Schnitzer Steel Industries, Inc. Second Quarter Fiscal 2021 Earnings Call

April 7, 2021

Operator

Good day and thank you for standing by and welcome to the Schnitzer Steel Second Quarter 2021 Earnings Results Call and Webcast. (Operator Instructions)

I would now like to turn the call over to your speaker, Michael Bennett, Investor Relations. You may begin.

Michael Bennett, Sr. Director Investor Relations

Thank you and good morning. I'm Michael Bennett, the company's Senior Director of Investor Relations. I am happy to welcome you to Schnitzer Steel's earnings presentation for the second quarter of fiscal year 2021. 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 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 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 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.

In preparing for our earnings call this morning, I took a look back at our announcement a year ago. My remarks last year centered on our designation as an essential business and part of the nation's critical infrastructure, which enabled us to operate continuously throughout the pandemic. I discussed the health and safety protocols we were deploying and the support we were providing to our communities and health workers.

I noted at the time that there was no playbook for how to deal with the COVID-19 pandemic but that there was a long legacy in our company of facing challenges head-on, navigating through the toughest of times and doing what's right to protect our people, serve our customers, support our suppliers and help our communities.

A year later, I am happy to report that the operational and financial results that we will discuss today are Schnitzer's best results in over a decade. They would not have been possible without all our employees, from our frontline workers to those who have been working remotely, living our core values of safety, sustainability and integrity.

Our success is the direct result of how they have embraced these values. And their performance reflects the collaboration, innovation and resilience that define our culture and our company.

So, let's now turn to Slide 4 to get started.

Ensuring the health and safety of our employees and all who visit our sites is our top priority. On the health front, we are continuing to follow all CDC guidelines. These include social distancing, wearing face coverings, frequently washing our hands and wiping down high-touch areas. We are actively communicating with our employees regarding resources we can provide in support of their physical and mental well-being. To that end, we are providing paid time-off for every employee to receive a full COVID-19 vaccination.

On the safety front, as many of you know, in each of the last 2 fiscal years, we have reduced workplace injuries to record lows for our company. Through the first half of this fiscal year, we are on track to extend this trend. I want to highlight the work of our frontline team members who have deployed new work processes to protect our employees and all visitors to our sites while continuing to work safely and deliver improved safety performance. We still have work to do, but our team's commitment to safety is clearly showing through.

In addition to health and safety, our commitment to our other multiyear sustainability goals, as shown on this slide, continues to increase in importance in today's environment. These goals are focused on conserving resources; reducing waste and emissions; maintaining an ethical, engaged and inclusive workforce; and giving back to the communities where we operate.

In recent months, we were recognized by several well-respected organizations for various aspects of our sustainability program. Ethisphere named us one of the World's Most Ethical Companies for the seventh consecutive year. And S&P Global named us a 2021 Sustainability Yearbook Member and an Industry Mover. Being recognized as an Industry Mover by S&P Global is reserved for one company in each ranked industry that demonstrates the strongest year-over-year improvement. I want to acknowledge the contributions of all our team members as these honors reflect their ongoing commitment to our core values and our culture.

Let's turn now to Slide 5 for a review of our second quarter highlights.

Earlier this morning, we announced our fiscal '21 second quarter adjusted earnings per share of $1.51. Our results reflect adjusted EBITDA of $71 million, which was up almost 80% sequentially and is 2.5x higher than our adjusted EBITDA in the second quarter of last year.

Our results reflect strong global demand for recycled metals and finished steel products as well as benefits from the commercial initiatives and productivity improvements related to the transition to our One Schnitzer operating model. Notably, our adjusted EBITDA per ton of $73 was significantly better than in fiscal '11, which was the last time that ferrous and nonferrous prices were at higher levels than we saw in Q2. This illustrates the benefits we've been able to achieve from our productivity and commercial initiatives.

Notwithstanding the strong quarterly demand and our overall performance, our ferrous sales volumes were down approximately 5% sequentially due to the impact of severe weather in February on the timing of shipments, and our nonferrous volumes were down slightly due to tight availability in the container market.

During the quarter, we also returned capital to our shareholders through our 108th consecutive quarterly dividend.

Let's turn now to Slide 6 for a review of pricing trends for recycled metals and finished steel products.

As you can see on this slide, prices for ferrous export and domestic scrap rose to multiyear highs during the quarter. Price volatility during the quarter and through the first month of Q3 was significant, but trading was maintained at much higher levels than in the recent past, reflecting the stronger demand associated with both the post-pandemic economic recovery and positive structural commodity trends.

Nonferrous scrap prices also reached multiyear highs during the quarter driven by strong global demand, including from China. Zorba, which was trading as low as $0.34 per pound last year, now trades around $0.75. And while not shown on these charts, PGM pricing has also reached multiyear highs.

The sharp increases in ferrous and nonferrous prices during the quarter were driven by low inventory levels after many quarters of destocking, followed by significantly higher steel mill and smelter buy plans and production levels.

There are also many long-term trends that support strong and sustainable ferrous and nonferrous scrap demand, including: the new domestic steelmaking capacity that is projected to come online in the coming months; the global transition to lower-carbon technologies such as electrification and renewables; the increased use of scrap and basic oxygen furnaces; China's elimination of quotas for nonferrous scrap imports that meet its metal content standards; and lastly, the prospect of China's reemergence as an importer in the global ferrous scrap market.

During the quarter, we also saw strength in demand for our finished steel products. Our steel mill is one of the very few whose primary energy source comes from hydroelectricity. Combined with the use of recycled scrap metal as its primary raw material, the steel made in our electric arc furnace steel mill in Oregon has an exceptionally low carbon impact as compared to the industry average. In a world that is seeking decarbonization, recycled scrap metal as well as the low-carbon-emission steel we produce will be increasingly important metals carbon solutions. And we expect demand to continue to accelerate.

Let's turn now to Slide 7.

Decarbonization and broader ESG factors, including government-supported green investments, together with the catalyst effects of global stimulus are serving as structural drivers of demand for recycled metals. Scrap, in other words, is now an important strategic solution for companies, industries and governments that are focused on carbon reduction. It is a differentiator for metal producers and fabricators, and it is a critical part of every community's commitment to reducing material going to landfills and their commitment to supporting a circular economy.

A low-carbon economy and many low-carbon technologies are widely acknowledged to be more metal intensive. Whether it is the transition to electric vehicles, the increased use of renewables such as wind and solar for energy, the transition to 5G or the efficiency and convenience of smart grids, these low-carbon technologies require more metal. And recycled metals require less carbon to produce than mined metals. While a variety of solutions will be required to decarbonize the manufactured metals value chain, increasing the use of recycled metals is one path that is achievable immediately.

We can see how some of these trends have already been translated into higher ferrous scrap metal usage by looking at the chart in the upper right-hand corner of this slide. Electric arc furnace steelmaking, which uses scrap as its primary raw material, has been expanding and is projected to increase further. In China, scrap usage in steelmaking is expected to increase by 50% from current levels driven by additional EAF capacity as well as by the increased use of scrap in their BOFs.

Let's turn now to Slide 8 to review the strategic actions we have underway, which are aligned with these long-cycle trends.

Efficiency, innovation and volume growth underpin our strategic initiatives to leverage the positive long-term trends underlying our business.

Our innovative investments in advanced metal recovery technologies are critical components of our strategic plan to increase our efficiency and grow our nonferrous volumes. Since the end of the quarter, we have commissioned 2 of the advanced metal recovery technology systems which are key to the execution of our strategic plan and the achievement of our sustainability goals.

Extracting more nonferrous metals from our shredding activities is a significant value-added process and is directly aligned with global demand trends. Copper and aluminum demand, for example, will benefit materially from the low-carbon transition through growth in electrification and renewables. We expect the benefits from these projects to be substantial and to increase our volumes and revenues, lower our operating costs and improve our margins, expand our product offerings and our customer base and support our sustainability objectives of increasing recycling and reducing waste.

We expect the remaining systems to be commissioned in stages and for all of them to be fully operational by the end of the first half of fiscal '22.

So now let me turn it over to Richard. for a more detailed review of these projects and our financial performance.

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 our advanced metal recovery technology initiative.

Strong progress on our rollout continues. And as Tamara just mentioned, we commissioned 2 major new plants since the end of the second quarter. One is on the West Coast, a primary nonferrous recovery system that is integrated with our shredding operation. We will use this new system to recover zorba, which contains aluminum; zurik, which contains stainless; and insulated copper wire.

The other system that's being commissioned is an advanced aluminum separation system in the Southeastern U.S. that will cover our East Coast operations. This new system will give us the capability to convert zorba into a variety of higher-value products, including twitch, which contains a higher percentage of aluminum, as well as stainless, brass and zinc.

Construction is in process on an additional primary nonferrous recovery system on the East Coast and also on an advanced copper separation system in the West that will primarily recover refinery-grade copper.

As part of our technology initiative, we also have 5 other systems currently in the permitting or engineering phases. Subject to no further COVID-related or other delays, we are now targeting completion of the rollout of our installations by the end of the first quarter of fiscal '22 and, after production ramp-up, to be fully operational on all of our new systems by the end of the second quarter of that fiscal year.

On an annual basis, our shredding process currently creates approximately 250 million pounds of nonferrous products. We expect our new technology will enable us to increase recovery of metal and to provide optionality to create a range of higher-value products. Based on our current volumes and after we complete the rollout, we expect our nonferrous from shredding to increase by 20% to 300 million pounds per annum.

We now expect the total capital investment for our new, advanced metal recovery technology to be $105 million. Of this amount, we have spent approximately $60 million including $19 million in the first half of fiscal '21. In the balance of fiscal '21, we expect to spend an additional $30 million and then the remaining $15 million in the first quarter of fiscal '22.

Now I'd like to turn to Slide 10 to discuss our consolidated results, ferrous sales and the market dynamics.

Adjusted EBITDA per ferrous ton reached $73, our highest quarterly performance since 2008. This represented a sequential increase of $35 and was higher by $44 on a year-over-year basis.

At the beginning of the quarter, market prices for recycled ferrous rose sharply before dipping in January, then increasing back to higher price ranges towards the end of the quarter. The sharply rising prices and the market volatility led to a significant expansion in our metal spreads and a benefit of $10 per ferrous ton from average inventory accounting. Our strong results also benefited from increases in selling prices for recycled nonferrous, platinum group metals and for finished steel products.

Ferrous volumes were flat year-over-year and sequentially were down by 7% due to severe winter weather, which delayed 3 shipments originally planned for February. The impact of this delay to the quarter offset approximately half of the benefit from average inventory accounting.

We sold our ferrous volumes to 10 countries, including Mexico, Bangladesh, Ecuador and Peru. Export sales to the Americas represented almost 1/3 of the total volume, which was a record for that region and reflected tight regional scrap supply due to the pace of economic recovery from COVID. The percentage of domestic sales was sequentially higher, which was due to the impact of delayed shipments on our export sales volumes. Sequentially, average selling prices for ferrous rose by 43%. And year-over-year, prices were up by 51%.

The strong global demand for recycled ferrous is being driven by both cyclical and structural factors, including continuing economic recovery, benefits of government stimulus, tight supply, growth in EAFs and the increased use of scrap in steelmaking.

Now let's turn to Slide 11 for an update on nonferrous sales and the market dynamics.

Demand for nonferrous increased in the second quarter. Market prices for aluminum, copper and zorba all reached multiyear highs. Nonferrous sales volumes were up by 10% on last year's second quarter and slightly down sequentially due to timing of shipments that were impacted by the tightness in container availability.

Our nonferrous products were sold to 18 countries, including India, Malaysia, South Korea and China. Average selling prices for nonferrous were up by 51% year-over-year and sequentially by 30%. Zorba prices have now returned to levels last seen in 2018.

Now let's turn to Slide 12 to discuss our steel mill trends in West Coast markets.

Finished steel sales volumes were up sequentially by 1% and year-over-year by 5%. West Coast demand remained strong, and our sales volumes represented our highest second quarter since 2008. Finished steel sales prices were up by 10% year-over-year and by 11% on a sequential basis. These increases reflected the strong demand and the flow-through of higher input cost of scrap. Rolling mill utilization was 88%, up significantly year-over-year but down sequentially due to normal seasonality and temporary impacts of severe winter weather on production in February.

Now let's move to Slide 13 and discuss cash flow, capital structure and our outlook.

Operating cash flow in the second quarter was positive $5 million. Benefits from increased profitability more than offset impacts to working capital from the higher price environment and from increases in inventory from the delayed timing of shipments.

Net debt increased sequentially to $159 million. And at the end of the second quarter, our net leverage was 18%, and our ratio of net debt-to-adjusted EBITDA was still only 1x.

Capital expenditures in the second quarter totaled $23 million and for the year-to-date are $55 million. For fiscal 2021 as a whole, we expect to invest capital expenditures of up to $120 million. Just under half of this amount will be for growth projects and the remainder for maintaining the business, including on environmental-related capital projects.

Our effective tax rate was an expense of 20% on our adjusted second quarter results. This rate was lower than expected primarily due to increased federal tax deductions that were driven by our higher level of earnings. Looking ahead, we expect our tax rate in the third quarter and also for fiscal '21 to be approximately 22%. This projected tax rate is subject to our performance trends in the balance of our fiscal year.

With almost 2 months of the quarter still to go, I'll now turn to our outlook for the third quarter.

In the third quarter, we expect our ferrous sales volumes to increase sequentially in the range of 15% to 20%. Nonferrous sales volumes are also expected to increase sequentially in the range of 10% to 15%. We anticipate the improved volumes will be supported by strong demand, completing the shipments that had been delayed by severe weather and strengthening supply flows that we expect will return to levels last seen before the pandemic.

We expect our finished steel sales volumes to be sequentially in line with our strong second quarter and rolling mill utilization to remain high despite a planned maintenance outage.

Adjusted EBITDA per ferrous ton is expected to approximate the second quarter. We expect to generate significant operating leverage from sequentially higher volumes and from seasonally higher retail parts sales. This operating leverage is expected to replace the part of our expanded metal spreads in the previous quarter which had resulted directly from the market volatility. We expect benefits from average inventory accounting will be similar to the second quarter.

And finally, on outlook, we expect our operating cash flow to be positive in the third quarter.

I'll now turn the presentation back over to Tamara.

Tamara Lundgren, Chairman and Chief Executive Officer

Thank you, Richard. Our strong second quarter results reflect the resiliency of our operations and the agility of our team in leveraging positive market conditions while delivering on our operational and strategic 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 this quarter 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 the projected benefits from our advanced metal recovery projects and a greater emphasis on recycling. Together with the continued growth in global EAF steelmaking capacity and the increased metal intensity of lower carbon-based economies, the future for our business and industry is bright.

In closing, I'd like to thank our employees for their excellent performance, which demonstrates why we have continued to be a leader in our communities and the recycling industry for over a century. 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, your country and our company.

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

Operator

(Operator Instructions) Our first question comes from Michael Leshock with KeyBanc Capital Markets.

Michael Leshock, KeyBanc Capital Markets

So first, I wanted to touch on the volume outlook. Specifically, with ferrous export volumes, we saw the sequential decline there. What was the primary driver of that decline? And how should we think about those volumes going forward at least directionally?

And then secondly, if you could talk to what you've seen thus far from the Chinese import market given the import restrictions that were lifted this year. Just what activity have you seen there so far?

Tamara Lundgren, Chairman and Chief Executive Officer

Sure. So, on the ferrous volumes, as Richard mentioned, we had 3 ships that were delayed due to severe weather in February, that moved over into Q3. And that was really the driver of the decline in the Q2 volumes. And in Q3, as you can see, -- even putting aside the volume -- the extra volumes that are coming over from Q2, the top of -- end of our range assumes an increase in volumes.

Regarding China, we haven't -- and I assume you're talking about ferrous into China. Regarding China, we haven't seen a lot of ferrous imports by China from the U.S. or from the EU. Where they've been taking them in has been from Asia. And the reason for that, I think, is really due to 2 issues. One is there are still some significant scrap metal content questions that are outstanding, and there are complex import procedures. But I would expect that those will be resolved because there is demand. There is demand that's underpinned by carbon reduction goals, among other things. So I think that this is just a matter of time.

Michael Leshock, KeyBanc Capital Markets

Okay. And on the holding gains of about $10 a ton in the quarter, did that cover the steel business as well? And if so, what was the split there between AMR and steel?

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

It's Richard here. That's our overall average inventory accounting benefit for our results, that $10 a ton. As you can see from our outlook, we're predicting similar in the third quarter.

Michael Leshock, KeyBanc Capital Markets

Okay. And on the infrastructure bill, I wanted to get your take on just how you foresee an infrastructure program playing out. If you could talk to the potential impacts to your business given your exposures there, that would be helpful.

Tamara Lundgren, Chairman and Chief Executive Officer

Sure. So, it's still early on to know what the timing of that will be. But I think that a U.S. infrastructure bill is more a question of when, not if.

And I think that the impact to the scrap business as well as to the steel business will be significant. And I know people are doing a lot of back-of-the-envelope analyses to exactly how many tons could be a part of the demand profile as a result of the infrastructure bill, but I think that you've got to think about it broadly. Yes, there will be definitely an increase in steel usage. And there -- we also project that there will be a significant increase in GDP growth. And those growth drivers have multiplier effects. They have multiplier effects in terms of jobs, in terms of consumer activity. The more consumer activity that you see, you see more generation of scrap.

And then you have to take into account the transition to low-carbon technologies, specifically the commitment on the part of the major auto producers to transition from ICEs to EVs. That in and of itself will result in significant demand for new vehicles and probably the encouragement of replacement of existing ICEs. So, we see the infrastructure bill as being a long-cycle underlying demand driver for both recycled metals as well as for steel.

Michael Leshock, KeyBanc Capital Markets

Got it. That's helpful. And lastly for me, just as we look at the balance sheet, 1x net debt-to-EBITDA, where do you feel comfortable taking your leverage? In the same vein, do you see any opportunities in the current M&A environment?

Tamara Lundgren, Chairman and Chief Executive Officer

So, we don't have a target that we've put out there. But clearly, we've got a strong balance sheet with a lot of room to look at both organic and inorganic investments. And we are -- we have been doing that. We will continue to do that.

And I think that with the increasing focus on carbon reduction and the investments that companies need to make, recycling companies as well as steel companies but in particular recycling companies, to reduce their environmental footprint, we are leaders in that, and we see opportunities for us as we expect the industry to consolidate.

Operator

And I'm not showing any further questions at this time. I would now like to turn the call back over to Tamara Lundgren for any further remarks

Tamara Lundgren, Chairman and Chief Executive Officer

Thank you, operator, and thank you, everyone, for your time today. We look forward to speaking with many of you in the coming days and again in midsummer when we report our third quarter results. In the interim, stay safe and stay well. Thank you.

Operator

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