose fortunes were soaring in the early part of 2012, has been ravaged by falling prices; it couldn't have happened at a worse time. Heavily in debt, the company's balance sheet has been severely dented by the downward trend of the rare earths market. S&P has lowered Molycorp's rating and placed it on watch. The company's stock has fallen 50% in the last three months.

Molycorp's problems aren't entirely due to the prevailing economic situation – much of it is self inflicted. Not only did Molycorp get heavily into debt to pull off its acquisition of Neo, it's now also saddled with Neo's legacy debts which amount to some $230 million in convertible notes. Added to this, Molycorp's modernization and expansion of their flagship Mountain Pass mine is expected to cost the company around $900 million.

With a dwindling cash flow, Molycorp will be forced to seek more financing to fund its operations as well as its Mountain Pass expansion plans. For a company whose revenues in 2011 were around $400 million, a loss was inevitable with all these heavy debts combined with lower market rates for its rare earths products. Expect this debt to grow as the company seeks financing to the tune of $400 million this quarter.

Molycorp's Mountain Pass mine is expected to achieve full Phase I production of 19,500 tons by the end of Q4 2012. The company's Phase II production target of 40,000 tons is slated for mid-2013. While this will mean that the company will have more produce to sell, it doesn't necessarily mean a return to profitability.

According to a recent press release, China, the world's largest producer of rare earths, has increased rare earths export quotas by 2.7% to a 3 year high. With this increase China's export quota for 2012 will be around 30,996 tons. It is expected that China's export allocations for 2013 will be similar. Add to this the output from other existing and new rare earth mines that will come online by the end of Q4 and during next year.

When Molycorp achieves full Phase 1 and Phase 2 production, there will be a huge quantity of rare earths in the market - much more than there is right now. Another point to take into account is the aggressive search for alternatives to rare earths. Considering that prices are lower now than in 2011, we can expect a further fall in rare earths prices. Given this scenario, Molycorp seems to be caught in a deadly spiral, one that's going to be difficult to come out of.

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The Chinese Steel Production Paradox

With demand for steel on the wane, producers across the world have reported losses or sharp drops in profitability. The slowdown in the steel market has been attributed to the slowdown in the Chinese economy, the ongoing euro zone crisis and a sluggish U.S. economy. Though China, the largest consumer of steel has taken measures to boost its economy, it is not expected to result in an increased demand for steel in the short term.

Raw steel production in China recorded a 2% increase in early August this year taking the country's steel production to a record 400% increase over a period of 10 years. In 2012 China's steel production is expected to touch 715 million tons. Despite production cuts, slackening demand and rising stockpiles China's output for 2012 is expected to be 5.2% up from 2011.

The paradox here is that though the demand for steel is down and reaching lower levels daily, Chinese steel mills are still producing to achieve record steel output figures. According to China Iron and Steel Association (CISA), the country's steel stockpile is up by 26% from last year. The CISA also reports that the country's steelmakers saw profits fall by 96% on the back of slowing demand, triggering speculations about a possible revival of tax breaks for Chinese steel producers. However, the country's steel production shows no signs of letting up barring a few production cuts.

Many analysts believe that perhaps the numbers don't reveal the full story as China's steel production figures are largely based on the output of state owned manufacturers whose primary objective is to meet the government's production targets, irrespective of market conditions. It is perceived that while CISA's figures for China's steel output takes into account the actual production of affiliated steel mills it only makes an estimate of the output of the unaffiliated mills. Analysts point out that while CISA's numbers point to increased production, it is possible that smaller steel mills in China could have already cut back on production and this is not being reflected in CISA's numbers.

That the country's steel production is heading for a serious downswing is evident by the fact that for the second time this year, China's steel mills have defaulted on, or deferred taking shipments of almost four million tons of iron-ore. The Shanghai rebar futures was down at $560 per ton. China's slowdown has impacted iron ore prices; the price of high grade iron ore is down by 2.7% to $106.40 last week, the lowest since 2009.

Baosteel, China's largest steel manufacturer expects steel prices to continue to be under pressure as the industry's output hasn't slowed even while the economy has slowed down. Analysts expect that steel prices may hit rock bottom by around March 2013. China's excessive production despite weakening demand could totally wipe out its steel sector's profitability.

Considering that China has shown remarkable acumen and strategy in becoming a dominant force in the steel market, it's a bit difficult to think of the current paradox as a lapse of policymaking. Whatever it is, there's no doubt that the markets are extremely sensitive to every little move that China makes.