Schnitzer Steel Industries Inc. First Quarter Fiscal 2018 Earnings Call

January 9, 2018

Operator

Good day, ladies and gentlemen, and welcome to the Schnitzer Steel's First Quarter 2018 Earnings Release Call. (Operator Instructions) And as a reminder, this conference is being recorded. I would now like to introduce your host for today's call, Mr. Stefano Gaggini, Vice President, Corporate Controller and Principal Accounting Officer. Sir, you may begin.

Stefano Gaggini, Vice President, Corporate Controller and Principal Accounting Officer

Thank you, Amanda. Good morning. I'm Stefano Gaggini, the company's Vice President, Corporate Controller and Principal Accounting Officer. Welcome to Schnitzer Steel's First Quarter Fiscal 2018 Earnings Presentation. In addition to today's audio comments, we have issued our press release and posted a set of slides, both of which you can access on our website at www.schnitzersteel.com or www.schn.com.

Before we get started, let me call your attention to the detailed safe harbor statements on Slide 2, which are also included in our press release and in the company's Form 10-Q, which will be filed later today.

As we note in Slide 2, we may make forward-looking statements on our call today, such as our statements about our outlook and targets for growth. Our actual results may differ materially from those projected in our forward-looking statements. Additional information concerning factors that could cause actual results to materially differ from those in the forward-looking statements is contained in Slide 2 as well as our press release of today and our Form 10-Q.

Please note that we will be discussing some non-GAAP measures during our presentation today. We have included a reconciliation of those metrics to GAAP in the appendix to our slide presentation.

Now let me turn the call over to Tamara Lundgren, our Chief Executive Officer. She will host the call today with Richard Peach, our Chief Financial Officer and Chief of Corporate Operations.

Tamara Lundgren, President and Chief Executive Officer

Good morning. I hope everyone had a great holiday season, and for those of you on the East Coast, I hope you're managing safely through the early winter storm.

Thank you all for joining us on our first quarter conference call. We appreciate your interest in our company and we look forward to sharing our results with you this morning. On our call today, I'll review our quarterly performance, the market and macroeconomic trends underlying each of our businesses and progress against our strategic growth initiatives. Richard will then provide more details on our segment performance and our capital structure. I'll wrap up with some closing remarks and then we'll take your questions. So let's begin by turning to Slide 4.

Earlier this morning, we announced our fiscal '18 first quarter adjusted earnings per share of $0.63, our best Q1 performance since fiscal '11, even after accounting for a $0.14 negative impact from a legacy environmental liability.

Our results reflect continued strong operating and financial performance in each of our operating divisions driven by our sustained productivity improvements, benefits from our volume growth and margin expansion efforts, and a market environment supporting higher prices and higher demand.

On a year-over-year basis, AMR's ferrous and nonferrous sales volumes were up 11% and 3%, respectively, reflecting the success of our ongoing focus on broadening our supply channels and commercial initiatives to increase our Pick-n-Pull car purchase volumes. While we grew our volumes, we also expanded our margins. AMR's adjusted operating income per ton of $44 was more than double last year's first quarter. We'll speak to this in more detail later, but it's worth highlighting here that this level of operating income per ton was last reached during fiscal '11, when both our volumes and scrap prices were significantly higher. This is further testament to the improved operating leverage we created in our platform through our multiyear productivity and cost reduction initiatives.

CSS also delivered a strong first quarter performance with adjusted operating income of $8 million. These results were positively impacted by lower levels of rebar imports, higher prices and volumes, and contributions from productivity improvements, including synergies from the integration of our steel mill with our Oregon recycling operations.

If you turn now to Slide 5, we can review first quarter metal market trends. On a year-over-year basis, both ferrous and nonferrous market prices rose significantly. In the ferrous market, export prices followed a U-shaped trajectory. Beginning the quarter at levels slightly above $350 per ton, softening in October and then beginning a recovery towards the latter part of the quarter. The export market continued to strengthen through December and recently reported prices are in the range of $380 to $400 per ton. While calendar year U.S. ferrous scrap export levels have not yet been reported through October, exports were on pace to exceed 2016's level. U.S. ferrous exports to Turkey through October were up 11% year-over-year as Turkey's steel production has increased significantly to meet both internal and export demand. For the same period, U.S. exports to Asia increased 15%, driven by increased demand from China, Bangladesh and Vietnam.

The domestic market followed a similar trajectory throughout the quarter, although at lower price levels than export. U.S. capacity utilization was up approximately 8% year-over-year but is still below the long-term U.S. average. In both markets, increased pricing has been driven by significantly lower Chinese exports of semi-finished and finished steel products as well as expanding U.S. and global GDP and higher utilization.

Scrap has remained competitively priced against semi-finished goods such as billets. As you can see on the graph in the upper right-hand corner of this slide, prices for high-grade iron ore and met coal are trading at levels which are supporting higher scrap prices. This chart also illustrates the widening price differential between low-grade and high-grade iron ore, which is being driven by China's enforcement of tighter environmental regulations to lower emissions from steel manufacturing. These trends, combined with an almost 30% decrease in steel exports from China during calendar year '17, have continued to support improved global market pricing and demand for ferrous scrap.

Now looking to the long term, we anticipate these pricing trends could continue as China and the rest of the global steel community migrate to more environmentally sensitive production practices, including a greater prevalence of EAFs across the sector and a higher use of scrap in BOFs. These are positive developments supporting the long-term demand and sustainable value proposition of recycled ferrous metals.

If we look at nonferrous pricing trends, copper and aluminum continued to strengthen both sequentially and on a year-over-year basis, driven by improved market conditions. The pending National Sword regulations, which are anticipated to go into effect in March, are expected to require higher levels of product quality, creating stronger demand for product from metals recyclers like ourselves, who have invested and continue to invest in processing capabilities to meet more stringent specifications for higher-yielding and cleaner recycled nonferrous metals. All of these trends support an improved and stronger long-term market for our company with continued opportunities for growth.

So now let's turn to Slide 6 to review steel market trends. During the first quarter, the long products markets improved, with rebar pricing up about 13% year-over-year, driven by lower imports, higher raw material costs and steady seasonal construction activity. Rebar import pricing increased at a higher rate than domestic, resulting in a significant reduction in the spread to domestic rebar prices and contributing to a reduction in rebar imports of approximately 40% sequentially and year-over-year. We believe the prospects for the long products markets remain very positive, underpinned by current and anticipated construction spending and the reduced level of imports. These trends, combined with improving global production discipline, should result in higher utilization and a healthier domestic steel industry.

Now let's turn to Slide 7 for an update on the leading U.S. economic indicators impacting our industry. On this slide, we can see the key leading indicators for scrap generation and steel demand that we've been highlighting over the last year, which continue to display strong fundamentals. Through November, the U.S. industrial production index, which includes the energy, automotive and construction industries, continued its year-over-year rise on a softer dollar, stronger durable goods orders and improved GDP growth. Consumer confidence remains strong in 2017, hitting a 17-year high in November. This higher level of confidence stems from several factors, including the improved labor markets and an optimistic outlook on global growth. This confidence is also reflected in personal consumption expenditures, which has continued its positive year-over-year trajectory.

The stronger white goods appliance shipment trends, the higher average age of vehicles on the road and the more aggressive pricing of both used and new light vehicle sales are also contributing to stronger supply flows, including the supply of end-of-life vehicles.

We also believe that the recent federal tax reform legislation should prove beneficial to the domestic steel markets as the lower tax rate environment and capital investment incentives are expected to spur both corporate and individual spending.

Collectively, these domestic economic trends, along with prospects for higher global GDP growth and a potential U.S. infrastructure program, lend considerable support to greater demand for recycled metals and finished steel products.

Let's turn now to Slide 8 for an update on our strategic initiatives. Our strategic initiatives can be viewed as 3 pillars: expanding our margins, increasing our volumes and deploying our capital to further grow our businesses. These initiatives are supported by 3 foundational elements: operational excellence, a strong balance sheet and a continuation of the positive industry trends and macroeconomic environment we have been experiencing over the last year.

Last year, as you'll recall, we announced a 3-year plan to increase our volumes and expand our margins by leveraging the operating efficiencies we had developed through the successful execution of our productivity and cost-savings initiatives. Our plan was also founded on increasing the flexibility of our operating platform, expanding our supply channels and using analytics to increase our processing and commercial effectiveness. We set a target to grow our company-wide ferrous sales volumes to approximately 4.3 million tons by fiscal '19, from a base of 3.3 million tons at the end of fiscal '16, and to increase AMR's operating income per ton by at least 40% to $39 per ton from a base of $28 per ton on a re-segmented basis. The results of these initiatives through the first quarter of fiscal '18 can clearly be seen in our operating trends: our company-wide ferrous sales volumes are up 12%, on track to reach our fiscal '19 target and AMR's operating income per ton is tracking ahead of pace, averaging $35 over the last 4 quarters.

Market conditions in the last several quarters have been stronger than anticipated when we set these targets. While political and economic uncertainties could impact the timing and the trajectory of our targets, if current market conditions and trends continue, the retained capacity in our platform should enable us to grow our company-wide ferrous sales volumes to 5 million tons by fiscal '21. In such circumstances, we believe that our embedded operating leverage will enable us to expand AMR's annual fiscal '21 margins by at least another 15% from AMR's fiscal '19 target of $39 per ton.

So now let me turn it over to Richard for a review of our segment performance and our capital structure.

Richard Peach, Senior Vice President, Chief Financial Officer and Chief of Corporate Operations

Thank you, Tamara. I'll start with a performance review for the Auto and Metals Recycling business.

AMR's results for the first quarter continued a strong positive trend. Adjusted operating income per ton of $44 was more than double last year's first quarter, and was higher sequentially by 54%. These significant improvements were driven by higher volumes, expanded metal spreads, the increased price environment, and sustained benefits from our productivity initiatives.

Our integrated sales and commercial process was a major contributor to our margin expansion, as selling ahead led to higher priced export shipments in the middle of the quarter at a time when the domestic market had softened.

Over the last 4 quarters, AMR has generated an average operating income of $35 per ton. This performance is tracking ahead by about $4 per ton compared to where we expected to be at this stage when we publicly announced our multiyear margin goals back in April of 2017.

In the first quarter, AMR's ferrous sales volumes were 797,000 tons, representing year-over-year volume growth of 11%. On a sequential basis, ferrous sales volumes were lower due to normal seasonality and from timing of sales. Nonferrous sales volumes followed similar trends to ferrous and were slightly higher year-over-year and lower sequentially.

Average ferrous selling prices were up by 51% year-over-year and by 11% on a sequential basis. Selling prices for nonferrous were also up substantially by 26% year-over-year and sequentially by 14%. The improved metal market conditions continue to be supported by positive U.S. economic trends, rates of global growth and from supply side reform in China.

AMR's performance trends are also supported by our continuing volume growth. This reflects our stronger supply flows, benefits from supplier channel strategies, higher car purchase volumes, which were up by 15% year-over-year, actions to diversify our sales, and an integrated transportation and logistics process. Consequently, our ferrous volumes are tracking in line with the upper end of our fiscal '19 target of 4.3 million tons, and based on these current trends, we would expect our volumes to continue to grow. Our existing yard capacity of 5 million tons creates plenty of runway to capture additional growth.

In the shorter term, as we look ahead to the second quarter of fiscal '18, we expect AMR's ferrous sales volumes to increase year-over-year by a range of 15% to 20%. This would also be an increase sequentially, driven by our improved supply flows and from higher overseas demand. Nonferrous sales volumes are also expected to increase year-over-year by approximately 15%. AMR's operating income per ton is expected to be approximately 20% higher than last year's second quarter, which was $34 per ton and to include a modest benefit from average inventory accounting.

Moving to Slide 10, I'll now cover the operating trends for Cascade Steel and Scrap. Adjusted operating income for CSS was $8 million, up by $11 million year-over-year and by $1 million compared to the previous quarter. The significant year-over-year improvement reflected increased finished steel sales volumes and selling prices, expanded finished steel metal margins and further synergies from the recent integration of our steel manufacturing and Oregon recycling operations. I should also note that the prior year's first quarter included one-time costs of approximately $2.5 million which resulted from major equipment upgrades and the decommissioning of an old rolling mill.

Demand for our steel products increased substantially year-over-year, which was mainly due to reduced rebar imports on the U.S. West Coast. Finished steel sales volumes were higher by 26% year-over-year, while lower sequentially reflecting the normal patterns of seasonality we see at this time in the annual cycle. Average selling prices for finished steel were also higher, both year-over-year and sequentially, by 22% and 6%, respectively. This strengthened pricing was primarily driven by the lower imports and from higher input costs of scrap.

Looking ahead to the second quarter, we expect finished steel sales volumes to be higher year-over-year by approximately 10%. Compared to the first quarter, we expect finished steel sales volumes will be seasonally lower by approximately 10%, which, together with seasonally lower utilization due to planned maintenance and the holiday period, is expected to impact operating income sequentially by approximately $3 million. We expect the higher year-over-year steel volumes and continuing healthy metal margins to result in our best CSS second quarter performance in recent years.

Moving on, let's proceed to Slide 11 to review our capital structure. Our balance sheet remains very healthy with low leverage of 24% and a ratio of net debt to EBITDA of only 1.4x. Operating cash flow in the first quarter was impacted by increased working capital but we anticipate a return to positive operating cash flow in the second quarter.

Our capital expenditures in the first quarter were $15 million and for the fiscal year as a whole we expect to invest CapEx in the range of $55 million to $70 million. We anticipate this will include investments in environmental capital projects, upgrades and replacement of mobile equipment, supporting increased volumes, further investment in nonferrous processing technologies and capital spend on maintaining the business.

Turning to corporate costs we expect the second quarter to be $4 million lower sequentially, as the first quarter included the legacy environmental item.

Our effective tax rate during the first quarter was approximately 24%.

Looking ahead to the remainder of fiscal '18, we expect our effective tax rate to be lower as a result of the recently enacted federal tax reform. We are still assessing the impact of the new tax law and are not yet in a position to quantify the effects.

Finally, in the first quarter we paid our 95th consecutive quarterly dividend and our priorities for capital allocation remain balanced among investing in and growing our business, managing our debt and returning capital to our shareholders.

Now I'll turn the remainder of our presentation back over to Tamara for her summary remarks

Tamara Lundgren, President and Chief Executive Officer

Thank you, Richard. Over the last several quarters, we've highlighted favorable industry trends and leading economic indicators that are creating conditions for improving scrap and steel markets. We are successfully executing on our strategic initiatives to capitalize on these improved markets, and our financial and operational performance this quarter is a continuation of the trend of strong performance we have been steadily delivering. We remain on a positive trajectory towards meeting or exceeding our fiscal '19 volume and margin goals.

We will continue to invest in technologies and systems to enhance our products, increase our service offerings to our customers and operate our company even more efficiently.

We have maintained a strong capital structure, which provides the foundation for continued investment in organic and transactional growth while retaining the ability to consistently return capital to our shareholders. We are firmly focused on achieving our goals to further increase shareholder value in fiscal '18 and beyond.

In closing, I'd like to thank our employees, many of whom I know are listening into our call this morning. Your operational excellence is one of the cornerstones of this company's foundation, and our performance is the direct result of your ability to drive best-in-class results without wavering from our core values of integrity, safety, environmental stewardship, quality and customer service. Each of you continues to meet our opportunities and challenges with dedication, commitment and resolve, strengthening our company at every turn. Thanks to your contributions, our achievements this quarter were many as we delivered our best first quarter performance since fiscal '11. My thanks go to each of you as you've truly demonstrated why we have continued to be a leader in our communities and the recycling industry for well over a century.

Now operator, let's open up the call for questions.

Piyush Sood, Morgan Stanley

So a couple of questions. The first one, the strong performance in AMR this quarter, how does that affect your outlook for 2019? Maybe it's a little early to comment on it but just wanted to take a sense of how you're thinking about your targets now. And second, did you see a benefit from -- or have you already seen a benefit from hurricane-related scrap and has it come through and if there's something more that's expected?

Tamara Lundgren, President and Chief Executive Officer

So let me start with the first one, Piyush. And you broke up in the second one, so you may have to repeat that. But on the first one, in terms of our fiscal '19 targets, as I mentioned in the prepared remarks, we are tracking ahead on volume and margin. We're 12% up [on volumes] through the first quarter of fiscal '18, which is slightly ahead of what would have been an average annual 10% increase in each of the years from '17, '18 and '19. And on our margins, we are tracking at $35 on a last 4 quarter basis against what was a $39 a ton basis on a resegmented basis because when we announced our targets, as you recall, we had not yet integrated Oregon and CSS. So we are ahead of '19 and that is one of the reasons why we have looked at retained capacity. And assuming that the market remains stable or continually -- continues this positive trajectory, we anticipate being able, on a similar growth rate, to hit our retained capacity of 5 million tons and to further expand from the '19 margin targets by at least another 15%. And you may recall that the 5 million ton volume target, we reached this recently at fiscal year '11. And your second question was what?

Piyush Sood, Morgan Stanley

About the hurricane-related scrap from all the hurricane impact. Has it flown through in some of your areas or do you think it's still to come in the coming quarters?

Tamara Lundgren, President and Chief Executive Officer

Well, the generation of scrap from hurricanes tends to be very localized and relatively short-lived. So we are seeing in Puerto Rico, where we operate -- we are seeing scrap generation and we are -- we got back up and operating fairly quickly after the storm concluded. So we are exporting from there and we do see a slight increase in the scrap volumes. In Texas, we're not operating shredding facilities. But again, I don't see it on a global or national basis being material.

Piyush Sood, Morgan Stanley

And I had a follow up on Cascade Steel. Can you give us some sense of, if the gains last quarter were primarily rebar margins or maybe if you could break out that so much was rebar margin and -- because I really want to figure out what's the benefit being derived from scrap integration?

Richard Peach, Senior Vice President, Chief Financial Officer and Chief of Corporate Operations

Yes. Hi, Piyush, it's Richard here. The operating income in CSS in the first quarter was mainly from the steel business. So it was primarily coming from steel manufacturing. The scrap that we supply to the mill, the profits from that are mainly seen in the margins that the mill delivers. In terms of the mix of our products at the mill, we do provide a mix in our press release but rebar is our primary product, and that's mainly where our profit is coming from.

Piyush Sood, Morgan Stanley

So the realized price for rebar last quarter was, I would say, relatively higher to -- at least there's some historical -- when we compare benchmark versus realized, it seems like, typically, it comes in below benchmark. But last quarter, it was much higher. So has the -- kind of the lag or the formula changed, or anything you can kind of point out?

Richard Peach, Senior Vice President, Chief Financial Officer and Chief of Corporate Operations

Nothing in particular other than in terms of the prices themselves. What you're seeing is the higher input cost of scrap feed through into the rebar selling prices themselves.

Phil Gibbs, KeyBanc

Question on the outlook a little bit. I know that the nonferrous prices did extraordinary well in the first quarter on a sequential basis and they're still moving up, I think, a little bit on a lag. So are you anticipating that the second quarter, Richard, will have more potential gains from pricing appreciation in the nonferrous market?

Richard Peach, Senior Vice President, Chief Financial Officer and Chief of Corporate Operations

We're not seeing anything that changes the current market dynamics. So we're expecting another strong quarter.

Phil Gibbs, KeyBanc

Okay. And then on the outlook for the second quarter. I think you did mention that there could be some inventory -- not inventory gain, I'm sorry, but on what you call them the...

Richard Peach, Senior Vice President, Chief Financial Officer and Chief of Corporate Operations

Average inventory.

Phil Gibbs, KeyBanc

The inventory accounting, yes.

Richard Peach, Senior Vice President, Chief Financial Officer and Chief of Corporate Operations

Yes.

Phil Gibbs, KeyBanc

So curious what modest -- I was going to say curious what modest meant.

Richard Peach, Senior Vice President, Chief Financial Officer and Chief of Corporate Operations

That is small, somewhere in the range of a couple of dollars, that type of couple dollars per ton is modest in our mind.

Phil Gibbs, KeyBanc

And then Tamara, just a question in terms of China right now. Are you seeing their interest levels in terms of perhaps wanting to procure more scrap from you moving forward? Or do you think some of their growth on the EAF side is going to be met by internal consumption and how are you thinking about that?

Tamara Lundgren, President and Chief Executive Officer

Well, I think the answer is both, Phil. Clearly, we are seeing increasing scrap utilization in China. BOFs are increasing their charge and clearly, there's a trend for increased usage of EAFs. Part of that is being met internally and part of that is being met through import, which has been the flows for many, many years. As their utilization's increasing, as they are becoming more and more environmentally sensitive, their desire for scrap has increased and so we have recently seen an uptick in demand for scrap imports for China. And I would imagine that, that's going to continue for the foreseeable future.

Phil Gibbs, KeyBanc

Are you selling to them right now, the Chinese, this past calendar year?

Tamara Lundgren, President and Chief Executive Officer

Yes.

Phil Gibbs, KeyBanc

Okay. And then last question, I just wanted for clarification. Tamara, did you mention that scrap pricing in Turkey right now is $400 a ton? Did I hear you say that or was I making that up?

Tamara Lundgren, President and Chief Executive Officer

What I said was that recently reported prices have ranged from $380 to $400 per ton. And that range is -- varies depending upon the coast and size of shipment demand, et cetera. But that is the range globally.

Operator

And at this time, I'm showing no further questions. I'd like to turn the conference back over to management for the closing remarks.

Tamara Lundgren, President and Chief Executive Officer

Thank you, operator. Thank you, everyone, for joining us on our call today and for your interest in our company. We wish you all a safe, healthy and prosperous 2018, and we look forward to speaking with you again in April when we report our second quarter results. Thank you, operator.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Everyone, have a great day.