Lynas Corporation Ltd (ASX: LYC)

Listed shares	*3,677.1 million*	*ordinary fully paid*
Performance rights	*97.8 million*	*exercisable at various dates from Aug 2017*
Warrants	*18.2 million*	*exercisable at 3.8¢, expiring 30 Sep 2018*
Warrants	*348.8 million*	*exercisable at 5¢, expiring 30 Sep 2020*
*Convertible bonds**	*3,000.0 million*	*convertible at 10¢ by 30 Sep 2020*
Total securities	*7,142.0 million*	

**Face value US$225m, coupon 1.25%, convertible at 10¢ per share at forex 0.75.*

Share price *$8.6¢ as at 9 June 2017*
Market cap *$340m based on in-the-money securities, $586m fully diluted*

Low risk leverage to any recovery in rare earth prices

- LYC is my preferred equity investment for exposure to rare earths.

- Its key advantages are that it is already in steady state operation, has no project funding risk and no commissioning risk, unlike the other listed players.

- The company is cash flow positive. Cash from operating and investing activities was $11.6m in the March quarter on product prices of $19.40 per kg including NdPr of $43 per kg, taking the closing cash position to $52m.

- Product prices continue to improve albeit they are still at historically depressed levels. Cash flow should exceed $15m in the current quarter based on average prices of $22 per kg.

- LYC is highly levered to REO prices. For the 2017/18 financial year I believe profits could exceed $70m based on volumes of 15,000t REO sold at prices of $25 per kg. But if one assumes prices of $30/kg profits could be $145m. No tax will be expensed for some years.

- Assuming the shares can get past 10¢ on a continuation of current pricing trends and incremental project improvements, the convertible bonds will be in the money and the company's high debt will be a thing of the past, albeit at the expense of diluting existing shareholders.

- Some 70% of the company's revenue is derived from sales of NdPr and the outlook for these products appears especially bright. They are a key raw material for the magnets used in motors for electric cars.

Operations

Lynas operates a rare earths mine and concentrator at Mt Weld WA, and a plant at Kuantan in Malaysia which processes the concentrate into marketable products.

At Mt Weld, ore reserves within the Central Lanthanide zone at 30 June 2016 were 9.7Mt grading 10.7% REO. This is sufficient to sustain more than 25 years of continuous operation at the intended production rate of 22,000 tpa REO. The assemblage of rare earth elements within the deposit has not been stated for many years, but probably has little changed from the original assemblage of La 23.9%, Ce 47.6%, Pr 5.2%, Nd 18.1%, the SEG oxides 4.0%, the still lighter oxides 0.4% and Y 0.8%.

The mineral resource at the Central Lanthanide Zone (inclusive of ore reserves) is 14.9Mt grading 8.8% REO, and in addition the Duncan deposit has a resource of 8.2Mt grading 4.7% REO. There is also a niobium-rich REO deposit of 37.7Mt at Mt Weld also containing phosphorus, tantalum, zirconium and titanium.

Ore is mined on a campaign basis as required. The concentrator is believed to have the capacity to treat 240,000 tpa of ore to produce some 66,000 tpa concentrate grading 40% REO which is shipped to the plant in Malaysia. The annual production from Malaysia is currently some 15,000tpa REO comprising 5,300t of NdPr, 500t of lighter REOs, 4,000t La and 5,200t Ce. The plant is now operating at about nameplate after the many years of ramp up since commissioning commenced in 2012, and there is scope to increase production through debottlenecking. At current prices NdPr accounts for about 70% of revenues.

In the early years of the project the Malaysian operation was threatened with closure by a very active environmental lobby, who were concerned about the risk of pollution from waste including radioactive elements, but the plant has always operated well within its environmental guidelines and the fuss has died right down.

Financial position

LYC spent over one billion dollars on building its operation in an era of very high REO prices, and borrowed most of the funds. The subsequent collapse in product prices combined with the slow production ramp-up saw the company in financial difficulties and in December 2016 following shareholder approval the two debt components were restructured for the second time. The key change was a huge cut in the conversion price of the bonds from US53.7¢ per share. The interest rates were cut also (but subject to upwards adjustment if NdPr prices rise above US$38/kg) with interest payable on 30 June and 31 December, and the terms extended two years to 2020. The two debt components are now:

- Unsecured convertible bonds of US$225m held largely by US investors with a coupon of 1.25% and maturing on 30 September 2020. The conversion rate is at US7.5¢ per share(10¢ per share at a fixed forex rate of 75¢) thus if fully converted 3 billion shares

would be issued. The bond holders were also issued with 348 million 5¢ warrants as part of the restructuring deal.

- Secured senior debt of US$203m held by JARE[1] with a coupon of 2.5%, maturing on 30 June 2020. There are no fixed repayments of principal but a cash sweep mechanism is in place under which unrestricted cash balances above $40m will be applied as principal repayments.

For equity investors buying LYC today, the appropriate way to regard the convertible bonds is to treat them as equity (if they don't think the shares have the potential to rise above 10¢ they wouldn't be buying them). It should only require a small increase in REO prices to put the shares above 10¢. Existing shareholders will be diluted almost in half, but so be it.

Meanwhile, the company is now cash flow positive. Cash from operating and investing activities was $11.6m in the March quarter (bringing the YTD total to $11.4m). During the quarter sales receipts were $69.2m on sale of 3,437t of REO. At 31 March the company's cash position was $52.6m comprising $28.3m in restricted cash (earmarked for interest payments) and $24.3m in unrestricted cash.

I think cash flow from operating and investing activities will approximate $16-18m in the current quarter.

Profitability

Ignoring the deemed profit of $22.9m from the debt restructure an underlying pretax loss of $35.8m was recorded in the half year to 31 December 2016. My estimate for the full year is for an underlying pretax loss of $14m on revenues of $264m derived from 13,600t REO sold at A$20/kg.

The 2018 year is dependant mostly on sales volume and prices, to state the obvious. On my estimates:

- Sales of 15,000t at a price of A$25/kg would result in revenues of $364m, EBITDA of $124m and a pretax profit of $73m.
- Sales of 15,000t at a price of A$30/kg would result in revenues of $364m, EBITDA of $196m and a pretax profit of $145m.

You can see from that how levered LYC is to REO prices, and of course especially NdPr prices.

One can derive fully diluted PEs of 8.0 and 4.0 on these scenarios. At this point I would say the first scenario is achievable. The second is a stretch for 2018 but could occur in 2019.

[1] Japan Australia Rare Earths BV, owned by Japan Oil Gas and Metals National Corporation (JOGMNC) and Sojitz, the sales agent for LYC in Japan. Under the deal with JARE, Japan is entitled to a minimum of 8,500 tpa REO, plus or minus 500t.

Unrecognised tax losses are $558m so no tax will be expensed or payable for some years.

Outlook for product prices

So, what is the outlook for REO prices? I have been monitoring prices and they have been creeping up over recent quarters. In the December quarter 2016 NdPr prices were US$31.00 per kg, in the March quarter just finished they were US$33.00 per kg and the current quarter looks like being about US$34.50 per kg.

Demand for these particular REOs is coming from electric motor manufacturers who need them to make magnets and especially from electric car producers, and the picture looks bright.

The big unknown is Chinese supply. They dominate the industry (although I should point out that LYC is now the largest exporter of NdPr to OECD markets) but much of it is used internally. How quickly can China increase production in response to higher prices? Or has rising consumption within China (due mainly to electric vehicles), and constraints on its REO production due to pollution, changed the fundamentals? And to what extent?

I don't know the answers to these questions but it seems a reasonable bet that prices will continue to improve.

Conclusions

The focus of the stock market was first on graphite and lithium stocks, then on cobalt stocks, but what about REOs? They are just as important for the electric car industry.

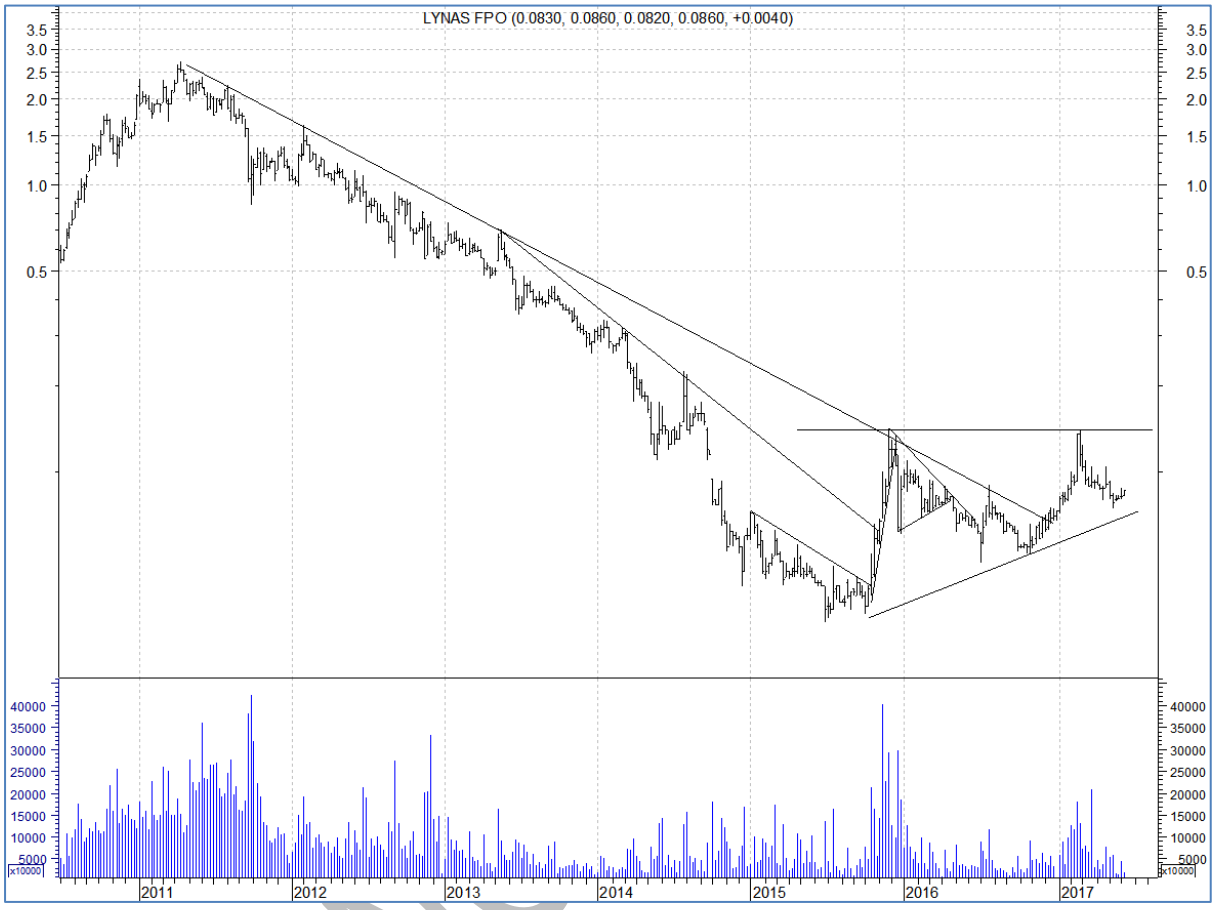
I believe LYC is by far the best investment, or should I say speculation, within the listed ASX REO sector. It is already in steady-state production whereas the "hopefuls" have to raise hundreds of millions of dollars, won't be in production for years and years, and have to face all those commissioning risks.

I have completed a quick analysis of the fundamentals of each of these other projects using my long term prices and have related these back to share prices. For parameters such as capital intensity per revenue dollar, EBITDA margin and fully diluted EV/EBITDA, LYC does not look out of line with the others. Indeed some others are less attractive on these parameters.

Yet LYC is far superior to the others on timing and on risk.

Historical share prices for LYC

Weekly prices for LYC from the 2011 peak of $2.70 are provided in the graph below, shown on a semi-log scale.



Disclaimer

This analysis is cursory in nature and is not intended to be relied upon by third parties, who should make their own enquiries. The report does not does not contain investment advice.

Any views expressed in this report are purely my own unless otherwise indicated.

Disclosure

I have not received any remuneration from any person for this report.
Associated entities own a small position in the shares at the time of writing.

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