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

June 30, 2021

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Schnitzer Steel's Third Quarter 2021 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 over to your speaker today, Michael Bennett, Investor Relations. Please go ahead.

Michael Bennett, VP Investor Relations

Thank you, Josh, and good morning. I'm Michael Bennett, the company's Vice President of Investor Relations. I am happy to welcome you to Schnitzer Steel's earnings presentation for the third 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'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. I'm pleased to welcome you to our fiscal '21 third quarter earnings call. 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. I'd like to thank our employees for their extraordinary efforts over the past 15 months. Our success is the direct result of how you have embraced these values, and your performance reflects the collaboration, innovation and resilience that define our culture and our company.

So let's turn now to Slide 4 to begin a more detailed quarterly review.

Our performance this quarter continued to benefit from efficiencies gained from our One Schnitzer organizational model that we implemented at the beginning of this fiscal year and from growth achieved through the execution of our strategic plan. Our sustainability framework of People, Planet and Profit is the foundation upon which these results were achieved. And I'd like to highlight some examples of the significant progress we've made in each area.

On the People front, we continued to improve our safety performance. As many of you know, in each of the last 2 fiscal years, we've reduced workplace injuries to record lows for our company. Through the third quarter of this fiscal year, we're on track to extend this trend. We still have work to do, but our team's commitment to safety is clearly showing through.

We're also well on track to achieve our Planet goals of reducing absolute greenhouse gas emissions from our recycling operations by at least 25%, achieving 100% net carbon-free electricity use and increasing landfill diversion through our investments in technologies that enable us to extract more recyclables from the material that we process.

And the financial and operating results that we announced earlier this morning reflect that we are delivering on our Profit goals of growing volumes and expanding margins.

So now let's turn to Slide 5 for a review of our third quarter results.

Earlier this morning, we announced our fiscal '21 third quarter adjusted earnings per share of $2.20, which represents our highest quarterly performance since 2008. Adjusted EBITDA of $97 million was up almost 40% sequentially and is more than 5x higher than the third 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 $80 was significantly better than in fiscal 2012, which was the last time that ferrous and nonferrous prices were at levels as high as we saw this quarter. This illustrates the benefits we've been able to achieve from our productivity and commercial initiatives.

Our results also reflect a strong sequential lift in sales volumes, with ferrous up 24%, nonferrous up 15% and finished steel up 12% despite constraints in the freight markets. The pace of our sales volumes is now solidly back to pre-pandemic levels. During the quarter, we also returned capital to our shareholders through our 109th consecutive quarterly dividend.

So let's turn now to Slide 6 for a review of pricing trends for recycled metals and finished steel products.
As you'll see on this slide, prices for ferrous scrap during Q3 rose to multi-year highs, continuing a trend

that we saw in Q2. Notably, during the quarter, both pricing peaks and troughs were at respectively higher levels than we've seen in the past decade. And even though prices have dipped slightly since the end of the quarter, they remain at multi-year highs. These stronger pricing levels are supported by cyclical and structural trends, including the post-pandemic economic recovery and the global focus on decarbonization.

Export sales off the East Coast continue to be driven by Turkey. Turkey's annual crude steel production has increased 21% through May to meet higher domestic and export demand and total scrap imports into Turkey reached a record high in April.

Export sales off the West Coast are also strong. The expected decrease in Chinese steel exports following the removal of their steel export rebate tax paired with higher Chinese steel demand is expected to increase overall ferrous scrap demand in Asia.

On the domestic front, ferrous scrap demand and prices remained high through the quarter as steel capacity utilization approached pre-pandemic levels of 83%.

During the quarter, nonferrous scrap prices also reached multi-year highs benefiting from the combination of cyclical and structural market trends, including tight supplies, shipping constraints and decarbonization programs. Zorba which was trading as low as $0.34 per pound last year has more than doubled in price. Demand for material continues to be broad-based, and we expect it to strengthen as auto production accelerates.

Finished steel prices and demand also reached multiyear highs during the third quarter. In late May, there was a fire at our steel mill with no injuries to personnel. Property loss and damage was limited to the mill's melt shop. There was no significant impact to our third quarter results, and we expect the melt shop to resume operations in late August or early September. As Richard will explain in more detail, we anticipate that our net insurance recoveries will cover most of the repair costs and also a significant amount of lost income resulting from the fire.

Our Oregon steel mill is one of the very few whose primary energy source comes from hydroelectricity. Combined with the use of recycled metal as its primary raw material, the steel made in our electric arc furnace has an exceptionally low carbon impact as compared to the industry average. As we return to full operations at our steel mill, we expect demand for our finished steel products to remain strong.

Let's turn now to Slide 7.

Increasing the use of ferrous and nonferrous scrap in industrial production is a great example of how "old economy" tools will lead the way to decarbonization of the new economy. A low carbon economy and many low-carbon technologies are widely acknowledged to be more metal intensive. 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. Decarbonization is a powerful structural driver of demand for recycled metals. And scrap is now an important strategic solution for companies, industries and governments that are focused on carbon reduction. It is a differentiator for metals producers and fabricators, and it is a critical part of every community's commitment to supporting a circular economy and reducing material going to landfills. We can see how some of these trends have translated into higher ferrous scrap metal usage in the U.S. and globally by looking at the charts on this slide, electric arc furnace steelmaking capacity, which uses scrap as its primary raw material, has been expanding and is projected to increase further. And in China, by 2025 scrap usage in steelmaking is expected to increase by 50% from last year's 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.

Innovation, efficiency and volume growth underpin our strategic initiatives. Our innovative investments in advanced metal recovery technologies are critical components of our strategic plan to increase our efficiency and grow our nonferrous volumes. During the quarter, we began ramping up production on 2 of our new systems with additional systems on track for commissioning by the end of this calendar year. 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 customer base and support our sustainability objectives of increasing recycling and reducing waste.

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.

In early April, we commissioned 2 major new plants, and since then, we have been testing performance and ramping up production. One of these new systems is on the West Coast, a primary nonferrous recovery system that produces zorba, zurik and insulated copper wire, all recovered from our shredding process.

The second new system is an advanced aluminum separation system situated in the Southeastern U.S. that is also going through ramp-up and which now gives us the capability to convert zorba into a variety of higher-value products, including twitch, copper, stainless, brass and zinc.

During the fourth quarter, we expect these 2 new systems to reach full production capability. We also expect to achieve $4 of incremental EBITDA per ferrous ton in the fourth quarter, including contributions from these 2 new systems and from the 3 advanced copper separation systems that we had previously implemented.

Construction is well progressed on an additional advanced copper separation system on the West Coast, which we will use to recover refinery grade copper. And on the East Coast, construction is progressing on another major primary nonferrous recovery system, which will serve that region. We expect construction of these additional 2 systems will be completed in the fourth quarter of fiscal '21 and by the middle of the first quarter of fiscal '22, respectively.

We also have 5 other planned systems progressing through the engineering and permitting phases. Subject to no further delays, such as timing of remaining permits, we are targeting completion of the rollout of our remaining installations by the end of calendar year 2021. And following production ramp-up, all of our new systems should be fully operational by around the end of the second quarter of our fiscal 2022.

We expect the new technologies will enable us to increase metal recovery and to provide increased optionality to create a range of higher-value products. Based on our current volumes and after we complete the rollout, we expect our nonferrous produced from shredding to increase by 20% or by approximately 50 million pounds per annum. We expect the total capital investment for our new advanced metal recovery technologies to be in the range of $105 million. Of this amount, we have spent approximately $70 million, including approximately $30 million in fiscal '21 year-to-date. In the balance of fiscal '21, we expect to spend an additional $15 million and then spend the remaining $20 million in the first half of fiscal '22.

Now let's turn to Slide 10 to discuss our consolidated results, ferrous sales and the market dynamics.

Adjusted EBITDA per ferrous ton reached $80, our highest quarterly performance since 2008. This represented a sequential increase of $7 and was higher by $60 on a year-over-year basis. Our strong results benefited from increases in both sales volumes and selling prices for recycled ferrous, nonferrous and platinum group metals and for finished steel products. Revenues from sales of retail parts were seasonally up by $7 million sequentially and rising scrap markets led to a benefit of $7 per ferrous ton from average inventory accounting down by $3 compared to the second quarter.

Ferrous volumes were up by 24% sequentially and compared to last year's third quarter ferrous volumes were up by 31%. We sold our ferrous volumes to 9 countries with Turkey, Bangladesh and Vietnam, being the largest sales destinations in the quarter. Sequentially, average net selling prices for ferrous rose by 3% and year-over-year prices were up by 72%. Strong global demand for recycled ferrous continues to be driven by both cyclical and structural factors, including continuing economic recovery, benefits of government stimulus, tight supply, growth in EAF 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 third quarter Market prices for copper reached record levels and prices for aluminum and zorba both reached multi-year highs. Nonferrous sales volumes were up by 15% sequentially and by 27% over last year's third quarter. Our nonferrous products were sold to 16 countries, including Malaysia, India, China and South Korea. Average net selling prices for nonferrous were up by 17% sequentially and by 80% year-over-year.

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

Finished steel sales volumes were up sequentially by 12% and year-over-year by 23%. West Coast demand remains robust and our third quarter sales volumes represented our highest quarter since 2014. Finished steel sales -- finished steel prices were up sequentially by 16% and year-over-year by 27%. These increases reflected the strong demand and the flow-through of higher input cost of scrap. Rolling mill utilization was 98%, significantly up both sequentially and year-over-year.

As Tamara mentioned earlier, there was a fire at our steel mill in late May with property loss and damage limited to the mill's melt shop. Given the timing of the incident, there was no significant impact on our financial and operational performance for the third quarter. We have been assessing the time required for repairs, and we currently expect our melt shop to resume operations by the end of the fourth quarter or by early September.

Inventory of finished steel products made with billets produced before the melt shop fire will be sold to our customers in the fourth quarter. We have insurance that we believe is fully applicable to the losses and are currently working with our insurers on claims for property loss and damage and business interruption losses. We anticipate that insurance recoveries net of policy deductibles and various conditions, exclusions and limits will cover most of the cost to repair and replace lost and damaged assets and also a significant amount of lost income as a result of the fire. The accounting recognition of such recoveries is expected to occur over several quarters.

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

Operating cash flow in the third quarter was $53 million. Benefits from increased profitability more than offset impacts to working capital from the higher price and volume environment. Free cash flow was $32 million and net debt decreased sequentially by $24 million. At the end of the third quarter, our net debt was $136 million. Net leverage was 14% and the ratio of net debt to adjusted EBITDA was 0.6x.

Capital expenditures in the third quarter totaled $22 million and for the year-to-date are $77 million. For fiscal 2021 as a whole, we expect to make capital expenditures of up to $110 million. Just under half of this amount will be for growth projects and the remainder for maintaining the business, including for environmental-related capital projects. As we are still assessing total costs, this projection excludes capital expenditures we incur in the fourth quarter in connection with repair and replacement of lost and damaged property and equipment as a result of the melt shop fire at our steel mill. Our effective tax rate was an expense of 18% on our adjusted third quarter results and included benefits from increased financial performance and certain discrete tax items. Looking ahead, we expect our tax rate in the fourth quarter to be approximately 22%. This projected tax rate is subject to our performance trends in the balance of our fiscal year. While it's still early in the fourth quarter with 2 months to go, I'll now turn to our outlook. In the fourth quarter, we expect our ferrous sales volumes to approximate the third quarter, which, as you might recall, benefited from several shipments which had been delayed in the previous quarter.

Our fourth quarter outlook would lead to annual ferrous volumes of over 4.4 million tons representing our highest volumes since 2013. Nonferrous sales volumes are expected to increase sequentially in the range of 10%, including benefits from the timing of sales, availability of containers and from increased production using our new technologies. We expect our finished steel sales volumes to be approximately 1/3 of the level of the third quarter and to arise from selling down of inventory of steel products made from billets created before the fire. While repairs to the melt shop are undertaken in the fourth quarter, the steel mill will have reduced revenues and lost margin and will incur fixed costs and other expenses. Although we anticipate that insurance recoveries will cover most of the cost to repair and replace lost and damaged assets and a significant amount of lost income as a result of the fire there is uncertainty as to the amount and timing of recognition of such insurance recoveries for accounting purposes, including in the fourth quarter. We intend to provide a further update on our steel mill around the end of August or in early September. Excluding the impact of the fire on the steel mill, the remainder of our business in aggregate is expected to contribute to consolidated EBITDA per ferrous ton at levels that approximate our outstanding third quarter performance, notwithstanding reduced benefits from average inventory accounting that we expect to drop by half sequentially.

And finally, we expect operating cash flow in the fourth quarter to be strongly positive, even excluding consideration of any potential insurance recoveries related to the steel mill fire.

I will now turn the presentation back over to Tamara.

Tamara Lundgren, Chairman and Chief Executive Officer

Thank you, Richard. Our excellent results this quarter were driven by increased volumes, operational efficiencies and positive market conditions.

Our strategic initiatives to further increase our volumes and to further expand our margins through investments in technology are on track and are expected to deliver additional material benefits. We have a strong balance sheet with low leverage and interest expense a track record of delivering positive 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.

With the continued growth in global EAF steelmaking capacity, the global focus on decarbonization and the increased metal intensity of low-carbon technologies, the future for our business and industry is bright. In closing, I'd like to thank our employees for their outstanding performance this quarter. They've demonstrated once again why we have continued to be a leader in the recycling industry for over a century.

Operator, let's now open up the call for questions.

Operator

(Operator Instructions). Our first question comes from Emily Chieng with Goldman Sachs.

Emily Chieng, Goldman Sachs

Tamara, Richard. My first question is just around the ferrous market outlook. And I think over the past couple of quarters, pricing for ferrous scrap exported had typically been a bit more of a premium to domestic first prices than what we saw this quarter. Is there anything that you're seeing there, either in the domestic or export markets that would have driven that narrowing of the premium. Perhaps in other words, would you categorize it as a stronger domestic market or a weaker export market. I think in one of your charts today, you outlined your export destinations has sort of shift quarter-over-quarter.

Tamara Lundgren, Chairman and Chief Executive Officer

What I would -- what we see right now in both the export and domestic markets is strong demand. And as you know, Emily, the domestic markets typically price -- the domestic market typically prices at the beginning of every month. And the export market trades on a daily or weekly basis.

What we're seeing with strong demand, fundamentally across the globe, is that those prices are really converging. And if you look back year, years ago, you saw a longer and wider premium of export to domestic. But with utilization being as high as it is around the globe, we're seeing strong demand in both markets.

Emily Chieng, Goldman Sachs

Got it. That's helpful. And then my follow-up is just around sort of what you're seeing around China scrap consumption so far, following sort of the export -- sorry, the import ban being lifted earlier this year?

Tamara Lundgren, Chairman and Chief Executive Officer

So the scrap import policy in China continues to be modified by the Chinese government. And I think their changes are still in the early days. I think the most important takeaway is their articulated goals and demand for more scrap. And whether they -- where they get the scrap, I think, is probably less relevant than the fact that their demand for scrap is increasing. We haven't seen a lot of imports from

North America into the Chinese market.

They've gotten the imports that they've taken to date from Asia. But their transition to utilizing a higher level of scrap in their BOFs and their articulation of their goal to increase the amount of steel that they produce in EAFs is another strong pull on long-term demand for recycled ferrous.

Phil Gibbs, KeyBanc Capital Markets

Question I had was on the nonferrous separation investments and just where you are in that process? I know you gave color in terms of where you are in the capital spending, but where are you in terms of the rollout? And how much of the -- I think, what was it about, $10 a ton EBITDA benefit, where are you at relative to that right now?

Tamara Lundgren, Chairman and Chief Executive Officer

Sure. Richard, why don't you take that?

Richard Peach, EVP, Chief Financial Officer and Chief Strategy Officer

Yes. Yes. We've just commissioned 2 major systems, one in the West Coast and one in the Southeastern U.S. The one in the West Coast is a nonferrous recovery system that extracts zorba and zurik from a shredding process. And the one in the Southeastern U.S. is another major plant that we can use to convert zorba into other products such as twitch. So between the 2 of them, when they are up to full production capability, which we expect in the fourth quarter, we'll by then be in a position to process more than 50% of our zorba through a combination of those 2 systems.

So we've been ramping up, and as I said, looking to get to full production capability in the fourth quarter. In terms of benefits, we expect in the fourth quarter to achieve incremental EBITDA per ton from these 2 new systems and the ones we implemented previously of $4 per ton, and that's coming from a combination of recovering more nonferrous from the shredding process, increasing the number of products we produce and benefits from converting zorba into other products such as twitch.

Beyond that, we have 2 additional systems in construction, another copper separation plant, which is on the West Coast and also an East Coast primary nonferrous recovery plant. We expect these -- construction to be completed in these by the end of the fourth quarter and the middle of the first quarter of fiscal '22, respectively. And we have 5 other systems that are in engineering and permitting phase. So we're making strong progress and beginning to get some of the major systems online with more to come.

Phil Gibbs, KeyBanc Capital Markets

Okay. So it sounds like by this quarter, you'll be around or including about half the benefits of at least what you had targeted initially, right, about a halfway through?

Richard Peach, EVP, Chief Financial Officer and Chief Strategy Officer

Yes. That was $4, yes. So that's -- yes, we're just short of half of the $10 we had targeted.

Phil Gibbs, KeyBanc Capital Markets

But you hadn't had any of the benefits before this coming quarter?

Richard Peach, EVP, Chief Financial Officer and Chief Strategy Officer

Not significant enough to call out in our results because these are 2 of the major systems that we are in the process of ramping up during the third quarter and the fourth quarter.

Phil Gibbs, KeyBanc Capital Markets

Okay. And then on the guidance commentary, I just wanted to be clear in terms of what you said. So this quarter, you did about $80 a ton in EBITDA per ferrous ton shipped. I think you said basically your ferrous scrap volumes will be about the same as this quarter. And you're saying even with a lower inventory accounting benefit, you'd be in and around that level, but then you have to tease out the steel impact separate from that? Is that what you communicated?

Richard Peach, EVP, Chief Financial Officer and Chief Strategy Officer

Yes, that's correct. The core business -- the core recycling business is doing very well, and we expect performance in Q4 to be as good as Q3, even notwithstanding that there will be only half of the benefit from average inventory accounting, that was $7 of benefit in Q3, and we expect only half in Q4. The impact of the fire, the repairs are underway, it's obviously temporary in nature and good progress is being made.

And we do believe that, as we said, insurance is going to cover most of the cost of repairing the damage and in addition, most of the lost business income. So we've got strong insurance coverage, but it's a timing issue in terms of when these insurance settlements are reached. So at the moment, there's uncertainty around the extent to which any insurance recoveries or progress thereon could be recognizable for accounting purposes in the fourth quarter, which is why we intend to provide a further update by the end of August or early September.

Phil Gibbs, KeyBanc Capital Markets

Okay. That's very helpful. And then lastly, your commentary on your nonferrous volumes for the fourth quarter. Does that take into account some of the early benefits you'd be seeing from benefiting from more nonferrous from your investments?

Richard Peach, EVP, Chief Financial Officer and Chief Strategy Officer

Yes, absolutely. That 10% increase sequentially in our nonferrous sales volume outlook includes benefits of increased production using the new technologies.

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. And thank you, everyone, for your time today. We look forward to speaking with you again in October when we report our fourth 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.