Schnitzer Steel Industries Inc. Second Quarter Fiscal 2018 Earnings Call

April 5, 2018

Operator

Good day, ladies and gentlemen, and welcome to the Schnitzer Steel's Second Quarter 2018 Earnings Release Call and Webcast. (Operator Instructions) And as a reminder, this conference is being recorded.

I would now like to turn the call over to Mr. Stefano Gaggini. Sir, you may begin.

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

Thank you, Amanda. Good morning. I am Stefano Gaggini, the company's Vice President, Corporate Controller and Principal Accounting Officer. Welcome to Schnitzer Steel's Second 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 statement 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 statement 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

Thank you, Stefano. Good morning, everyone. Thank you, all, for joining us on our second 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, our capital structure and taxes. 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 second quarter financial results. We reported adjusted earnings per share of $1.42. These results included discrete tax benefits of $0.52 from tax reform and the release of valuation allowances on certain deferred tax assets.

Our consolidated pretax operating income of $33 million was our best quarterly performance since fiscal '11 and more than double last year's results, reflecting benefits from our volume growth and margin expansion efforts, our sustained productivity improvements and supportive market conditions.

On a year-over-year basis, AMR's ferrous and nonferrous sales volumes were up 21% and 13%, respectively. These higher volumes, coupled with improved market conditions and our continued focus on productivity improvements, led to a 50% expansion in AMR's margins versus last year's second quarter.

CSS also delivered one of its strongest second quarters with adjusted operating income of $5 million. This is particularly noteworthy as CSS' second quarter included planned maintenance and is typically slower due to weather and holidays. Lower levels of rebar imports, higher prices and volumes and productivity improvements, including internal synergies from the integration of our steel mill and Oregon recycling operations, all contributed to this improved performance.

So, let's turn now to Slide 5 for a further review of steel market trends. As noted in CSS' results, during our second quarter, the U.S. long products market continued to improve with rebar pricing up about 10% year-over-year driven by significantly lower imports, higher raw material costs and strong construction demand.

After the end of the quarter in early March, the U.S. announced Section 232 tariffs on steel and aluminum imports aimed at lifting domestic utilization rates. Even before these tariffs were announced, anticipation of this action had led to reduced imports during the quarter and strengthening domestic steel pricing. Since the announcement of the tariffs, domestic rebar prices have increased further, significantly outstripping the rise in scrap prices. The full impact and duration of the 232 tariffs are not known since country and product exemptions are still being negotiated. At this point, however, the tariffs, together with the impact of earlier trade cases, have benefited the U.S. steel industry, including CSS.

Let's turn now to Slide 6 to review second quarter metal market trends. Ferrous scrap pricing during the second quarter continued its upward trend. This improvement in both the domestic and export markets has been driven primarily by synchronous global growth and a reduction in Chinese semi-finished and finished steel exports which are now down about 30% year-over-year.

During the quarter, scrap remained competitive against semi-finished goods such as billets. In China, pollution controls, the high price of premium coking coal and initiatives to increase BOF scrap consumption from 11% to 20% all contributed to a higher scrap, higher quality iron ore and lower coal mix in the BOF charge. China's policies to reduce steelmaking capacity by 150 million tons by 2020 is tracking ahead of schedule. In addition, China curtailed steel production in a number of regions this past winter. Together, these actions are indicative of a supply discipline in Chinese steel to reduce overproduction and to do so structurally and sustainably.

Assuming that recent and future trade actions and reactions do not derail these positive GDP and supply discipline trends, we expect domestic and export demand for ferrous scrap to continue as stronger global growth translates into improved demand for commodities.

On the nonferrous front, copper and aluminum prices both hit multiyear highs during the quarter, driven by a combination of strong global demand, supply disruption and greater regulation. On March 1, China's National Sword regulations went into effect. This has created stronger demand for higher metallic content products which we are able to provide as a result of our investments in advanced processing capabilities.

A few days ago, Section 232 retaliatory tariffs were announced by China on imports of aluminum scrap. While it is still too early to know the full impact and duration of these tariffs, in the short term, there are a number of actions we can take to adjust. These include changes to our purchase prices, accessing alternative markets and continuing to invest in processing technologies. Long term underlying demand for recycled metals is expected to be in our favor as the world migrates to more environmentally sensitive production practices, including a higher use of ferrous and nonferrous scrap.

Let's move now to Slide 7 to review the leading 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 February, the U.S. industrial production index, which includes the energy, automotive and construction industries, continued its year-over-year rise on stronger durable goods orders and improved GDP growth. Consumer confidence remains strong with the February numbers getting a boost from tax reform and driving up the index to near 18-year highs. While the index did fall slightly in March, confidence remains high given the strong labor markets and lower tax rates. This confidence is also reflected in the growth in personal consumption expenditures which has continued its positive year-over-year trajectory.

The stronger white goods appliance shipment trend, the high average age of vehicles on the road and the more aggressive pricing of both used and new light vehicle sales are all contributing to stronger supply flows, including the supply of end-of-life vehicles. Also, federal tax reform legislation should prove beneficial to the domestic steel market as the lower tax rate environment and capital investment incentives should spur both corporate and individual spending. Barring long term negative impacts from current and potential tariffs, these domestic economic trends, along with prospects for higher global GDP growth, lend considerable support to greater supply and demand for recycled metals and finished steel products.

Let's now turn to Slide 8 for an update on our strategic initiatives. There are 3 pillars that form the framework of our strategy: volume growth, margin expansion and capital deployment to further expand our businesses.

Last year at this time, 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 3-year targets to grow our company-wide ferrous sales volumes by approximately 30% and to increase AMR's operating income per ton by at least 40%. The results of these initiatives through the first half of fiscal 2018 can clearly be seen in our operating trends. Our company-wide ferrous sales volumes are tracking slightly ahead on our way to achieving our fiscal 2019 target, and we have already reached our margin growth target 18 months ahead of our goal.

The supportive market conditions over the last year have been stronger than anticipated when we set these targets. While political and economic uncertainties could impact the timing and the trajectory of our goals, building on the successful execution of our plan to date and assuming the continuation of supportive market conditions, we are targeting company-wide sales volumes of 5 million tons by fiscal '21, utilizing the existing capacity in our platform. This should also generate additional operating leverage and enable us to further expand our margins.

Moving now to Slide 9. While uncertainty regarding trade actions clearly exists, it is important to note that we've developed and we've invested in our platform to enable us to quickly take steps to benefit from tailwinds and to mitigate headwinds as they arise. Our customer base and logistics enable us to access both the domestic and export markets in almost equal proportion. Through the integration of our businesses, through our focus on expanding our customer and supplier base and through our investment in commercial analytics, we have improved our ability to adjust purchase prices and sales to optimize volumes and margins. By directly participating in all aspects of the supply chain, from retail auto parts, to ferrous and nonferrous scrap processing, to manufacturing finished steel products, we can offset weakness in one part of our supply chain with strength in another.

We are successfully executing on our strategic initiatives, and this quarter is a continuation of the trend of strong performance that we have been steadily delivering. We expect to continue to invest in technologies and platforms to enhance our products, increase our service offerings to our customers and operate our company even more efficiently.

Now I'll 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 review of the results of the Auto and Metals Recycling business. AMR's performance for the second quarter was its best result in over 6 years. Adjusted operating income of $45 million was up by 81% year-over-year and adjusted operating income per ton of$50 was up by 50% compared to last year's second quarter. These significant improvements were driven by continuing operating leverage from higher volumes, expanded metal spreads, the increased price environment and sustained benefits from productivity and commercial initiatives, including increased car purchase volumes which were up by 6% year-over-year.

AMR's second quarter results also benefited from average inventory accounting which contributed $5 per ton. While this benefit was comparable to last year, it was much less in proportion to our higher operating income in the current period.

In the second quarter, AMR's ferrous sales volumes were 896,000 tons, which represented year-over-year volume growth of 21%. Nonferrous volumes were also higher, up by 13% compared to the prior year quarter. The primary driver was stronger global demand for recycled metals. This led to an increase in our export sales off both the East and West Coasts.

Average ferrous and nonferrous selling prices in the second quarter were up year-over-year by 27% and 13%, respectively. The improved price environment continued to be supported by U.S. economic trends, positive rates of global growth and from supply-side reform in China which has reduced their exports of steel.

While early in the third quarter, as we look ahead, we expect another strong set of results, although the daily news on trade actions creates further uncertainty. AMR's ferrous sales volumes are expected to increase year-over-year by approximately 10%. Nonferrous sales volumes are expected to be slightly below the prior year subject to any further impacts from the recently announced retaliatory tariffs by China on recycled aluminum products. Compared to last year's third quarter, AMR's operating income per ton is expected to be higher by approximately 30%, including a lower benefit sequentially expected from average inventory accounting.

Moving to Slide 11. I'll now cover the operating trends for Cascade Steel and Scrap. Adjusted operating income for CSS was $5 million, which was up by $7 million year-over-year. This performance was particularly strong given the seasonal holiday period and normal planned maintenance which temporarily affected our production. Compared to the prior year, the CSS results also had benefits from increased ferrous volumes which included an additional bulk export shipment to Asia.

Synergy benefits from the CSS integration are coming in much higher than we expected, and we are trending to an annual benefit of $6 million. We are seeing improvements from a combination of integrated inventory management, enhanced product quality, commercial sales and supplier initiatives and from improvements in productivity and labor efficiency.

Finished steel sales volumes were higher by 18% year-over-year from stronger West Coast construction demand and from lower levels of rebar imports. Average selling prices for finished steel were also higher, up by 20% year-over-year, primarily on increased input costs of scrap.

Looking ahead to the third quarter, we expect finished steel sales volumes to be in a similar range year-over-year and our steel metal spreads to expand compared to the prior year period. Operating income is expected to increase significantly and to be around double our second quarter results.

Moving on, let's proceed to Slide 12 to review our capital structure. Operating cash flow in the quarter was positive with our strong profitability outpacing increased working capital as a result of higher prices and volumes. Our balance sheet continues to have low leverage of 25%, and we maintain our ratio of net debt to adjusted EBITDA of only 1.3x.

Our capital expenditures in the second quarter were $12 million. And for the fiscal year as a whole, we expect to invest CapEx in the range of $60 million to $75 million. We anticipate this will include investments in environmental capital projects, upgrades and replacement of frontline equipment to support our increased volumes, further investment in nonferrous processing technology and normal capital spend on maintaining the business.

Turning to corporate items. Corporate costs in the second quarter were $17 million. This included a one-time special bonus to employees following tax reform, higher incentive accruals based on our strong performance and increased legal expense and professional fees. Looking to the third quarter, we expect overall corporate costs to be lower sequentially by around $3 million.

Our effective tax rate during the second quarter was a benefit of approximately 34%. The rate was driven by discrete benefits of approximately $7 million from tax reform as well as a further $7 million in benefits from releasing valuation allowances on certain deferred tax assets. Together, these two discrete items contributed $0.52 in earnings per share.

Looking ahead to the third and fourth quarters of fiscal '18, we expect our effective tax rate for each of these quarters to be in the range of 20%, while our rate for fiscal '18 as a whole will be lower, primarily due to the discrete benefits that I mentioned earlier. Looking further ahead to fiscal '19, we expect our effective tax rate to normalize in the range of 25%. Please note, our accounting for the impact of tax reform reflects provisional estimates as of the end of the second quarter and may be adjusted over the course of the next 4 quarters.

Finally, in the second quarter, we paid our 96th consecutive quarterly dividend and we also returned capital through the repurchase of 100,000 shares.

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. Today, we have also highlighted some trends, notably trade actions, that may create both tailwinds and headwinds.

In sum, our message today is very simple. We delivered another great quarter. We have a strong outlook. We're delivering operating leverage. We're tracking ahead of our fiscal '19 goals. And we believe we can adjust nimbly to the tariff uncertainty. We have maintained a healthy 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 through our quarterly dividend and share repurchases. We are firmly focused on achieving our goals and controlling that which we can control 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. We were pleased to be able to reward our team with a special one-time bonus award to share in the benefits of our performance and tax savings from recent tax reform. 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. Thanks to your contributions, our achievements this quarter were many as we delivered our best quarterly 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.

Matthew Korn, Goldman Sachs

So, a question on AMR. As you pointed out, you pushed past that target for the AMR op income per ton quicker than expected. And you've noticed that -- you've noted the market has been supportive. Has there been -- also, any piece of that, that you can point to that's also been due to positive surprise versus your plan on the operational side with the efficiencies, the operating leverage, et cetera, that you cited as being also a big factor in Cascade?

Tamara Lundgren, President and Chief Executive Officer

Well, I'll start and Richard may have some things that he wants to add as well. But when we set up our plans to integrate legacy MRB and APB, we outlined a number of internal synergies that we planned to achieve. And we did those, but then also found that in the course of new product development, new business development, customer outreach, internal just-in-time, if you will, efficiencies, success snowballed into greater success. And so, I think a combination of all of those factors is what has allowed us internally to achieve those goals in advance, obviously, supported by stronger market conditions than when we set it out. But you've seen that as well, as you point out, in CSS where our initial plan for synergies has been exceeded because initial success bred further success.

Matthew Korn, Goldman Sachs

Got it. That, of course, prompts my next question which is, we've seen how you've formalized the year '21, the '21 five million ton target for total volumes. And I see there on Slide 8 that the AMR margin expansion arrow is pointing up at a nice angle. Given what you've seen and what you've learned in the markets that you expect, is it realistic to think that the ceiling is then higher for that per ton ferrous metric into 2020?

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

I think, Matt, this is Richard here, we've obviously seen as our volumes have increased the operating leverage we've created enabled that constant increase in our margins. As we go forward, assuming supportive market conditions, we would expect that the business model we have here, where we're spreading more volume over fixed costs, our integrated sales and purchasing and our ability to get more yields from the shredding and auto process, would enable us to further expand our margins if we remain in a supportive market environment.

Matthew Korn, Goldman Sachs

Got it. We'll look for that. The last one for me. You've mentioned the policy uncertainties which have been numerous over the last couple of weeks even. Can you talk any more about the state of overseas scrap demand today? Have you seen now the churn of news regarding U.S. trade policies, China trade policies? Has that had any discernible effect on the engagement of your buyers offshore?

Tamara Lundgren, President and Chief Executive Officer

We're still seeing broad-based demand in our export market. Turkey has been out of the market for a few weeks, but this is consistent with their established purchasing patterns, and they've begun buying in the European market. So, we're not seeing any change in behavior in the ferrous scrap markets because of the tariffs.

Tyler Kenyon, KeyBanc

So, when I look at just the AMR EBIT per ton profitability improvement year-over-year and if I just exclude the inventory accounting impact, I arrive at something pretty close to $18 a ton. Is there any way to couch how much of that was kind of was kind of purely driven by the operating leverage and the volumes? Was it perhaps 25% of that improvement, 75% of that improvement?

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

Yes, Tyler, it's Richard here. I'd say that there is a combination of, obviously, of our own internal initiatives and the market. In terms of the year-over-year, we'd certainly put more of it down to the market, but there's a meaningful portion coming from our own internal initiatives and operating leverage. As far as what contributed to the year-over-year getting better, clearly, the higher volumes, expanded metal spreads, we had some improved pricing and then we had the sustained benefits from our productivity initiatives, too. So, we really have been firing on all fronts.

Tyler Kenyon, KeyBanc

Okay. And then finally, just noticed a very strong uplift in just the CSS ferrous and nonferrous volumes, both quarter-over-quarter and year-over-year. Any way to think about how much of that improvement was driven by a stronger export market versus perhaps some strength in the domestic market?

Tamara Lundgren, President and Chief Executive Officer

Are you talking about export -- the export activity out of CSS or you're talking....

Tyler Kenyon, KeyBanc

Yes, correct, versus that of kind of maybe what you're seeing just domestically as well in the CSS scrap operations?

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

Well, we've really got two things driving there, Tyler. First of all, the export markets off the West Coast have been particularly strong. So, the strong demand and higher prices which brings out more flows. And then the second thing has been our own steel mill has been doing extremely well. And the scrap that goes to the steel mill is routed through our Oregon recycling operations. So, it's been a combination of strength in steel manufacturing and the strength of the export markets for recycled metals that have helped drive out that higher supply flow together with our own channel initiatives to increase our supplier base.

Tyler Kenyon, KeyBanc

And then just last one for me. Just given kind of what we've seen in the headlines as I think you've already well addressed just as it relates to concern around trade policy. You mentioned just some of the initiatives that you've had ongoing for quite some time. But any way to think about kind of where some of those other potential geographies are where you could be sending scrap or where some of the new business you potentially foresee coming from?

Tamara Lundgren, President and Chief Executive Officer

Well, China, obviously, is not the only market that buys aluminum scrap. And aluminum scrap is a valuable product and one that either continues to grow in value as manufacturing increases and global growth increases. What we see is that in situations like this, alternative markets for additional processing will develop and investments in advanced processing technologies, which we have been involved in for a number of years, will continue. So, I anticipate that the alternative markets that are buying now will have the opportunity to grow. But I would preface all of this with -- it is still very unclear how the new tariffs will be implemented and who will be covered. So, I think we want to watch this for a while to see whether there are significant changes to the buying patterns.

Operator

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

Tamara Lundgren, President and Chief Executive Officer

Thank you, everyone, for joining us on our call today and for your interest in our company. We look forward to speaking with you again in June when we will be reporting our third quarter results. Thank you.

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.