SCHNITZER STEEL INDUSTRIES INC
Form 10-K
October 29, 2007

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended August 31, 2007

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the transition period from __ to __

Commission File Number 0-22496

SCHNITZER STEEL INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

OREGON	**93-0341923**
(State of Incorporation)	(I.R.S. Employer Identification No.)
3200 N.W. Yeon Ave., Portland, OR	**97210**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (503) 224-9900

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, $1 par value	**The NASDAQ Stock Market, LLC**
(Title of Each Class)	(Name of each Exchange on which registered)

Class A Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in the definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (check one)

Large Accelerated Filer [X] Accelerated Filer [ ] Non-Accelerated Filer [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

The aggregate market value of the registrant s voting common stock outstanding held by non-affiliates on February 28, 2007 was $813,850,848.

The Registrant had 21,230,715 shares of Class A Common Stock, par value of $1.00 per share, and 7,328,387 shares of Class B Common Stock, par value of $1.00 per share, outstanding at October 19, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement for the January 2008 Annual Meeting of Shareholders are incorporated herein by reference in Part III.

SCHNITZER STEEL INDUSTRIES, INC.
FORM 10-K

TABLE OF CONTENTS

Table of Contents

FORWARD-LOOKING STATEMENTS

Statements and information included in this Annual Report on Form 10-K by Schnitzer Steel Industries, Inc. (the Company) that are not purely historical are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements in this Annual Report on Form 10-K include statements regarding the Company s expectations, intentions, beliefs and strategies regarding the future, including statements regarding trends, cyclicality, and growth in the markets the Company sells into, strategic direction, changes to manufacturing processes, the cost of compliance with environmental and other laws, liquidity positions, ability to generate cash from continuing operations, expected growth, the potential impact of adopting new accounting pronouncements, expected results including pricing, sales volume, operating margins and operating income, obligations under the Company s retirement plans, savings or additional costs from business realignment programs, and the adequacy of accruals.

When used in this report, the words believes, expects, anticipates, intends, assumes, estimates, evaluat could, opinions, forecasts, future, forward, potential, probable, and similar expressions are intended forward-looking statements.

The Company may make other forward-looking statements from time to time, including in press releases and public conference calls. All forward-looking statements made by the Company are based on information available to the Company at the time the statements are made, and the Company assumes no obligation to update any forward-looking statements, except as may be required by law. Actual results are subject to a number of risks and uncertainties that could cause actual results to differ materially from those included in, or implied by, such forward-looking statements. Some of these risks and uncertainties are discussed in Item 1A. Risk Factors of Part I of this Form 10-K. Other examples include volatile supply and demand conditions affecting prices and volumes in the markets for both the Company s products and raw materials it purchases; world economic conditions; world political conditions; changes in federal and state income tax laws; impact of pending or new laws and regulations regarding imports and exports into the United States and other foreign countries; foreign currency fluctuations; competition; seasonality, including weather; energy supplies; freight rates; loss of key personnel; expectations regarding the Company s compliance program; business integration issues relating to acquisitions of businesses and the separation of the joint ventures described herein; credit worthiness of suppliers and customers; new accounting pronouncements; availability of capital resources and business disruptions resulting from installation or replacement of major capital assets.

PART I

ITEM 1. BUSINESS

General

Founded in 1906, Schnitzer Steel Industries, Inc. (the Company), an Oregon corporation, is currently one of the nation s largest recyclers of ferrous and nonferrous metals, a leading recycler of used and salvaged vehicles and a manufacturer of finished steel products.

The Company provides an end of life cycle solution for a variety of products through its vertically integrated businesses, including processing auto bodies and other metal products, resale of used auto parts and manufacturing scrap metal into finished steel products. The Company operates in three reportable segments: the Metals Recycling Business (MRB), the Auto Parts Business (APB) and the Steel Manufacturing Business (SMB). Corporate expense consists primarily of unallocated corporate expense for management and administrative services that benefit all three business segments. As a result of this unallocated expense, the operating income of each segment does not reflect the operating income the segment would have as a stand-alone business. For further information regarding the Company s segments, including financial information about geographic areas, refer to Note 17 Segment Information, in the notes to the consolidated financial statements, in Part II, Item 8 of this report.

Metals Recycling Business

Business

MRB buys, collects, processes, recycles, sells, trades and brokers recycled ferrous metals (containing iron) to foreign and domestic steel producers, including SMB, and nonferrous metals (not containing iron) to both domestic and export markets. MRB processes large pieces of scrap metal into smaller pieces by sorting, shearing, shredding, torching and baling, resulting in metal processed into pieces of a size, density and purity required by customers to meet their production needs. Smaller, more homogenous pieces of processed metal have more value because they melt more easily than larger pieces and, in the case of ferrous metals, more completely fill a steel mill s furnace charge bucket, which results in lower energy usage and shorter cycle times, thus reducing costs.

One of the most efficient ways to process and sort recycled metals is to use shredding systems. Currently, each of the Company s Everett, Massachusetts; Portland, Oregon; Oakland, California; and Tacoma, Washington facilities has a mega-shredder capable of processing over 2,500 tons of metal per day. The Company s Johnston, Rhode Island facility operates a large shredder capable of processing up to 1,500 tons of metal per day, and the Kapolei, Hawaii and Anchorage, Alaska facilities operate smaller shredders. Coupled with additional capacity, the mega-shredders provide the ability to shred more efficiently and process a greater range of materials, including larger and thicker pieces of metal. Mega-shredders are designed to provide a denser product and, in conjunction with new separation equipment, a more refined and preferable form of ferrous metal which can be more efficiently used by steel mills. The larger shredders are also able to accept more types of material, resulting in more efficient processing. Shredders can reduce autobodies, home appliances and other metal into fist-size pieces of shredded recycled metal in seconds. The shredded material is then carried by conveyor under magnetized drums that attract the recycled ferrous metal and separate it from the nonferrous metal and other residue found in the shredded material, resulting in a relatively pure and clean shredded ferrous product. The remaining nonferrous metal and residue then pass through a series of mechanical and manual sorting systems that are designed to separate the nonferrous metal from the residue. The remaining nonferrous metal is either hand sorted and graded before being sold or is sold as a mixed product. MRB continues to invest in nonferrous metal recovery methods in order to maximize the recoverability of valuable nonferrous metals.

MRB has a global trade component of its business that purchases processed ferrous metal from metal processors operating in Russia and certain Baltic countries, and sells this metal to steel mills located primarily in Europe and the Mediterranean. Russia and the Baltic countries are attractive markets because of the ample supply of unprocessed metal available to metal processors due to the Cold War Era infrastructures, many of which are closed or obsolete. However, the Russian and Baltic transportation infrastructures make it more economically challenging to access the metal. MRB s management believes that this business complements its processing

Table of Contents

business and allows it to further meet its customers needs as well as expand its global market share of the recycled ferrous metal business.

Products

MRB sells both ferrous and nonferrous scrap metals. The ferrous products include shredded, sheared, torched and bundled scrap metal, and other purchased scrap metal. MRB also processes and sells nonferrous scrap metals, including aluminum, copper, stainless steel, nickel, brass, titanium and high temperature alloys.

Customers

MRB sells recycled metal to foreign and domestic customers and provides nearly 100% of the ferrous scrap metal required by SMB. MRB has developed long-standing relationships with foreign and domestic steel producers.

Presented below are MRB revenues by continent for the year ended August 31 (in millions):

	2007	2006	2005
Asia	$ 755	$ 562	$ 402
North America	639	424	178
Europe	608	373	-
Africa	87	47	-
Sales to SMB	(186)	(142)	(137)
Revenue from external customers	$ 1,903	$ 1,264	$ 443

In 2006, MRB accomplished its goal of expanding and diversifying its customer base by significantly increasing its sales to customers in Taiwan, Turkey, Malaysia, Spain, India, Egypt, Mexico and other countries located in Asia and Europe. In 2007, MRB further expanded its base of regular scrap consumers to include, among others, customers in Greece, Japan and Indonesia. MRB has representatives in South Korea, China, Taiwan, Southeast Asia and Japan to better serve the Asian markets to which it sells.

MRB s five largest ferrous metal customers accounted for 25%, 23% and 66% of recycled ferrous metal revenues to unaffiliated customers in fiscal 2007, 2006 and 2005, respectively. There were no external customers that accounted for 10% or more of consolidated revenues in fiscal 2007 or fiscal 2006. In fiscal 2005 there was one external customer that accounted for $108 million, or 13%, of consolidated revenues. Customer purchase volumes of recycled ferrous metals vary from year to year due to demand, competition, relative currency values and other factors. Ferrous metal sales are generally denominated in United States (U.S.) dollars, and most shipments to foreign customers are supported by letters of credit. Ferrous metal is shipped to customers by ship, railroad, barge, container or truck.

The following table sets forth the amount of recycled ferrous metal sold by MRB to certain groups of customers during the last three fiscal years ended August 31:

	2007		2006		2005	
	Revenues[1]	Volume[2]	Revenues[1]	Volume[2]	Revenues[1]	Volume[2]

Foreign-processed	$	925,410	2,865	$	533,453	2,098	$ 336,262	1,175
Foreign-trading		381,066	1,212		330,296	1,272	-	-
SMB		185,699	705		142,296	668	137,092	625
Domestic - processed		189,678	722		125,475	523	14,852	65
Total recycled ferrous metal	$	1,681,853	5,504	$	1,131,520	4,561	$ 488,206	1,865

(1) Revenues stated in thousands of dollars.
(2) Volume in long tons (2,240 pounds).

MRB also sells recycled nonferrous metal to foreign and domestic customers. By continuing to improve the extraction processes used to recover nonferrous metal from the shredding process, MRB has been able to increase the supply of nonferrous product available to sell to foreign and domestic customers. Many of MRB s industrial suppliers utilize nonferrous metal in manufacturing automobiles and auto parts.

The following table sets forth the amount of recycled nonferrous metal sold by MRB to foreign and domestic customers during the last three fiscal years ended August 31:

	2007		2006		2005	
	Revenues(1)	Volume(2)	Revenues(1)	Volume(2)	Revenues(1)	Volume(2)
Foreign	$ 193,752	209,725	$ 150,670	194,496	$ 65,336	116,999
Domestic	201,985	173,361	116,103	107,114	5,411	8,746
Total recycled nonferrous metal	$ 395,737	383,086	$ 266,773	301,610	$ 70,747	125,745

(1) Revenues stated in thousands of dollars.
(2) Volume in thousands of pounds.

Markets

Prices for both domestic and foreign recycled ferrous metals are generally based on prevailing market rates, which can differ by region and are subject to market cycles that are influenced by many factors, including worldwide demand from steel and other metal producers and the availability of materials that can be processed into saleable scrap. In recent years, worldwide demand for finished steel products has been growing at a faster rate than the available supply of recycled ferrous metal, which is one of the primary raw materials used in the manufacturing of steel. Demand for steel and for raw materials to produce steel products has increased recently, including as a result, the substantial increase in Chinese production and consumption of steel. MRB s average net sales price per ton for recycled ferrous metal increased from $215 per ton in fiscal 2006 to $263 per ton in fiscal 2007, setting a historical record. Export recycled ferrous metal sales contracts generally provide for shipment within 30 to 90 days after the price is agreed to, which, in most cases, includes freight. MRB responds to changing price levels by adjusting scrap metal purchase prices at its recycling facilities in order to help maintain its operating margin dollars per ton. However, the margin between selling prices and the cost of purchased material are subject to a number of factors, including differences in the market conditions in the domestic regions where recycled metal is acquired and the areas in the world where the processed materials are sold, market volatility from the time the sales price is agreed to with the customer until the time the material is acquired, and changes in the assumed costs of transportation to or from the seller s facility. MRB believes it generally benefits from rising recycled metal prices, which allow it to better maintain or expand both margins and unprocessed metal flow into its facilities. MRB also reduces its exposure to declining market prices by reducing the time that inventory is held, thus increasing inventory turnover.

Consolidation in the Scrap Metal Industry

The metals recycling industry has been consolidating over the last several years, primarily due to an increase in scrap metal prices, the growth in global demand for scrap metal, a high degree of fragmentation in the industry and the ability of large, well-capitalized processors to achieve competitive advantages by investing in capital improvements to improve efficiencies and lower processing costs.

Distribution

MRB delivers recycled ferrous and nonferrous metals to foreign steel customers by ship and container, and domestically by barge, rail and over the road transportation networks. Cost efficiencies are achieved by operating deep water terminal facilities at Everett, Massachusetts; Portland, Oregon; Oakland, California; Tacoma, Washington; Anchorage, Alaska; and Providence, Rhode Island. All of MRB s terminal facilities except for the Providence, Rhode Island facility, which is operated under a long-term lease, are owned. The Kapolei, Hawaii and Anchorage, Alaska operations ship from public docks. Additionally, because most of the terminal facilities are operated by MRB, it is not normally subject to the same berthing delays often experienced by users of unaffiliated terminals. MRB believes that its loading costs are lower than they would be if it utilized third-party terminal facilities.

Sources of Unprocessed Metal

The most common forms of purchased raw metals are obsolete machinery and equipment, such as automobiles, railroad cars, railroad tracks, home appliances, waste metal from manufacturing operations and demolition metal from buildings and other obsolete structures. This metal is acquired from suppliers who unload at MRB s facilities, from drop boxes at a diverse base of suppliers industrial sites and through negotiated purchases from other large suppliers, including railroads, industrial manufacturers, automobile salvage facilities, metal dealers and individuals. The majority of MRB s scrap metal collection and processing facilities receive raw metal via major railroad routes, waterways or major highways. Metals recycling facilities situated near unprocessed metal sellers and major transportation routes have the competitive advantage of reduced freight costs because of the significant cost of freight relative to the cost of metal. The locations of MRB s West Coast facilities allow it to competitively purchase raw metal from Hawaii, the San Francisco Bay area, northwards up the West Coast to Western Canada and Alaska and to the east, including Idaho, Montana, Utah and Nevada. The locations of the East Coast facilities provide access to sources of unprocessed metal in Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont. In the Southeastern U.S., approximately half of MRB s ferrous and nonferrous unprocessed metal volume is purchased from industrial companies, with the remaining volume being purchased from smaller dealers and peddlers. These industrial companies provide MRB with metals that are by-products of their manufacturing processes. The Southeastern U.S. has recently become a highly attractive location for domestic and international auto manufacturers, specifically Alabama and Georgia where MRB s Southeastern facilities are located. With the rise of automobile manufacturing in the Southeast, automobile parts manufacturers have also established facilities in this area. These manufacturers have provided a consistent and growing supply of scrap metal.

Seasonality

MRB makes a number of large recycled ferrous metal shipments to foreign steel producers each year. Control over the timing of shipments is limited by customer requirements, shipping schedules, availability of suitable vessels and other factors. Variations in the number of shipments from quarter to quarter, often as a result of the timing of obtaining vessels, can result in significant fluctuations in quarterly revenues, earnings and inventory levels. Freezing conditions in the Baltic region generally limit the ability to ship product from this area during parts of the second and third fiscal quarters.

Backlog

On August 31, 2007, MRB had firm orders to sell $141 million of export ferrous metals compared to $145 million on August 31, 2006.

Competition

MRB competes in domestic and foreign markets for the purchase of scrap metal from suppliers. Competition for metal purchases comes primarily from large well-financed recyclers of scrap metal as well as smaller metal facilities and dealers. Many of these recyclers have varying types and sizes of processing equipment that include fixed and mobile shears and large and small ferrous metal shredders, all of which have varying effects on the purchase price of recycled metal. MRB also competes with brokers who buy scrap metal on behalf of domestic and foreign steel mills. Brokers have also begun to coordinate shipments of certain grades of processed scrap from smaller scrap dealers to foreign mills via shipping containers. The predominant competitive factors that impact recycled metal sales and the ability to obtain unprocessed metal are price (including shipping cost), availability and reliability of service and product quality.

MRB also competes in foreign and domestic markets for the sale of processed recycled metals to finished steel producers. Price (including shipping cost) and availability are the two most important competitive factors, but reliability of service and product quality are also relevant factors.

Table of Contents

Auto Parts Business

Business and Products

APB purchases used and salvaged vehicles and sells used parts from these vehicles through its self-service and full-service auto parts stores, which are located across the U.S. and Western Canada. The remaining portions of the vehicles are sold to metal recyclers, including MRB where geographically feasible.

Auto parts stores operated by APB as of August 31, included the following:

	2007	2006(1)
Self-service locations	35	35
Full-service locations	17	17
Total stores	52	52

(1) Included in the 2006 self-service locations was one location that was under conversion from a full-service location to a self-service location and was not operational at August 31, 2006.

Customers

Self-service stores generally serve customers who are looking to obtain serviceable used auto parts at a competitive price. These customers remove the used auto parts from vehicles in inventory without the assistance of store employees. Full-service stores generally serve business or wholesale customers, typically collision and repair shops, that are looking to obtain serviceable used parts at prices that are less than prices for new parts. Full-service stores retain professional staff to dismantle and inventory individual parts. Once parts are sold, they are pulled from inventory, cleaned, tested and delivered via APB delivery trucks and third parties to the customer. APB has one location that is comprised of both self-service and full-service stores. APB believes that it has enhanced the Company s competitive advantage through its proprietary technology, which is used to centrally manage and operate the geographically diverse network; by applying a consistent approach to offering customers a large selection of vehicles from which to obtain parts; and by its efficient processing of autobodies. Additionally, APB has taken various steps, including remodeling certain facilities, to improve the customer s shopping experience. There were no external customers that accounted for 10% or more of consolidated revenues in fiscal 2007, 2006 or 2005.

APB is dedicated to supplying low-cost used auto parts to its customers. In general, management believes that the prices of parts at its self-service stores are significantly lower than those offered at full-service auto dismantlers, retail car part stores and car dealerships. Each self-service store offers an extensive selection of vehicles from which consumers can remove parts. APB carries domestic and foreign cars, vans and light trucks and regularly rotates its inventory to provide its customers with greater access to a continually changing parts inventory.

APB total revenues for the year ended August 31 were (in thousands):

	2007	2006	2005
North America	$ 266,354	$ 218,130	$ 107,808

Sales to MRB	(22,209)	(14,513)	(13,253)
Revenues from external customers	$ 244,145	$ 203,617	$ 94,555

Fragmentation of the Auto Parts Industry

The auto parts industry is characterized by diverse and fragmented competition and is comprised of a large number of aftermarket and used auto part suppliers of all sizes. These companies range from large, multinational corporations, which serve both original equipment manufacturers and the aftermarket on a worldwide basis, to small, local producers that supply only a few parts for a particular car model. The auto parts industry is also characterized by a wide range of consumers as some consumers tend to demand original replacement parts, while others are price sensitive and exhibit minimal brand loyalty.

Distribution

APB sells used auto parts from each of its self-service and full-service retail stores. Upon arriving at a self-service store, a customer typically pays an admission charge and signs a liability waiver before entering the facility. When a customer finds a desired part on a vehicle, the customer removes it and pays a pre-established price for the part. The full-service business sells its parts primarily to collision and mechanical repair shops through its sales force, which includes inside and outside sales people. Once these parts are sold, they are pulled from inventory, cleaned, tested, and shipped to the customer through a network of company delivery trucks. In addition, the full-service business offers its customers visibility to all parts in inventory within a given region and fulfills orders with next day delivery by running nightly transfer trucks between locations.

Once the vehicle is removed from the customer area, certain remaining parts that can be sold wholesale (cores) are removed from the vehicle. In California, Florida and Texas, these cores (such as engines, transmissions and alternators) are consolidated at central facilities. From these facilities, the parts are sold through an auction system to a variety of wholesale buyers. Due to larger volumes generated by this consolidation process and higher prices for nonferrous metals, APB has been able to obtain increasingly higher prices for these cores.

After the core removal process is complete, the remaining autobody is crushed and sold as scrap metal in the wholesale market. The autobodies are sold on a price per ton basis, which is subject to fluctuations in the recycled ferrous metal markets. During fiscal 2007, 2006 and 2005, APB generated revenues of $22 million, $15 million and $13 million from sales to MRB respectively, thereby making MRB the single largest wholesale customer of APB. APB s wholesale business consists of its core and scrap sales.

Marketing

APB continues to support the marketing initiatives unique to each of the self-service and full-service business lines. The full-service brand marketing plan recognizes the role that institutional entities, such as insura