

# Momentum versus fundamentals, that is the question for Neo Performance Materials

written by InvestorNews | November 14, 2022

I can honestly say that the volatility around earnings the last 2 to 3 quarters has been unprecedented. A miss versus expectations or disappointing guidance can lead to enormous losses for a stock with a single day double digit percentage loss becoming increasingly common. I don't know if it's related to the lack of confidence in the overall market, the rise of the retail investor (Robinhood and Reddit come to mind), or the increasing influence of algo trading that exacerbates both positive and negative momentum, but something has changed making these massive one day moves far more frequent. I guess one possible benefit to this is that if you feel the market has overreacted it could make for a great short-term trade in the event the market re-evaluates all the information available and determines things aren't as bad as the market initially thought.

That introduction sets the stage for us to review a company that continues to see sequential top line growth, has an iron clad balance sheet, is squarely in the driver's seat of the green revolution but as a result of some input cost pressures and demand issues, the bottom line saw an unexpected quarterly loss leading to a 17% yard sale on Friday. That company is [Neo Performance Materials Inc.](#) (TSX: NEO), manufacturer of the building blocks of many modern technologies that enhance efficiency and sustainability. Neo's advanced industrial materials – magnetic powders and magnets, specialty chemicals, metals, and alloys – are critical to the performance of many everyday products and emerging technologies. Neo has a global

platform that includes 10 manufacturing facilities located in China, the United States, Germany, Canada, Estonia, Thailand and South Korea.

So let's see if we can diagnose what happened in [Q3](#) that caused the market to punish Neo, driving it down to lows not seen since the pandemic plunge in early 2020. As I noted above, revenue numbers continue to see sequential growth both quarterly and year over year in all three of the Company's business segments – Magnequench, Chemicals & Oxides and Rare Metals. For the three and nine months that ended September 30, 2022, revenues of US\$146.6 M and US\$481.1 M were 22.4% and 24.7% higher, respectively, than the corresponding periods of 2021. Unfortunately, there's more to earnings than just revenue and that's where some of the challenges in the quarter occurred.

Starting with the Magnequench division, where Neo is the world leader in the production of permanent magnetic powders used in bonded and hot-deformed, fully dense neodymium-iron-boron magnets, there was a decline in volumes compared to the corresponding periods of 2021. The recent spike in COVID-19 has affected the free flow of people and production supplies across many parts of Asia and the ongoing semiconductor chip shortage is continuing to impact customers in the automotive and other industries. Additionally, by the third quarter of 2022, selling prices for Magnequench powders declined 30% to 40% from the peak (in the first quarter of 2022) negatively affecting (when prices are falling) overall pricing and margins due to the lead-lag effect of higher cost inventory on hand. In addition to lower margin on sales in the quarter, Neo recorded \$8.0 M of provisions for inventories in the third quarter, related to higher cost inventory on hand, relative to lowered selling prices.

Moving on to the Chemicals & Oxides (C&O) division, which

manufactures and distributes a broad range of rare-earth-based industrial materials including automotive catalysts, permanent magnetics, consumer electronics, petroleum refining catalysts, medical devices, and wastewater treatment, we see a similar theme. This segment was the biggest drag on the quarter with the three months ended September 30, 2022, reporting an operating loss of US\$5.3 M, compared to operating income of \$7.1 M in the same period of 2021. The C&O segment continues to see strong demand for various rare earth products, particularly its magnetic-based products, although the segment was adversely affected by the earlier noted rapid decline of rare earth prices while processing higher cost inventory. C&O saw mixed volumes for rare earth elements but slower volumes in the environmental catalyst end markets driven by semiconductor chip shortages. The rapid decline in prices necessitated C&O to record US\$6.0 M of provisions for inventories.

As a potential investor, it's now up to you to decide if the headwinds faced in Q3 are transitory or not. Looking forward, Magnequench, which accounts for roughly 45% of Neo's revenue, has pass-through pricing agreements for rare earth magnetic elements on the vast majority of its sales contracts. Magnequench earns a targeted margin spread per ton when rare earth prices are stable and over the long term. However, the short-term timing mechanics of the pass-through agreements generally lead to increasing margins when rare earth prices rise and declining margins when rare earth prices fall. The C&O segment, accounting for a little over 1/3<sup>rd</sup> of revenue, continues to see strong demand for various rare earth products, particularly its magnetic-based products and the environmentally protective water treatment solutions business continues to perform well with higher volume and new customer adoption. The Rare Metals business continues to make progress in several key strategic initiatives, including selling more products outside

of the aerospace industry, expanding its customer base, and diversifying its total end-market exposure. Sales prices in a number of end markets have recovered and gallium-based products are exhibiting improved market demand.

Neo Performance Materials closed Friday trading at 9.2x trailing 12 month earnings, has a 4.4% dividend yield and C\$3.65/share of cash sitting on the balance sheet. Last week the Company [announced](#) it has been awarded a grant of up to 18.7 M Euros from the Government of Estonia under Europe's Just Transition Fund program to help pay for the cost of constructing a state-of-the-art sintered rare earth permanent magnet manufacturing facility in Estonia. The question is, are fundamentals the most important thing in the market these days or momentum trading?