Schnitzer Steel Industries, Inc. Third Quarter Fiscal 2019 Earnings Call (*Corrected*)

June 26, 2019

Operator

Good day, ladies and gentlemen, and welcome to Schnitzer Steel's Third Quarter 2019 Earnings Release Call and Webcast. (Operator Instructions) As a reminder, today's program is being recorded.

And now I'd like to introduce your host for today's program, Michael Bennett, Investor Relations. Please go ahead, sir.

Michael Bennett, Sr. Director Investor Relations

Thank you, Jonathan. Good morning. I'm Michael Bennett, the company's Senior Director of Investor Relations. I'm happy to welcome you to Schnitzer Steel's earnings presentation for the third quarter of fiscal 2019.

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 schn.com.

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

As we note on Slide 2, we may make forward-looking statements on our call today, such as our statements about our outlook, targets, volume growth and future margin expansion. 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. We've 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, Michael. Good morning, everyone. Thank you all for joining us on our third quarter of fiscal 2019 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 the highlights of our quarterly performance, the macroeconomic and market trends influencing our businesses and the progress on our strategic initiatives. Richard will then provide details on our productivity initiatives, capital investment program, segment performance and capital structure. I'll wrap up, and then we'll take your questions.

Before we get started, however, I'd like to make a few comments about safety. Safety underpins everything we do at Schnitzer, and we have continued to raise awareness, increase training and sharpen our focus. I am pleased that these results have yielded improved safety performance.

For example, through the first 3 quarters of fiscal '19, our total recordable injury rate is lower by 26% versus last year. This reflects a multiyear trend of continuing improvement. We are proud of the men and women throughout the company who have demonstrated the leadership necessary to achieve these results and we are all committed to even further improvement. The health and safety of our employees and all who work and visit our sites remain paramount.

So let's turn now to Slide 4 to get started. Earlier this morning, we announced our fiscal '19 third quarter adjusted earnings per share of $0.63. This is our second best Q3 performance since fiscal '11. Both divisions delivered solid operating results, and I'd like to start this morning by mentioning a few of our key achievements in the quarter.

First, AMR. AMR delivered operating income per ferrous ton of $31, which was almost 25% higher than the second quarter.

AMR's performance reflected the benefits from both higher ferrous and nonferrous sales volumes, which are each up approximately 9%. In addition, seasonally improved supply flows and retail sales and continuing benefits from the productivity initiatives we announced earlier this year, all contributed to AMR's stronger results.

Second, CSS achieved operating income of $8 million, which was 41% higher than their Q2 results despite lower average net selling prices. Their performance reflected the benefits from seasonally higher finished steel sales volumes, which were up approximately 38% and also significantly increased utilization.

And third, our focus on profitability, inventory management and cost containment led to another quarter of strong operating cash flow. This enabled us to further reduce our debt and return capital to our shareholders through our 101st consecutive quarterly dividend.

Let's now turn to Slide 5 to review Q3 market trends and current conditions.

During the quarter, both export and domestic prices declined, with domestic prices hitting an 18-month low. Domestic prices fell significantly more than export prices, and by the end of the quarter, export prices were trading at a premium to domestic prices, which we hadn't seen since 2018. Looking at the chart on the top right of this slide, iron ore prices continued to strengthen throughout Q3 as supply concerns, strong steel demand in the Chinese domestic market and low iron ore inventory levels at Chinese ports contributed to higher pricing.

The scrap to iron ore ratio is currently at/or slightly below 3x versus almost 4x during Q2 and versus about 4.5x over the last 2 years. This ratio makes scrap very attractive at current levels.

Looking at nonferrous prices, prices and demand for zorba and copper scrap continued to weaken during the quarter, with zorba hitting multiyear lows, primarily due to Chinese import restrictions including tariff and nontariff barriers and also by softer end product demand, including weaker auto sales in China and the rest of Asia.

The uncertainty around China's quality and licensing regulations for the import of nonferrous scrap continues to weigh on demand and prices.

Before we move to the next slide to review finished steel market trends, it's worth focusing on the chart on the lower right. China's finished steel exports have dropped by almost 50% since their peak in 2015. This downward trend is due to, among other things, the impact of the trade cases, which importantly were filed before the imposition of the Section 232 tariffs and are effective irrespective of any changes to the 232 tariffs.

So let's turn now to Slide 6 to continue our conversation. Average domestic rebar pricing trended down during the quarter, primarily driven by customer destocking and lower scrap prices. West Coast demand continues to benefit from robust private construction spending and has the potential to benefit longer term from increased state-level support for infrastructure projects.

As shown in the graph on the bottom left on this slide, domestic rebar to scrap metal spreads reached an 8-year high during the quarter, driven by sustained low levels of imports, which continue to benefit domestic utilization rates and lower scrap prices.

Now let's turn to Slide 7 to discuss the long-term drivers of scrap demand. Long-term demand for scrap is underpinned by several trends, and these include: the increased focus on the environmental impact from steelmaking; the wide-ranging objective to lower greenhouse gas emissions; and the economic and environmental benefits of reducing energy consumption.

We can see how these trends have been translated into higher scrap usage. By looking at the chart in the upper left-hand corner of this slide, as the chart shows, steel scrap usage has significantly outpaced the growth in crude steel production in some of the largest steel manufacturing countries. Equally as important, the share of global steel production from electric arc furnaces continues to grow, not only in the U.S. but also in China.

By 2025, Chinese steel production from EAFs is expected to double compared to 2017, and China is aiming to increase its ratio of scrap consumption and steelmaking by 50% from average scrap input estimates of 20% in 2018.

So now let's turn to Slide 8 for a review of our ferrous sales. Profitable growth in our ferrous sales volumes has been a successful, multiyear strategic focus for AMR. AMR's financial performance has benefited from increased flexibility provided by our investments to expand our ability to access the domestic market as well as by our focus on expanding our sales to additional export markets and customers in Asia, South and Central America, the Middle East and Europe. The results are evident throughout our year-to-date performance. And as the relationship between domestic and export prices shifted, we were able to pivot our sales to the export market as we focused on capturing the benefits of the export premium versus domestic prices.

Now let's turn to Slide 9 for an update on our nonferrous sales. Sequentially, our third quarter nonferrous sales volumes increased approximately 9% and were up more than 5% year-over-year. Through the first 3 quarters of fiscal '19, we shipped more than 2/3 of our nonferrous products to countries other than China. We have replaced the drop in China's imports of zorba and related products with the sales to countries such as India, Japan, South Korea, Malaysia, Taiwan and Thailand.
Similar to the ferrous market, this demonstrates strong results from our sales diversification strategy and our ability to adapt to changing market dynamics.

Assessing the timing of China's future import demand, it's still a bit of a challenge. Recent reports have indicated that the Chinese government is beginning to establish quotas for Chinese scrap importers ahead of issuing import licenses and may also be examining an industry proposal to discard the use of the term scrap by officially renaming certain copper scrap products as recyclable copper raw materials to reflect the high purity of furnace-ready feedstock. These are both good indications that the Chinese government is trying to balance the need for clean grades of scrap with its desire to eliminate the import of solid waste. While the situation remains fluid, our team has accessed alternative markets for our nonferrous products and has continued to increase our sales to customers around the world.

Looking forward, we have a well-developed and focused strategy that includes enhancing and continuing to grow our nonferrous platform.

Let's turn to Slide 10 to discuss this in more detail.

Productivity improvements, ferrous volume growth and technology investments underpin our strategy to more than offset the compression in margins we've experienced in fiscal '19 from the extended weakness in zorba prices. This drop in zorba prices and demand has adversely impacted our operating income by approximately $15 per ton. So let's review each initiative in order.

First, our productivity initiatives. The $35 million of productivity initiatives we announced at the beginning of the fiscal year should enable us to offset approximately one half of this margin compression. Our financial results have already benefited from approximately 2/3 of this amount, with the remainder to be achieved in fiscal '20.

Second, our ferrous volume growth initiative. We have underway a multiyear volume initiative to continue to grow our ferrous volumes. As many of you know, we completed a year early our 3-year plan to increase our organic ferrous volumes by 25% to 30%, reaching 4.3 million tons at the end of fiscal '18. Our current volume initiative targets additional growth of 700,000 tons to reach 5 million tons based on our retained capacity by the end of fiscal '21. We expect this growth to create operating leverage equal to approximately $1 in operating income per ton on all tons for each incremental 100,000 tons.

Third, our technology investment initiative. We're rolling out a capital investment program to implement advanced metal recovery technologies at our major operating facilities. We believe that the benefits from these investments will deliver at least $8 per ton, once they are fully operational.

The benefits come from 3 sources: First, improving the efficiency of our processes to enable us to meet global metal content and quality requirements on a cost-effective basis; second, increasing our throughput and extracting more materials from our shredding process; and third, creating product optionality and furnace-ready materials that can be marketed globally and both broaden and deepen our customer relationships. Importantly, these investments will also support the multiyear sustainability goals, which we plan to include in our next sustainability report in the fall.

As Richard will explain in more detail, we expect the aggregate investment to be in the range of $65 million to $75 million over the next 18 months.

Once implemented, we expect the short payback period and returns well in excess of our cost of capital, assuming average price and demand levels similar to Q3.

Together, our productivity, volume growth and technology investment initiatives should enable us to significantly expand our margins and to continue generating strong operating cash flow, providing us with additional opportunities to grow and to return more capital to our shareholders. We expect these initiatives to expand our margins in the range of $15 to $20 per ton with approximately half of the benefits in fiscal '20 and the full year run rate achieved by the end of fiscal '21.

Now I'll turn the presentation over to Richard, who will provide more details on our segment performance, including our cash flow generation and our technology CapEx investments and productivity initiatives. Richard?

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

Thank you and good morning. As Tamara mentioned earlier, productivity initiatives represent a critical element of our strategic priorities. Our plan is to deliver annual benefits of $35 million, with at least 80% of the total in fiscal 2019 and a full run rate in fiscal 2020. Of the targeted annual benefits, AMR share is $27 million, with $5 million in CSS and $3 million in corporate.

We have made significant progress already in the execution of our productivity measures and continue to track ahead of the rollout schedule that we originally set.

In the third quarter, we achieved consolidated benefits of $9 million and year-to-date have achieved total benefits of $20 million, including approximately $15 million in AMR, $4 million in CSS and $1 million in corporate. In AMR, we are achieving production cost efficiencies, benefits from enhanced asset management, reducing outside services, optimizing use of logistics and improving our retail yields. Of the AMR total, 80% is in cost of goods sold and 20% in SG&A and increased retail sales.

In CSS, all the benefits are to cost of goods sold through use of analytics in maintenance practices, improving yields and enhancing product quality.

And in corporate, the SG&A savings are coming primarily from lower professional fees and reducing outside services.

Now let's move to Slide 12 for an update on our nonferrous technology strategy. Over the past several years, we've had a strong focus on use of advanced nonferrous processing technologies within our recycling business. This already includes downstream sorting equipment in our major export facilities, which we have developed over time to meet changes in quality standards in different markets.
Most recently, these existing processing capabilities have enabled us to grow our nonferrous sales volumes by over 20% between fiscal years 2016 and 2018.

We produce high-quality products, which meet our customers' needs and which have supported the diversification of our sales to almost 20 countries, including to the United States.

As Tamara outlined, we have commenced a major capital investment program to replace, upgrade and add to our existing metal recovery technologies. These improvements will be taking place in at least 5 of our major facilities on both the East and West Coast of the United States and is expected to create additional operating leverage as we target further growth in volumes over the next few years.
In recent months, we've continued to develop our plan, which now includes new wet and dry processing technologies, enhanced zorba separation capabilities, more advanced sorting equipment and an expansion of our cable chopper rollout, which we had stated in the last fiscal year.

Once implemented, these new technologies are expected to increase our throughput and metal recovery, broaden our product set and enable us to produce more furnace-ready materials.
From a sustainability perspective, we expect the environmental benefits of the new technology will include greater diversion of waste from landfills, reductions in our air emissions, use of recycled water and improvements to our energy efficiency.

Engineering, permitting and equipment procurement is already well in process and we anticipate commencing construction in the fourth quarter of fiscal '19 with the rollout continuing throughout the whole of calendar year 2020.

We now expect the aggregate investment to be in the range of $65 million to $75 million with up to $10 million of that amount in fiscal '19.

Once the new technology is fully implemented and assuming average prices and demand similar to Q3, we expect the benefit to operating income to be at least $8 per ferrous ton based on current volumes. We also expect to achieve up to 1/3 of that benefit in fiscal 2020. We expect the return on investment to be significantly in excess of our cost of capital with an average payback of less than 3 years, once we commence operations with the new equipment. We will continue to provide regular progress updates on these investments on a quarterly basis.

Now let's turn to Slide 13 and discuss performance in Auto and Metals Recycling. In the third quarter, AMR's operating income was $29 million. This represented operating income per ferrous ton of $31, which was a sequential improvement of $6, primarily driven by operating leverage from increased volumes and seasonally higher sales of retail parts. Average inventory accounting had an adverse impact in the third quarter of $1 million, which was similar sequentially and which compared to a benefit of $2 million in the prior year third quarter.

AMR's ferrous sales volumes increased by 9% sequentially and benefited from seasonally improved supply flows, higher car purchase volumes, which were up by 15%, and benefits from our commercial initiatives.

Average ferrous net selling prices in the third quarter were down by 13% year-over-year and up by 2% sequentially.

In the first part of the third quarter, the domestic market was higher than export but domestic prices then declined significantly, and currently export prices are at price premium to domestic of $15 to $20 per ton. As the export market was relatively stronger for most of the quarter, AMR increased its exports to 67% of ferrous sales, which was up from 60% in the second quarter.

Our flexible platform gives us the ability to pivot our sales activity to achieve best available margins, dependent on relative conditions between export and domestic markets.

Nonferrous sales volumes were also up by 9% sequentially on the higher supply flows and from our ability to diversify sales.

In the third quarter, we shipped our nonferrous products to 16 different countries as we continue to sell to a broad range of customers in Asia, Europe and in North America.

Average nonferrous net selling prices increased by 7% sequentially but decreased by 16% year-over-year, with zorba prices reducing by considerably more than the average change.

Over the past year, the primary driver of nonferrous price weakness has been the continued impact of Chinese retaliatory tariffs and import restrictions.

However, prices for recycled nonferrous products did increase sequentially in the third quarter as customers in Asia were buying ahead of China's latest round of new import regulations and quality standards, which are due to be implemented this summer.

Looking ahead to the fourth quarter, we anticipate AMR's ferrous sales volumes to increase sequentially in the range of 5% to 10%. Key influences on volumes over the remainder of the quarter include the impact on supply flows of the lower prices in the domestic market. Nonferrous sales volumes are expected to approximate the third quarter.

We expect AMR's operating income per ton to be lower sequentially by approximately 10%, reflecting the impact on metal spreads from the lower price environment.

Now let's move to Slide 14 and discuss operating trends in CSS. CSS third quarter operating income was $8 million, which was a sequential improvement of $2 million compared to the second quarter. Operating results benefited sequentially from a significant increase in sales volumes and higher utilization, partially offset by the impact of lower average net selling prices and high beginning inventory costs.

Our finished steel sales volumes were 38% higher sequentially. Demand in West Coast markets remains strong, and we benefited from a seasonal improvement following weather-related construction delays, which had impacted the second quarter.

Rolling mill utilization was also much improved and reached 98% in the third quarter, up from 76% in the second quarter, which had included planned downtime.

Average selling prices for finished steel were consistent year-over-year but down sequentially by 5%, including from sales mix.

Looking ahead to the fourth quarter, we expect CSS finished steel sales volumes to be consistent with the higher levels achieved in the third quarter. Due to product mix, extended customer destocking and the relative strength of the export scrap market versus domestic, all of which are clouding visibility at this time, we expect CSS operating income in the fourth quarter will be sequentially lower than the third quarter performance.

Moving on. Let's proceed to slide 15 to review our capital structure. Operating cash flow in the third quarter was $40 million, driven mainly by profitability and a small decrease in working capital despite our higher volumes. Our operating cash flow for the year-to-date is now $63 million.

And looking ahead, we expect positive operating cash flow again during the fourth quarter.

Capital expenditures in the third quarter totaled $20 million and included a combination of spend on maintaining the business, environmental capital projects and investments in growth. For the year-to-date, our capital expenditures have totaled $61 million.

In fiscal '19, as a whole, we expect to invest up to $90 million in capital expenditures. This reflects higher CapEx sequentially, including on major environmental projects and on our investments in growth. However, our full year estimate is lower than we communicated last quarter, primarily due to the timing of expected cash outflows in respect of our major nonferrous technology projects.

Our strong operating cash flow enabled us to reduce net debt by $16 million in the third quarter while also returning capital to shareholders through the issuance of our 101st consecutive quarterly dividend.

Net debt of $134 million at the end of the third quarter is almost $29 million lower than one year ago, and our balance sheet remains strong with net leverage of 16% and a net debt-to-adjusted EBITDA ratio of 0.8x.

Turning to corporate items. Corporate costs in the fourth quarter were $13 million, a $4 million increase compared to the second quarter of fiscal '19, and a decrease of $2 million year-over-year.

The sequential increase is primarily driven by a $2 million charge related to the settlement of a wage and hour class action lawsuit and higher incentive compensation accruals.

Looking ahead to the fourth quarter, we expect corporate costs to be $2 million lower than our expense in the third quarter.

Our effective tax rate in the third quarter was an expense of 26%. Our tax rate for the fourth quarter is expected to be approximately 24%, although our actual tax rate will be subject to our level of financial performance and other relevant factors.

I'll now turn the presentation back over to Tamara

Tamara Lundgren, President and Chief Executive Officer

Thank you, Richard. As you've heard this morning, in the third quarter, we delivered a strong set of financial results despite challenges in both the nonferrous and ferrous markets. Our performance can be attributed to the steps we have taken over the past several years and steps which are currently underway to continually improve our business performance.

With global scrap consumption growth outpacing crude steel production increases, the long-term outlook for scrap is strong. We remain focused on our strategic priorities, which include productivity improvements, volume growth and major investments in advanced metals recovery technology.

These initiatives should enable us to significantly expand our margins and to continue generating strong operating cash flow, providing us with additional opportunities to grow and to return more capital to our shareholders.

In closing, I'd like to thank our employees, many of whom I know are listening to our call this morning. Our performance is the direct reflection of your ability to drive best-in-class results without wavering from our core values. My thanks go to each of you as you've truly demonstrated why we continue to be a leader in our communities and the recycling industry.

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

Hunter Alley, Goldman Sachs

This is Hunter Alley on for Matthew Korn. U.S. tariffs on Turkey rebar under Section 232 were recently lowered from 50% to 25%. What impact are you seeing from that change on the -- on rebar side and on the scrap side as well?

Tamara Lundgren, President and Chief Executive Officer

Thank you. We clearly saw an uptick in scrap prices to Turkey right after the announcement of the elimination of the excess tariffs. But we haven't seen any noticeable imports of finished goods of rebar into the U.S. from Turkey. Turkey remains in the market in terms of buying scrap, but on a year-over-year basis, it's still lower than what has been historically traditional in terms of their scrap demand.

Hunter Alley, Goldman Sachs

Got it. Got it. That's great. And then just switching gears a bit, in regards to capital allocation, what -- how are you all thinking about share buybacks and debt repayment going forward? And then regarding leverage, is there a particular leverage target that you have in mind?

Tamara Lundgren, President and Chief Executive Officer

We don't have a leverage target articulated. You've seen that we have over the course of the last 5 years really significantly reduced our debt and continued to generate strong operating cash flow.

In terms of share buybacks and dividends and overall capital allocation, our priorities remain growth in the business, maintaining a strong balance sheet and then returning capital to shareholders. And as our strategic initiatives that we described are rolled out and implemented, they should clearly drive increased earnings and drive even higher cash flow, enabling us to consider increases in contributions to each of those buckets.

Philip Gibbs, KeyBanc

Tamara and Richard, just maybe go through some of the assumptions in CSS/steel in terms of why you've just provided commentary of being, I guess, directionally down. I wasn't sure why you kind of withheld providing more detail behind that if effectively right now you've got rebar steel shipments flattish and the spread environment continues to be pretty good. Your energy cost hits should be winding down. So that was a little bit, I guess, head scratching to me in terms of the reasoning behind the lack of visibility, I think, as you said it. So anything there would be helpful.

Tamara Lundgren, President and Chief Executive Officer

So Phil, let me start and then Richard can add some detail. Clearly, we're seeing steady demand but the tone of the market represents extended destocking. And fundamentally, product mix with extended destocking and the export strength versus domestic for scrap are all factors that we're watching very closely and are our influencers on the outlook. The -- and I think you've mentioned this in your reports as well--scrap low prices and finished goods low prices, we believe, are really a near-term timing issue, not structural. But we've got a unique combination of extended destocking combined with delayed spring supply flows. And I think that we're at an inflection time, and so we're watching those factors very carefully. Richard?

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

Yes. And I would -- so we've got -- we've still got a couple of months to go in this quarter, and there is, due to factors Tamara has mentioned, a fair bit of uncertainty. Some things I would mention to add. Relative to the product mix, one of the factors that has an impact there is in wire rod where the prices are down more relative to rebar. And then the destocking will come to an end, but currently there's some uncertainty when that would be. And then relative to export versus domestic in the Pacific Northwest, scrap markets can be driven very much by the export market. And at this time, that balance is still playing itself out. So as we said, there's some challenges with visibility at this time. And where we see a downward outlook versus what was a very strong Q3, it's difficult to get a number on it at this time.

Philip Gibbs, KeyBanc

Yes. I was just trying to balance your commentary in terms of your expectation that your own steel shipments are going to be pretty good. And I know you ran at a very high level of utilization at the rolling mill in the May quarter and presumably you would see the same thing in the fourth quarter. And so I just don't understand, I guess, the comments around destocking and you being heavily rebar-oriented and then also saying that you expect your own shipments to be flat at a high level of utilization. And so I guess that's where I'm confused. So...

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

Yes. This is -- it's Richard, again, Phil. Demand remains steady in the West Coast markets, which is underpinning our view that we expect another quarter of strong volumes. This is more of a question of tightening spreads in terms of margins relative to the 3 factors that we have mentioned.

Philip Gibbs, KeyBanc

Okay. And then just a follow-up on your guidance comments and I might have a couple of more, so I'll jump back. Your view that, I think, corporate costs will be down, was that relative to your unadjusted $13 million? So I should expect $13 million to $11 million? Is that how to think about it?

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

Yes.

Operator

And this does conclude the question-and-answer session of today's program. I'd like to hand the program back to Tamara Lundgren, CEO for any further remarks.

Tamara Lundgren, President and Chief Executive Officer

Thank you. And thank you all for joining us on our call today and for your interest in our company. We look forward to speaking with you again during the investor conferences that we'll be attending this summer and in October when we report our fourth quarter fiscal '19 results. Thank you.

Operator

Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.