Schnitzer Steel Industries, Inc. Third Quarter Fiscal 2020 Earnings Call

July 1, 2020

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Schnitzer Steel's Third Quarter 2020 Earnings Release Call and Webcast. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) I would now like to hand the conference to your speaker today, Michael Bennett, Investor Relations. Please go ahead, sir.

Michael Bennett, Sr. Director Investor Relations

Thank you, Joelle. Good morning. I am Michael Bennett, the company's Senior Director of Investor Relations. I am happy to welcome you to Schnitzer Steel's earnings presentation for the third quarter of fiscal 2020. In addition to today's audio comments, we have issued a press release and posted a set of slides, both of which you can access on our website at 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 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 today. 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 Chairman and Chief Executive Officer. She will host the call today with Richard Peach, our Chief Financial Officer and Chief Strategy Officer.

Tamara Lundgren, Chairman and Chief Executive Officer

Thank you, Michael. Good morning, everyone. Thank you all for joining us on our third quarter fiscal 2020 conference call.

I'd like to start the call today by thanking our employees for their extraordinary efforts this quarter. They've worked tirelessly through this pandemic, continuously serving our customers and communities, supporting our suppliers and demonstrating the critical and essential role of our business and industry. The operational and financial results we announced this morning reflect their agility as well as the strength of our culture and the resiliency of our platform.

I'd like to turn to a discussion of our response to the COVID-19 crisis, address our third quarter financial results and update you on the strategic initiatives we have underway. Richard will follow with more detail on our segment performance, our CapEx investments and our capital structure. I'll wrap up, and then we'll take your questions.

And one last note before we begin. We are encouraged by the gradual restart of economic activity in the U.S. and globally, which support stronger macro trends of higher scrap demand, supply flows and prices. However, it is still early in our quarter. And given the uncertainty caused by COVID-19, we will not be providing forward-looking guidance at this time.

So let's start now by turning to Slide 4.

We have operated continuously through the COVID-19 crisis. We are included in the critical infrastructure sector and related supply chain as defined by the U.S. Department of Homeland Security. And all our operating facilities were identified as essential businesses by state and local authorities in the U.S., including Puerto Rico and Canada. This reflects our company's important role in supplying the raw materials and finished steel products for the construction of critical infrastructure. Equally as important, the essential business designation reflects our role in supporting the health and safety of our communities by recycling materials that would otherwise be diverted to landfills or be disposed of in a less environmentally sustainable way.

Early on, we deployed health, safety and wellness protocols, rolled out training and engaged in steady communications across our platform to ensure the safety of our people, our customers, our suppliers and all who visit our sites. These actions include pre-entry thermal screening, wearing face coverings, social distancing, frequently cleaning our work sites and washing our hands and remote work arrangements where applicable. The early and comprehensive adoption of these protocols has enabled us to keep our employees safe, avoid the spread of the virus in our facilities and continue to operate throughout this pandemic. While implementing these new work protocols and practices, our team members have not lost their focus on operational safety. During the quarter, they continued to deliver improved safety performance. And as many of you may recall, our last fiscal year, fiscal '19, was the safest year recorded in our company's history. And I want to congratulate our team for their continued progress in further improving our TCIR trends through the first 9 months of the fiscal year.

Now before turning to the next slide, I'd like to take a moment to highlight the generosity of our team members who have used their ingenuity and our global networks to provide support to our communities and to people in need. During this crisis, we have procured and donated thousands of masks to local hospitals, led successful food drives with the support of our customers and donated to local food banks and the American Red Cross. There are countless other ways that our people have gone above and beyond during this pandemic, including through our Paid Time Off Donation program, converting our core values into committed actions.

So now let's turn to Slide 5.

Just as we have stayed focused on health and safety throughout the COVID-19 pandemic, we have also not wavered from our commitment to progress our sustainability goals, which are focused on People, Planet and Profit.

So let me spend a few minutes on people and planet, before I move on to a review of our financial results. What sets Schnitzer apart from many other businesses is that sustainability has been at the core of what we do and how we operate since our founding in 1906. Our company was built on a culture and by a workforce that have always been broad based and strengthened by diversity. I want to reaffirm in the clearest possible language my commitment and our company's commitment to a workplace based on respect, fairness and equal opportunity. This can only exist if we're a place where characteristics such as race, gender, religion and sexual orientation do not define talent or opportunity. We are dedicated to developing a diverse workforce at all levels of our organization and ensuring a culture of inclusiveness because we believe a wide range of perspectives and talent is crucial to creating a supportive culture for our employees and stronger business results.

Beginning in 2018, for example, we introduced a cultural awareness program across our company to engage in conversations and training about topics such as unconscious bias, discrimination and the importance of fostering a positive inclusive culture at work. The comfort and confidence that many of our employees gained as a result of this program enabled them to begin a series of new conversations about systemic racism in our society. We've taken a number of other steps over the last several years, but there is more that we can and will do. To read more about how we're integrating Diversity and Inclusion into all aspects of our business and measuring our progress, I encourage you to read our sustainability report, which you can access on our website.

Our commitment to environmental sustainability, the planet, means that we are continuing to invest in our manufacturing and recycling facilities to incorporate state-of-the-art environmental and safety controls. Today, our facilities are powered by 90% carbon-free electricity. And we have published and are tracking towards our multiyear goals to reduce our greenhouse gas emissions. During the quarter, we were again recognized for various aspects of our sustainability program. I want to acknowledge the contributions of all our team members for the excellent progress we're making in delivering on our sustainability commitments.

So let's turn now to Slide 6 to review our third quarter results.

Earlier this morning, we announced our fiscal '20 third quarter adjusted earnings per share of $0.05. During one of the most challenging quarters in recent times, we delivered positive segment operating performance, generated strong operating cash flow, reduced our net debt and issued our 105th consecutive quarterly dividend.

In the third quarter, CSS almost doubled its operating income sequentially, driven by a combination of new sales initiatives, higher utilization, lower raw material costs and productivity benefits. AMR delivered solid results in a market environment where ferrous and nonferrous scrap prices dropped to levels not seen since 2016.

Our team kept its focus on what we are calling the 5 Cs, COVID-19, Customers, Commercial Initiatives, Costs and Cash flow. This focus underpinned our ability to keep our people safe, optimize our sales, align our operating costs with lower supply and production volumes, effectively manage working capital, progress our strategic priorities and return capital to our shareholders through our dividend. I've already discussed how we deployed multiple operating protocols in order to work safely through the COVID-19 pandemic. Keeping our workforce and all who visit our sites safe has been and will continue to be our top priority. The actions that we've already taken have shown that we can move quickly and effectively as the situation requires and support our communities in the process of doing so. AMR's and CSS' strong customer focus came through very clearly in our third quarter performance. CSS' flexible and responsive customer service and the sales initiatives that it's implemented over the last year enabled it to maintain finished steel sales volumes at levels that were almost equal year-over-year, notwithstanding a very challenging economic environment.

At AMR, while overall demand for ferrous and nonferrous materials declined due to the COVID-19 shutdowns, our global sales diversification strategy and logistics expertise provided us with the expanded reach to serve customers in 21 countries during a very challenging quarter. AMR's retail sales of recycled auto parts also made a significant contribution to the quarter as Pick-n-Pull showed its countercyclical nature and continued to attract strong retail demand.

As a company, we benefit from an operating platform where the majority of our costs are variable. We have multiple levers available to us, and most importantly, the agility to adjust them in order to manage through volatile environments. During the quarter, lower prices for both ferrous and nonferrous metals, in combination with the economic slowdown and restrictions on suppliers related to COVID-19, severely constricted the supply of scrap metal, including end-of-life vehicles. Our team successfully implemented commercial initiatives and cost adjustments to partly offset the impact of lower prices and lower supply flows.

During this uniquely challenging quarter, our focus on productivity also did not falter. This quarter, we delivered ahead of schedule, the full run rate of the targeted productivity initiatives we announced last October. We also achieved early benefits from the ongoing transition to our One Schnitzer model. And lastly, our effective working capital management enabled us to deliver strong operating cash flow and reduce our net debt, while continuing to invest in our strategic CapEx projects and return capital to our shareholders.

So now let's turn to Slide 7 to review market trends and conditions in more detail.

As you can see or as you will see in the upper left-hand chart, in March, export and domestic ferrous sales prices fell over $50 per ton or approximately 20%, reaching multiyear lows. By May, prices had begun to recover, but were still materially below pre-COVID levels. Looking at export activity off the East Coast, during the quarter, Turkish demand was driven by 2 trends. Turkish Government fiscal incentives to support export and production-oriented growth in an effort to revive at its economy and billet demand from China due to higher iron ore prices and logistics challenges with Chinese domestic scrap. Demand off the West Coast from Asia during the quarter was relatively broad based as mills purchased inventory in anticipation of the lifting of lockdowns, higher steel mill utilization and government stimulus. Demand in the domestic market during the quarter was impacted by the suspension of auto production and other manufacturing activity. The pricing increase in May occurred as all grades of scrap were in shorter supply than what was needed. June domestic scrap prices varied from region to region with prices sideways to slightly down. But as U.S. manufacturing, including auto production restarts post the COVID-19 shutdowns, higher demand should return to the domestic market.

Turning to the nonferrous market. Like the ferrous markets, the recent price movements have largely been influenced by the impacts of COVID-19 and the gradual restart of economic activity in the U.S. and globally. During the quarter, copper and aluminum prices reached multiyear lows, reducing purchase prices to levels that inhibited efficient collection. Prices began to recover in late March and April, as confidence improved following the U.S. stimulus programs and the reopening of China's economy. For both, the ferrous and nonferrous markets, the economic consequences of the COVID-19 crisis have been weak scrap supply flows and lower prices. We expect to see this reverse as the U.S. and global economies reopen, although we expect near-term volatility to continue due to concerns over the speed and success of the reopenings.

So let's turn now to Slide 8 to discuss some of the longer term trends underlying demand for scrap.

There is a significant degree of uncertainty in the near-term market conditions due to COVID-19. Despite the current volatility, however, the long-term drivers of scrap demand remain intact due to the greater emphasis on recycling, the continued growth in global EAF steelmaking capacity and the increased metal intensity of lower carbon-based economies.

As you can see on this slide, on a year-over-year basis, U.S. exports of ferrous scrap metal are up significantly with Turkey, Mexico, Malaysia and Bangladesh, showing particularly strong trends, although the past few months have been weaker than the average due to the impact of COVID-19. In addition, the proportion of EAF steelmaking has been expanding and is projected to increase in the U.S. as well as in China and other Asian economies. And due to its lower carbon footprint, demand for metal-based products produced with recycled materials is expected to increase significantly in the years ahead. These long-term trends underpin our strategic initiatives. As we'll discuss on the next slide, we have kept a strong focus on our strategic priorities, notwithstanding the disruption caused by COVID-19. And as a result, we are already experiencing benefits.

So now let's turn to Slide 9 to review these activities.

Our strategic initiatives address 3 dynamics: cyclicality, structural change and long-term drivers of scrap demand. We're addressing each of these dynamics through productivity improvements and a more agile operating model, technology investments and higher volumes and increased offerings of products and services.

Let's discuss each of these in turn. At the beginning of our fiscal year, we announced a Productivity Improvement Program centered on production and functional cost efficiencies, improved asset management and logistics. We delivered the full run rate of savings and benefits from this program ahead of schedule.

In March, we announced our plan to transition to a functionally based integrated operating model, which we call the One Schnitzer model. This was the culmination of our evolution to a more simplified operating platform to improve our efficiency and enable greater focus on the critical drivers of our business.

Beginning in the first quarter of fiscal '21, our operations, sales, services and other functional capabilities will be consolidated at an enterprise level, and we will report our financial results in a single segment. This new structure will enable us to create a dedicated platform to accelerate growth in products and services, to further standardize our operations, to ensure our low-cost operating position and promote operational excellence, to solidify the productivity and cost efficiency savings and benefits from our productivity program and to increase the connectivity between shared services and operations.

Second, as Richard will describe in more detail, our investments in advanced metal recovery technologies continue to move forward, although we have seen some equipment delivery and permitting delays due to COVID-19. Once these projects are completed, we'll be able to improve the efficiency of our processes, increase our throughput, extract more materials from our shredding process and produce furnace-ready products.

Importantly, these investments will also support our Sustainability objectives of increasing recycling and reducing waste.

And the third leg of our strategic growth initiative is focused on increasing our sales of products and services. We've seen an increasing demand from customers for a wider range of products and services, including furnace-ready nonferrous products, recycled auto parts and logistics and related services. We're proactively working with companies and communities in their efforts to improve the sustainability of their own supply chains and reduce their carbon footprint. Together, we believe that these initiatives position us well to significantly grow our revenues, improve our margins and continue generating strong operating cash flow through the cycle.

So now let me turn it over to Richard for a more detailed review of our segment performance and our strategic CapEx investments. Richard?

Richard Peach, Executive Vice President, Chief Financial Officer and Chief Strategy Officer

Thank you, Tamara, and good morning. I'll begin with an update on the status of our technology strategy. We are continuing our strong focus on our program to replace, upgrade and add to our nonferrous metal recovery technologies. Engineering design, permitting, equipment manufacturing and delivery as well as construction are all critical elements of our plan. Even in the current COVID situation, we are still making progress. Two new cable processing plants are installed, operational and expected to make a positive contribution to our fourth quarter performance. We expect to complete the installation of major new nonferrous processing systems and heavy media plants at several of our major facilities between August 2020 and April 2021. Once implemented, most of the nonferrous from our shredding operations will be processed through the new equipment. With increased metal recovery, we expect our nonferrous volumes from shredding to increase by approximately 20%. We also aim to increase product optionality and to have the technology in place, which enables us to convert our zorba to higher quality furnace-ready products.

We expect our total capital investment for these advanced metal recovery projects to be in the range of $80 million to $90 million, of which, we have spent $30 million to date and expect to spend up to $20 million in the remainder of this fiscal year.

Once the new nonferrous technology is implemented, we expect the benefit to operating income to be at least $8 per ferrous ton. We plan to reach this run rate by the end of fiscal '21 once all the new plants are fully operational. With installations planned to occur over the next several quarters, in fiscal '21, we expect to achieve 1/3 of the target $8 per ton of profitability and 1/3 of the targeted increase in new nonferrous volumes.

Now let's turn to Slide 11 to discuss our ferrous sales platform. Demand for recycled ferrous metal in the third quarter came from customers across the globe who placed orders for their production needs or to rebuild inventory as economies began to reopen. The destination ports for our shipments remained open for business, and we used our global network and logistics expertise to make sales and deliver our products to customers in several continents, including Asia and Europe as well as to the U.S., Mexico and Canada.

In the third quarter, we used our flexible platform to sell 2/3 of our ferrous products to the export market, with the remainder sold domestically, including to our own mill. Our top country destinations for ferrous exports were Bangladesh, Turkey and Vietnam.

Now let's turn to Slide 12 for an update on our nonferrous sales platform. In the first 3 quarters of fiscal '20, our continued focus on sales diversification resulted in us shipping 90% of our nonferrous products to countries other than China. As part of more stringent regulations, China has been imposing quotas and other duties on scrap imports, but is still short on raw material to support economic growth. To meet this demand, some processors moved or established new operations in other countries. This shift in demand patterns has enabled us to continue to expand our nonferrous customer base. And in the third quarter, we sold our nonferrous products to 14 countries, including India, South Korea, Malaysia, Taiwan and Thailand.

China has also been developing new quality standards for imported scrap. We understand these standards are close to being implemented althoughthe effective date may be impacted by delays in finalizing new processes for inspections, tariffs and other import duties. Once implemented, we understand that nonferrous products that comply with the new quality standards may be eligible for import into China without quota limits. These structural changes continue to reinforce the importance of our technology strategy and the ability to produce higher value furnace-ready products to meet these changing standards and global demand.

Now let's turn to Slide 13 to discuss the operating trends at AMR.

AMR achieved positive adjusted operating income of $5 million or $6 per ton in the third quarter. Excluding the adverse impact from average inventory accounting of approximately $3 per ton, adjusted operating income was $9 per ton. The COVID-related economic slowdown led to AMR's performance being well below our second quarter. The positive operating income in the third quarter was directly as a result of our strong focus on execution of sales orders and shipments, keeping all our facilities open for business and the rapid action we took to adjust labor hours and to reduce variable operating costs by $3 million. The benefit to our performance from these actions partly offset the impact of lower supply and the decrease in prices for ferrous, nonferrous and platinum group metals.

Both our first and third quarters of this fiscal year were impacted by sharp drops in market prices. However, despite lower volumes, our third quarter adjusted operating income per ton, excluding average inventory accounting of $9, compares favorably on the same basis to our first quarter of $4 per ton. The primary reason for this improvement is benefits from our productivity initiatives that we have implemented since last October.

On a sequential basis, average ferrous selling prices and volumes both fell by 8%, while average nonferrous selling prices and volumes both decreased by 2%. Despite the reduced economic activity, our sales of recycled auto parts were up sequentially by $4 million. This trend illustrates the countercyclical benefit of our retail stores because demand for mechanical parts has historically increased in weaker economic environments when auto sales are down and cars are being replaced less often.

Now let's move to Slide 14 and discuss operating trends in CSS.

CSS achieved strong results in the third quarter with operating income of $7 million, almost double their result in the second quarter. We used a strong focus on sales initiatives and customer service to take advantage of resilient West Coast construction demand for long products. As a result, our finished steel sales volumes were only 4% lower sequentially despite the disruption from COVID. Sequentially, finished steel sales prices were up slightly and CSS was able to expand metal spreads due to the lower scrap price environment. The steady steel demand also supported strong production and our rolling mill utilization of 91% was well ahead of our second quarter, that had included some timeout for planned maintenance. While the lower scrap price environment reduced the contribution from CSS' recycling operations, this was significantly offset by benefits of productivity initiatives, which reduced production costs and SG&A.
Let's move to Slide 15 and discuss our capital structure and corporate items.

Operating cash flow in the third quarter was strong at $39 million and for the year-to-date is $56 million. This performance once again demonstrates our strong track record of delivering positive operating cash flows through the cycle. We reduced net debt sequentially by $11 million. And at the end of the quarter, our net debt was $121 million. Our net leverage ratio was just 15%, and our ratio of net debt to adjusted EBITDA was 1.4x.

At the end of the third quarter, we were in full compliance with our debt covenants. However, in light of uncertainty over the strength and timing of economic recovery, at the end of June, we agreed with our lenders a relaxation of our covenants for the next 4 quarters. This enables us to continue to navigate the COVID situation, run our ongoing business effectively and complete the rollout of our critical technology projects. The cost of amending our credit agreement is not material and for accounting purposes, will be spread over the remaining life of our facility. As a result of this credit amendment and our trend of strong cash flows, we intend to pay back cash that we drew down from our credit facility in early April.

Capital expenditures in the third quarter totaled $22 million. And for the fiscal year-to-date, our total CapEx was $59 million. We expect to spend a total of up to $90 million in fiscal '20. This total includes up to $50 million on growth projects and the balance of $40 million is for maintaining the business, including $10 million on environmental projects. Adjusted corporate costs in the third quarter were $8 million, and our effective tax rate was a benefit of 28%, driven in part by the recognition of tax benefits associated with the Federal CARES Act.

During the quarter, we made further progress in implementing productivity initiatives that are targeting realized benefits of $15 million in fiscal '20. Of this amount, $12 million has now been achieved year-to-date, including $6 million in the third quarter, and we now expect to exceed our original target for this fiscal year.

In connection with these productivity initiatives, we incurred restructuring charges and other exit-related costs of approximately $3 million in the quarter. These charges are excluded from our adjusted EPS.

During the third quarter, we also returned capital to shareholders through our 105th consecutive quarterly dividend. Finally, we expect to make the transition to our new One Schnitzer operating model at the beginning of our fiscal '21. Our enterprise level reporting will still include consolidated revenues, costs, SG&A, EBITDA and earnings. We also plan to continue reporting operating statistics, including volumes and selling prices for our major products as well as expected benefits and returns for our strategic initiatives.

I will now turn the presentation back over to Tamara.

Tamara Lundgren, Chairman and Chief Executive Officer

Thank you, Richard. During a rapidly evolving environment that presented unique and unprecedented challenges, our third quarter results reflect the resiliency of our operations and the agility of our team. It's worth noting that we are a company that was founded in 1906, and we've experienced downturns and volatility from The Great Depression to The Great Recession. There's a legacy at our company of successfully facing challenges head on and navigating through the toughest of times.

While the near-term outlook is uncertain, our team is experienced in managing what we can control in the short term while continuing to execute on our longer-term initiatives. We have a strong balance sheet with low net leverage and interest expense, a strong track record of delivering positive through the cycle operating cash flows, an ability to invest in the growth and productivity of our company and an uninterrupted record of returning capital to our shareholders through our dividend.

Our performance can be attributed to the steps we've taken over the past several years and steps which are currently underway to continually improve our business performance. With the greater emphasis on recycling, the continued growth in global EAF steelmaking capacity and the increased metal intensity of lower carbon-based economies, the long-term outlook for our business and industry is strong.

In closing, I'd like to thank our employees for their extraordinary efforts. This is a quarter in which you've truly demonstrated why we continue to be a leader in our communities and the recycling industry. Thank you for everything that you're doing to remain safe, to keep your families and friends safe and to support your colleagues, your communities, our company and our country.

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

Operator

(Operator Instructions) I'm not showing any questions at this time.

Tamara Lundgren, Chairman and Chief Executive Officer

Well, thank you, operator. With the extended commentary this morning and I think what we may have are some technical difficulties, I want to thank all of you who called in today and let you know that we look forward to speaking with you again in October when we report our fourth quarter and our full year fiscal '20 results. Thank you.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.