QUANEX CORP
Form 10-Q
August 30, 2006

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 31, 2006
OR
o 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 1-5725
QUANEX CORPORATION
(Exact name of registrant as specified in its charter)

DELAWARE	**38-1872178**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1900 West Loop South, Suite 1500, Houston, Texas 77027
(Address of principal executive offices and zip code)
Registrant s telephone number, including area code: **(713) 961-4600**

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 þ No o

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 þ Accelerated filer o Non-accelerated filer o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at August 25, 2006**
Common Stock, par value $0.50 per share	36,964,588

QUANEX CORPORATION
INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

QUANEX CORPORATION
CONSOLIDATED BALANCE SHEETS
(Unaudited)

	July 31, 2006	October 31, 2005
ASSETS	(In thousands except share data)	
Current assets:		
Cash and equivalents	$ 61,151	$ 49,681
Accounts and notes receivable, net of allowance of $4,657 and $7,609	184,413	152,072
Inventories	156,424	133,003
Deferred income taxes	10,212	12,864
Other current assets	6,396	4,669
Current assets of discontinued operations		5,504
Total current assets	418,596	357,793
Property, plant and equipment, net	437,500	423,942
Goodwill	196,349	196,341
Cash surrender value insurance policies, net	24,733	24,927
Intangible assets, net	77,053	82,360
Other assets	9,814	9,002
Assets of discontinued operations		5,846
Total assets	$ 1,164,045	$ 1,100,211
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 164,522	$ 129,152
Accrued liabilities	57,657	73,616
Income taxes payable	9,220	14,465
Current maturities of long-term debt	2,727	2,459
Current liabilities of discontinued operations		4,208
Total current liabilities	234,126	223,900
Long-term debt	130,680	133,462
Deferred pension credits		8,158
Deferred postretirement welfare benefits	7,296	7,519
Deferred income taxes	62,224	58,836
Non-current environmental reserves	5,911	6,732
Other liabilities	2,508	2,742
Liabilities of discontinued operations		2,120
Total liabilities	442,745	443,469

Stockholders equity:		
Preferred stock, no par value, shares authorized 1,000,000; issued and outstanding none		
Common stock, $0.50 par value, shares authorized 50,000,000; issued 38,319,959 and 38,198,199	19,155	19,092
Additional paid-in-capital	207,225	198,333
Retained earnings	546,396	445,670
Unearned compensation		(1,388)
Accumulated other comprehensive loss	(3,172)	(3,217)
	769,604	658,490
Less treasury stock, at cost, 1,225,042 and 0 shares	(46,556)	
Less common stock held by Rabbi Trust, 130,329 shares	(1,748)	(1,748)
Total stockholders equity	721,300	656,742
Total liabilities and stockholders equity	$ 1,164,045	$ 1,100,211

The accompanying notes are an integral part of the financial statements.

Table of Contents

QUANEX CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended July 31, 2006	Three Months Ended July 31, 2005	Nine Months Ended July 31, 2006	Nine Months Ended July 31, 2005
	(In thousands, except per share amounts)			
Net sales	$ 553,047	$ 492,559	$ 1,504,852	$ 1,485,737
Cost and expenses:				
Cost of sales (exclusive of items shown separately below)	442,789	373,323	1,191,414	1,141,897
Selling, general and administrative expense	23,963	26,938	68,776	73,869
Depreciation and amortization	17,268	16,077	52,566	47,844
Operating income	69,027	76,221	192,096	222,127
Interest expense	(1,234)	(2,463)	(3,689)	(7,758)
Other, net	2,296	(743)	2,763	(2,082)
Income from continuing operations before income taxes	70,089	73,015	191,170	212,287
Income tax expense	(25,186)	(28,110)	(69,986)	(81,734)
Income from continuing operations	44,903	44,905	121,184	130,553
Income (loss) from discontinued operations, net of taxes	(20)	27	(115)	(2,039)
Gain (loss) on sale of discontinued operations, net of taxes	250	(217)	(61)	(4,579)
Net income	$ 45,133	$ 44,715	$ 121,008	$ 123,935
Basic earnings per common share:				
Earnings from continuing operations	$ 1.20	$ 1.19	$ 3.21	$ 3.46
Income (loss) from discontinued operations	$	$ (0.01)	$ (0.01)	$ (0.17)
Basic earnings per share	$ 1.20	$ 1.18	$ 3.20	$ 3.29
Diluted earnings per common share:				
Earnings from continuing operations	$ 1.14	$ 1.14	$ 3.05	$ 3.33
Income (loss) from discontinued operations	$	$ (0.01)	$	$ (0.16)
Diluted earnings per share	$ 1.14	$ 1.13	$ 3.05	$ 3.17
Weighted-average common shares outstanding:				
Basic	37,531	37,857	37,785	37,700

Diluted		39,857		39,945		40,190		39,591
Cash dividends per share	$	0.1200	$	0.0900	$	0.3433	$	0.2700

The accompanying notes are an integral part of the financial statements.

Table of Contents

QUANEX CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOW
(Unaudited)

	Nine Months Ended July 31, 2006	Nine Months Ended July 31, 2005
	(In thousands)	
Operating activities:		
Net income	$ 121,008	$ 123,935
Loss (income) from discontinued operations	176	6,618
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	53,045	48,283
Deferred income taxes	6,040	3,150
Stock-based compensation	3,883	590
Changes in assets and liabilities, net of effects from acquisitions and dispositions:		
(Increase) decrease in accounts and notes receivable	(32,335)	16,162
(Increase) decrease in inventory	(23,396)	(6,040)
Increase (decrease) in accounts payable	35,370	(40,730)
Increase (decrease) in accrued liabilities	(12,846)	(847)
Increase (decrease) in income taxes payable	(5,253)	11,491
Increase (decrease) in deferred pension and postretirement benefits	(11,942)	1,544
Other, net	(4,024)	(1,275)
Cash provided by (used for) operating activities from continuing operations	129,726	162,881
Cash provided by (used for) operating activities from discontinued operations	(762)	(2,147)
Cash provided by (used for) operating activities	128,964	160,734
Investing activities:		
Acquisitions, net of cash acquired		(200,519)
Proceeds from sale of discontinued operations	5,683	11,592
Capital expenditures, net of retirements	(60,964)	(35,297)
Retired executive life insurance proceeds	461	
Other, net	275	674
Cash provided by (used for) investing activities from continuing operations	(54,545)	(223,550)
Cash provided by (used for) investing activities from discontinued operations	(14)	(362)
Cash provided by (used for) investing activities	(54,559)	(223,912)
Financing activities:		
Bank borrowings (repayments), net	(2,514)	29,865
Common stock dividends paid	(13,165)	(10,351)
Issuance of common stock from option exercises, including related tax benefits	11,112	10,328
Purchase of treasury stock	(58,326)	
Other, net		568

Cash provided by (used for) financing activities from continuing operations		(62,893)		30,410
Cash provided by (used for) financing activities from discontinued operations		(56)		(158)
Cash provided by (used for) financing activities		(62,949)		30,252
Effect of exchange rate changes on cash equivalents		14		10
Increase (decrease) in cash and equivalents		11,470		(32,916)
Cash and equivalents at beginning of period		49,681		41,743
Cash and equivalents at end of period	$	61,151	$	8,827
Supplemental disclosure of cash flow information:				
Cash paid during the period for interest	$	4,020	$	7,959
Cash paid during the period for income taxes	$	64,493	$	58,914
Cash received during the period for income tax refunds	$		$	171

The accompanying notes are an integral part of the financial statements.

Table of Contents

QUANEX CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(Unaudited)

Nine months ended July 31, 2006	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock & Other	Total Stockholders' Equity
	(In thousands, except per share amounts)					
Balance at October 31, 2005	$ 19,092	$ 198,333	$ 445,670	$ (3,217)	$ (3,136)	$ 656,742
Net income			121,008			121,008
Common dividends ($0.34 per share)			(13,165)			(13,165)
Treasury shares purchased, at cost					(58,326)	(58,326)
Reclassification of unearned compensation for restricted stock		(1,388)			1,388	
Stock option and restricted stock activity, including related tax benefit	63	10,280	(7,117)		11,770	14,996
Other				45		45
Balance at July 31, 2006	$ 19,155	$ 207,225	$ 546,396	$ (3,172)	$ (48,304)	$ 721,300

The accompanying notes are an integral part of the financial statements.

Table of Contents

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The interim unaudited consolidated financial statements of Quanex Corporation and its subsidiaries (Quanex or the Company) include all adjustments, which, in the opinion of management, are necessary for a fair presentation of the Company s financial position and results of operations. All such adjustments are of a normal recurring nature. These financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X.

In March 2006, the Company effected a three-for-two stock split in the form of a 50% stock dividend. All prior periods presented have been adjusted on a retroactive basis after giving effect to such stock split.

In January 2006, the Company sold Temroc Metals, Inc. (Temroc) and in the first quarter of 2005, the Company sold its Piper Impact business. Accordingly, the assets and liabilities of Temroc and Piper Impact are reported as discontinued operations in the Consolidated Balance Sheets presented, and their operating results are reported as discontinued operations in the Consolidated Statements of Income and Consolidated Statements of Cash Flow (see Note 14).

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and notes thereto included in the Quanex Corporation Form 10-K filed with the U.S. Securities and Exchange Commission for the year ended October 31, 2005.

2. New Accounting Pronouncements

Stock Based Compensation

On November 1, 2005, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R) issued by the Financial Accounting Standards Board (FASB) in December 2004. SFAS 123R requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in the consolidated financial statements. Prior to November 1, 2005, under the disclosure only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), the Company applied Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations in accounting for its stock option plans. Accordingly, prior to fiscal 2006, the Company recognized zero stock-based compensation expense in its income statement for non-qualified stock options, as the exercise price was equal to the closing market price of the Company s stock on the date of grant. However, the Company did recognize stock-based compensation expense for its restricted stock plans as discussed in Note 15, Restricted Stock and Stock Option Plans, of the Notes to the Consolidated Financial Statements in its Annual Report on Form 10-K for the fiscal year ended October 31, 2005. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123R. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R.

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The Company elected the modified prospective transition method as permitted by the adoption of SFAS 123R. Under this transition method, stock-based compensation expense beginning as of November 1, 2005 includes (i) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of October 31, 2005, based on the grant-date fair value estimated in accordance with the original proforma provisions of SFAS 123; and (ii) compensation expense for all stock-based compensation awards granted subsequent to October 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Prior to the adoption of SFAS 123R, unearned compensation was shown as a reduction of stockholders equity. The November 1, 2005 unearned compensation balance of $1.4 million was reclassified against additional paid-in-capital upon adoption of SFAS 123R. In fiscal 2006 and future periods, common stock par value will be recorded when the restricted stock is issued and additional paid-in-capital will be increased as the restricted stock compensation cost is recognized for financial reporting purposes. In accordance with the modified prospective transition method, the Company s Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R.

The Company recognizes compensation expense on a straight-line basis over the requisite service period of the award. As stock-based compensation expense recognized in the income statement beginning November 1, 2005 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, when necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. In the Company s proforma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred. Prior to the implementation of SFAS 123R, the Company computed stock-based compensation cost for employees eligible to retire over the standard vesting period of the grants. Upon adoption of SFAS 123R, the Company amortizes new option grants to such retirement-eligible employees immediately upon grant, consistent with the retirement vesting acceleration provisions of these grants. For employees near retirement age, the Company amortizes such grants over the period from the grant date to the retirement date if such period is shorter than the standard vesting schedule.

The following is the effect of adopting SFAS 123R as of November 1, 2005 (in thousands except per share amounts):

	Three Months Ended July 31, 2006		Nine Months Ended July 31, 2006	
Decrease in operating income and income from continuing operations	$	744	$	3,104
Related deferred income tax benefit		(275)		(1,148)
Decrease in net income	$	469	$	1,956
Decrease in basic earnings per common share	$	(0.01)	$	(0.05)
Decrease in diluted earnings per common share	$	(0.01)	$	(0.05)

The amounts above relate to the impact of recognizing compensation expense for stock options only, as compensation expense related to restricted stock was recognized by the Company before implementation of SFAS 123R under previous accounting standards.

In accordance with SFAS 123R, the consolidated statements of cash flow report the excess tax benefits from the stock-based compensation as financing cash inflows. For the three and nine months ended July 31, 2006, $0.3 million and $4.7 million, respectively, of excess tax benefits were reported as financing cash inflows.

Table of Contents

QUANEX CORPORATION

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Under SFAS 123R, the Company continues to use the Black-Scholes-Merton option-pricing model to estimate the fair value of its stock options. However, the Company has applied the expanded guidance under SFAS 123R and SAB 107 for the development of the assumptions used as inputs for the Black-Scholes-Merton option pricing model for grants beginning November 1, 2005. The Company s fair value determination of stock-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behavior. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company s employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management s opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company s employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123R and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

On November 10, 2005, the FASB issued FASB Staff Position No. SFAS 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards* (FSP 123R-3). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123R. The Company has until November 2006 to make a one-time election to adopt the transition method described in FSP 123R-3. The Company is currently evaluating FSP 123R-3; however, the one-time election is not expected to affect operating income or net income.

See Note 11 for additional stock-based compensation disclosures.

Other

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) which is effective for fiscal years beginning after December 15, 2006 (as of November 1, 2007 for the Company) and is an interpretation of FASB Statement No. 109, *Accounting for Income Taxes"*. FIN 48 prescribes a recognition threshold and measurement attribute for recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition and expanded disclosure requirements. The Company is currently assessing the impact, if any, that the adoption of FIN 48 will have on the Company s financial statements.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154), which replaces Accounting Principles Board Opinion No. 20, *Accounting Changes* and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements"*. SFAS 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005 (the Company s fiscal 2007) and requires retrospective application to prior period financial statements of voluntary changes in accounting principles, unless it is impractical to determine either the period-specific effects or the cumulative effect of the change. The impact of SFAS 154 will depend on the nature and extent of voluntary accounting changes or error corrections, if any, after the effective date, but the Company does not expect SFAS 154 to have a material impact on its consolidated financial statements.

Table of Contents

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

In March 2005, the FASB issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47) which is effective no later than the end of fiscal years ending after December 15, 2005 (as of October 31, 2006 for the Company) and is an interpretation of FASB Statement No. 143, *Accounting for Asset Retirement Obligations* . FIN 47 requires recognition of a liability for the fair value of a conditional asset retirement obligation when incurred if the fair value of the liability can be reasonably estimated. The Company does not expect the adoption of FIN 47 to have a material impact on its consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets, an Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions* (SFAS 153), as part of its short-term international convergence project with the International Accounting Standards Board (IASB). Under SFAS 153, nonmonetary exchanges are required to be accounted for at fair value, recognizing any gains or losses, if their fair value is determinable within reasonable limits and the transaction has commercial substance. SFAS 153 is effective for the Company for nonmonetary asset exchanges beginning November 1, 2005. The adoption of SFAS 153 did not have a material impact on the consolidated financial position, results of operations or cash flows.

In October 2004, the President signed into law the American Jobs Creation Act (the AJC Act). The AJC Act allows for a federal income tax deduction for a percentage of income earned from certain domestic production activities. The Company s U.S. production activities qualify for the deduction. Based on the effective date of this provision of the AJC Act, the Company is eligible for this deduction beginning in fiscal 2006. Additionally, in December 2004, the FASB issued FASB Staff Position 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes (SFAS 109), to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004* (FSP 109-1). FSP 109-1, which was effective upon issuance, requires the Company to treat the tax deduction as a special deduction instead of a change in tax rate that would have impacted the existing deferred tax balances. The Company has estimated that this special deduction will reduce the Company s effective tax rate in fiscal 2006 by approximately 1%.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs, an Amendment of ARB No. 43, Chapter 4* (SFAS 151), which adopts wording from the IASB s International Accounting Standard, Inventories, in an effort to improve the comparability of cross-border financial reporting. The new standard indicates that abnormal freight, handling costs and wasted materials are required to be treated as current period charges rather than as a portion of inventory costs. Additionally, the standard clarifies that fixed production overhead should be allocated based on the normal capacity of a production facility. SFAS 151 is effective for the Company for inventory costs incurred beginning as of November 1, 2005. The adoption of SFAS 151 did not have a material impact on the consolidated financial position, results of operations or cash flows.

Table of Contents

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

3. Acquired Intangible Assets

Intangible assets consist of the following (in thousands):

	As of July 31, 2006		As of October 31, 2005	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Non-compete agreements	$ 264	$ 237	$ 313	$ 247
Patents	25,877	6,751	25,877	4,149
Trademarks and trade names	37,930	3,282	37,930	2,013
Customer relationships	23,691	3,064	23,691	1,893
Other intangibles	1,201	776	1,201	550
Total	$ 88,963	$ 14,110	$ 89,012	$ 8,852
Unamortized intangible assets:				
Trade name	$ 2,200		$ 2,200	

The aggregate amortization expense for the three and nine month periods ended July 31, 2006 was $1.8 million and $5.3 million, respectively. The aggregate amortization expense for the three and nine month periods ended July 31, 2005 was $1.8 million and $4.9 million, respectively. Estimated amortization expense for the next five years, based upon the amortization of pre-existing intangibles follows (in thousands):

Fiscal Years Ending October 31,	Estimated Amortization
2006 (remaining three months)	$ 1,769
2007	7,033
2008	5,757
2009	3,873
2010	$ 3,792

4. Inventories

Inventories consist of the following:

	July 31 2006	October 31, 2005
	(In thousands)	
Raw materials	$ 44,479	$ 32,696
Finished goods and work in process	95,656	86,077
	140,135	118,773
Supplies and other	16,289	14,230
Total	$ 156,424	$ 133,003

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The values of inventories in the consolidated balance sheets are based on the following accounting methods:

	July 31 2006	October 31, 2005
	(In thousands)	
LIFO	$ 70,531	$ 62,820
FIFO	85,893	70,183
Total	$ 156,424	$ 133,003

An actual valuation of inventory under the last in, first out (LIFO) method can be made only at the end of each year based on the inventory costs and levels at that time. Accordingly, interim LIFO calculations must be based on management s estimates of expected year-end inventory costs and levels. Because these are subject to many factors beyond management s control, interim results are subject to the final year-end LIFO inventory valuation which could significantly differ from interim estimates. To estimate the effect of LIFO on interim periods, the Company performs a projection of the year-end LIFO reserve and considers expected year-end inventory pricing and expected inventory levels. Depending on this projection, the Company may record an interim allocation of the projected year-end LIFO calculation. With respect to inventories valued using the LIFO method, replacement cost exceeded the LIFO value by approximately $40.3 million and $34.3 million as of July 31, 2006 and October 31, 2005, respectively.

5. Earnings Per Share

The computational components of basic and diluted earnings per share from continuing operations are as follows (shares and dollars in thousands except per share amounts):

	For the Three Months Ended					
	July 31, 2006			July 31, 2005		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Basic earnings per share	$ 44,903	37,531	$ 1.20	$ 44,905	37,857	$ 1.19
Effect of dilutive securities						
Common stock equivalents arising from settlement of contingent convertible debentures	493	1,776		480	1,360	
Common stock equivalents arising from stock options		354			581	
Restricted stock		66			15	
Common stock held by rabbi trust		130			132	
Diluted earnings per share	$ 45,396	39,857	$ 1.14	$ 45,385	39,945	$ 1.14

Table of Contents

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

	For the Nine Months Ended					
	July 31, 2006			July 31, 2005		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Basic earnings per share	$ 121,184	37,785	$ 3.21	$ 130,553	37,700	$ 3.46
Effect of dilutive securities						
Common stock equivalents arising from settlement of contingent convertible debentures	1,477	1,785		1,441	1,141	
Common stock equivalents arising from stock options		433			603	
Restricted stock		57			15	
Common stock held by rabbi trust		130			132	
Diluted earnings per share	$ 122,661	40,190	$ 3.05	$ 131,994	39,591	$ 3.33

The computation of diluted earnings per share excludes outstanding options in periods where inclusion of such options would be anti-dilutive in the periods presented. Options to purchase 0.2 million shares of common stock were outstanding as of July 31, 2006 but were not included in the computation of diluted earnings per share for the three and nine months ended July 31, 2006 as the options exercise price was greater than the average market price of the common stock during those periods.

On January 26, 2005, the Company announced that it had irrevocably elected to settle the principal amount of its 2.50% Convertible Senior Debentures due 2034 (the Debentures) in cash when they become convertible and are surrendered by the holders thereof. The Company retains its option to satisfy any excess conversion obligation (stock price in excess of conversion price) with either shares, cash or a combination of shares and cash. As a result of the Company s election, diluted earnings per share include only the amount of shares it would take to satisfy the excess conversion obligation, assuming that all of the Debentures were surrendered. For calculation purposes, the average closing price of the Company s common stock for each of the periods presented is used as the basis for determining dilution.

6. Comprehensive Income

Comprehensive income comprises of net income and all other non-owner changes in equity, including realized and unrealized gains and losses on derivatives, minimum pension liability adjustments and foreign currency translation adjustments. Comprehensive income for the three and nine months ended July 31, 2006 and 2005 was as follows:

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
	(In thousands)			
Comprehensive income:				
Net income	$ 45,133	$ 44,715	$ 121,008	$ 123,935
Foreign currency translation adjustment	(14)	21	45	(2)

Total comprehensive income, net of taxes	$ 45,119	$ 44,736	$ 121,053	$ 123,933

Table of Contents

QUANEX CORPORATION

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

7. Long-term Debt

Long-term debt consists of the following:

	July 31, 2006	October 31, 2005
	(In thousands)	
Bank Agreement Revolver	$	$
2.50% Convertible Senior Debentures due 2034	125,000	125,000
City of Richmond, Kentucky Industrial Building Revenue Bonds	5,000	7,175
City of Huntington, Indiana Economic Development Revenue Bonds principle due 2010	1,665	1,665
Scott County, Iowa Industrial Waste Recycling Revenue Bonds	1,600	1,800
Capital lease obligations and other	142	281
	$ 133,407	$ 135,921
Less maturities due within one year included in current liabilities	2,727	2,459
	$ 130,680	$ 133,462

Approximately 95% and 93% of the total debt had a fixed interest rate at July 31, 2006 and October 31, 2005, respectively. See Interest Rate Risk section in Item 3 Quantitative and Qualitative Disclosures about Market Risk of this Form 10-Q for additional discussion.

Bank Agreement

The Company s $310.0 million Revolving Credit Agreement (Bank Agreement) is secured by all Company assets, excluding land and buildings. The Bank Agreement expires February 28, 2007 and provides for up to $25.0 million for standby letters of credit, limited to the undrawn amount available under the Bank Agreement. All borrowings under the Bank Agreement bear interest, at the option of the Company, at either (a) the prime rate or federal funds rate plus one percent, whichever is higher, or (b) a Eurodollar based rate.

The Bank Agreement requires maintenance of certain financial ratios and maintenance of a minimum consolidated tangible net worth. As of July 31, 2006, the Company was in compliance with all current Bank Agreement covenants. The Company had no borrowings under the Bank Agreement as of July 31, 2006 and October 31, 2005. The aggregate availability under the Bank Agreement was $296.0 million at July 31, 2006, which is net of $14.0 million of outstanding letters of credit.

The Company anticipates executing a new five-year unsecured bank agreement prior to the end of calendar 2006. The new facility is expected to be increased to approximately $350.0 million and is expected to bear interest at LIBOR based on a combined leverage and ratings grid.

Convertible Senior Debentures

On May 5, 2004, the Company issued $125.0 million of the Debentures in a private placement offering. The Debentures were subsequently registered in October 2004 pursuant to the registration rights agreement entered into in connection with the offering. In June 2006, the Company filed a post-effective amendment to deregister all unsold securities under the registration statement as the Company s obligation to maintain the effectiveness of such registration statement has expired; the post-effective amendment has not yet been declared effective. The net proceeds from the offering, totaling approximately $122.0 million, were used to repay a portion of the amounts outstanding under the Bank

Table of Contents

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Agreement. The Debentures are general unsecured senior obligations, ranking equally in right of payment with all existing and future unsecured senior indebtedness, and senior in right of payment to any existing and future subordinated indebtedness. The Debentures are effectively subordinated to all senior secured indebtedness and all indebtedness and liabilities of subsidiaries, including trade creditors.

The Debentures are only convertible under certain circumstances, including: (i) during any fiscal quarter if the closing price of the Company s common stock for at least 20 trading days in the 30 trading-day period ending on the last trading day of the previous fiscal quarter is more than 120% of the conversion price per share of the Company s common stock on such last trading day; (ii) if the Company calls the Debentures for redemption; or (iii) upon the occurrence of certain corporate transactions, as defined. Upon conversion, the Company has the right to deliver common stock, cash or a combination of cash and common stock. The Company may redeem some or all of the Debentures for cash any time on or after May 15, 2011 at the Debentures full principal amount plus accrued and unpaid interest, if any. Holders of the Debentures may require the Company to purchase, in cash, all or a portion of the Debentures on May 15, 2011, 2014, 2019, 2024 and 2029, or upon a fundamental change, as defined, at the Debentures full principal amount plus accrued and unpaid interest, if any.

The Debentures are convertible into shares of Quanex common stock, upon the occurrence of certain events, at an adjusted conversion rate of 39.2978 shares of common stock per $1,000 principal amount of notes. This conversion rate is equivalent to an adjusted conversion price of $25.45 per share of common stock, subject to adjustment in some events such as a common stock dividend or an increase in the cash dividend. Adjustments to the conversion rate are made when the cumulative adjustments exceed 1% of the conversion rate. In January 2005, the Company announced that it had irrevocably elected to settle the principal amount of the Debentures in cash when they become convertible and are surrendered by the holders thereof. The Company retains its option to satisfy any excess conversion obligation (stock price in excess of conversion price) with either shares, cash or a combination of shares and cash. Based on the provisions of EITF Issue No. 01-6 "*The Meaning of Indexed to a Company s Own Stock* and EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company s Own Stock"*, the conversion feature of the Debenture is not subject to the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133) and accordingly has not been bifurcated and accounted for separately as a derivative under SFAS 133.

Effective May 1, 2005, the Debentures became convertible and continue to be convertible through the quarter ending October 31, 2006. For each quarter in this period, the convertibility was triggered when the closing price of the Company s common stock exceeded the contingent conversion threshold price of approximately $30.54 for at least 20 of the last 30 trading days of the previous fiscal quarter.

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

8. Pension Plans and Other Postretirement Benefits

The components of net pension and other postretirement benefit cost are as follows:

	Three Months Ended July 31, 2006	Three Months Ended July 31, 2005	Nine Months Ended July 31, 2006	Nine Months Ended July 31, 2005
	(In thousands)			
Pension Benefits:				
Service cost	$ 1,302	$ 1,496	$ 3,641	$ 3,208
Interest cost	1,135	918	3,055	2,634
Expected return on plan assets	(1,393)	(1,216)	(3,327)	(2,651)
Amortization of unrecognized transition asset	26	29		(36)
Amortization of unrecognized prior service cost	44	32	150	145
Amortization of unrecognized net loss	222	286	720	684
Net periodic pension cost	$ 1,336	$ 1,545	$ 4,239	$ 3,984

	Three Months Ended July 31, 2006	Three Months Ended July 31, 2005	Nine Months Ended July 31, 2006	Nine Months Ended July 31, 2005
	(In thousands)			
Postretirement Benefits:				
Service cost	$ 3	$ 3	$ 54	$ 74
Interest cost	22	65	286	366
Net amortization and deferral	(5)	60	(40)	(51)
Net periodic postretirement benefit cost	$ 20	$ 128	$ 300	$ 389

During the three and nine months ended July 31, 2006, the Company contributed $15.0 million and $16.0 million, respectively, to its defined benefit plans. The $16.0 million contribution includes $13.9 million of voluntary contributions in addition to $2.1 million of minimum required contributions.

9. Industry Segment Information

Quanex manages the Company as a market-focused enterprise which utilizes its resources for two target markets where its products are sold: the Vehicular Products segment and the Building Products segment. These markets are driven by distinct economic indicators; domestic light vehicle builds and heavy duty truck builds primarily drive the Vehicular Products segment while housing starts and remodeling expenditures primarily drive the Building Products segment. The Vehicular Products segment includes engineered steel bar manufacturing, steel bar and tube heat-treating services, and steel bar and tube corrosion and wear resistant finishing services. The Building Products segment produces mill finished and coated aluminum sheet and various window and door products for the building products markets. Corporate and other includes corporate office charges and assets, intersegment eliminations and consolidated LIFO inventory adjustments.

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
	(In thousands)			
Net Sales				
Vehicular products	$ 259,836	$ 233,687	$ 724,006	$ 786,943
Building products[1]	293,211	258,872	780,846	698,794
Consolidated	$ 553,047	$ 492,559	$ 1,504,852	$ 1,485,737
Operating Income (Loss)				
Vehicular products	$ 40,297	$ 47,932	$ 113,968	$ 153,943
Building products[1]	41,639	42,804	103,411	96,267
Corporate & other	(12,909)	(14,515)	(25,283)	(28,083)
Consolidated	$ 69,027	$ 76,221	$ 192,096	$ 222,127

	July 31, 2006	October 31, 2005
	(In thousands)	
Identifiable Assets		
Vehicular products	$ 465,105	$ 425,536
Building products[1]	645,799	618,112
Corporate & other	53,141	45,213
Discontinued operations[2]		11,350
Consolidated	$ 1,164,045	$ 1,100,211
Goodwill		
Vehicular products	$	$
Building products[1]	196,349	196,341
Consolidated	$ 196,349	$ 196,341

(1) Fiscal 2005 includes Mikron as of December 9, 2004.

(2) Temroc and Piper Impact are included in discontinued

operations for all periods presented.

10. Stock Repurchase Program and Treasury Stock

On August 26, 2004, the Company s Board of Directors approved an increase in the number of authorized shares in the Company s existing stock buyback program, up to 2.25 million shares; and on August 24, 2006 the Board of Directors approved an additional increase of 2.0 million shares to the existing program. The Company records treasury stock purchases under the cost method whereby the entire cost of the acquired stock is recorded as treasury stock. The Company uses a moving average method on the subsequent reissuance of shares, and any resulting proceeds in excess of cost are credited to additional paid in capital while any deficiency is charged to retained earnings. The Company purchased 1,573,950 treasury shares for $58.3 million during the nine months ended July 31, 2006. As of July 31, 2006, the number of shares in treasury was reduced to 1,225,042 resulting primarily from stock option exercises. There were no treasury shares purchased during fiscal 2005. As of July 31, 2006, the remaining shares authorized for repurchase in the program was 676,050. After considering the approval of additional shares in the program in August 2006, the remaining shares authorized for repurchase was increased to 2,676,050.

Table of Contents

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

11. Stock-Based Compensation

In the first quarter of fiscal 2006, the Company adopted SFAS 123R which required the Company to measure all employee stock-based compensation awards using a fair value method and record such expense in the consolidated financial statements beginning as of November 1, 2005. See Note 2 for impact of the adoption.

The Company has restricted stock and stock option plans which provide for the granting of common shares or stock options to key employees and non-employee directors. The Company s practice is to grant options and restricted stock to directors on October 31st of each year, with an additional grant of options to each director on the date of his or her first anniversary of service. Additionally, the Company s practice is to grant options and restricted stock to employees at the Company s December board meeting and occasionally to key employees on their respective date of hire. The exercise price of the option awards is equal to the closing market price on these pre-determined dates. The following table shows a summary of information with respect to stock option and restricted stock compensation for 2006 and restricted stock compensation for 2005, which are included in the consolidated statements of income for those respective periods:

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
	(In thousands)			
Total pretax stock-based compensation expense included in net income	$ 1,086	$ 328	$ 3,883	$ 590
Income tax benefit related to stock-based compensation included in net income	$ 402	$ 126	$ 1,437	$ 228

The Company has not capitalized any stock-based compensation cost as part of inventory or fixed assets during the three or nine months ended July 31, 2006 and 2005. Cash received from option exercises for the nine months ended July 31, 2006 and 2005 was $6.4 million and $6.3 million, respectively. The actual tax benefit realized for the tax deductions from option exercises and lapses on restricted stock totaled $4.7 million and $4.1 million for the nine months ended July 31, 2006 and 2005, respectively.

The Company generally issues shares from treasury, if available, to satisfy stock option exercises. If there are no shares in treasury, the Company issues additional shares of common stock.

Restricted Stock Plans

Under the Company s restricted stock plans, common stock may be awarded to key employees, officers and non-employee directors. The recipient is entitled to all of the rights of a shareholder, except that during the forfeiture period the shares are nontransferable. The awards vest over a specified time period, but typically either immediately vest or cliff vest over a three-year period with service as the vesting condition. Upon issuance of stock under the plan, fair value is measured by the grant date price of the Company s shares. This fair value is then expensed over the restricted period with a corresponding increase to additional paid-in-capital. A summary of non-vested restricted shares at July 31, 2006, and changes during the nine months ended July 31, 2006, is presented below:

Table of Contents

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

	Shares	Weighted-Average Grant-Date Fair Value Per Share
Nonvested at October 31, 2005	115,650	$ 22.31
Granted	33,885	40.50
Vested	(6,750)	17.60
Forfeited	(18,000)	20.87
Nonvested at July 31, 2006	124,785	$ 27.71

The weighted-average grant-date fair value of restricted stock granted during the nine months ended July 31, 2006 and 2005 was $40.50 and $26.61, respectively. The total fair value of restricted stock vested during the nine months ended July 31, 2006 and 2005 was $0.1 million and $0.2 million, respectively. Total unrecognized compensation cost related to unamortized restricted stock awards was $1.6 million as of July 31, 2006. That cost is expected to be recognized over a weighted-average period of 1.7 years.

Valuation of Stock Options under SFAS 123R

Under SFAS 123R, the Company continues to use the Black-Scholes-Merton option-pricing model to estimate the fair value of its stock options. However, the Company has applied the expanded guidance under SFAS 123R and SAB 107 for the development of its assumptions used as inputs for the Black-Scholes-Merton option pricing model for grants beginning November 1, 2005. Expected volatility is determined using historical volatilities based on historical stock prices for a period that matches the expected term. The expected volatility assumption is adjusted if future volatility is expected to vary from historical experience. The expected term of options represents the period of time that options granted are expected to be outstanding and falls between the option s vesting and contractual expiration dates. The expected term assumption is developed by using historical exercise data adjusted as appropriate for future expectations. Separate groups of employees that have similar historical exercise behavior are considered separately. Accordingly, the expected term range given below results from certain groups of employees exhibiting different behavior. The risk-free rate is based on the yield at the date of grant of a zero-coupon U.S. Treasury bond whose maturity period equals the option s expected term. The fair value of each option was estimated on the date of grant. The following is a summary of valuation assumptions for grants during the nine months ended July 31, 2006 and 2005:

	Grants During the Nine Months Ended July 31,	
	2006	2005
Valuation assumptions	**(SFAS 123R)**	**(SFAS 123)**
Weighted-average expected volatility	35.00%	35.38%
Expected term (in years)	4.8-5.2	5.0
Risk-free interest rate	4.45%	3.49%
Expected dividend yield over expected term	2.00%	1.53%

The weighted-average grant-date fair value of options granted during the nine months ended July 31, 2006 and 2005 was $12.78 and $8.42, respectively. The increase in per share fair value of the options was primarily related to the increase in the Company s stock price on the date of grant from an average price of approximately $27 per share for grants during the nine months ended fiscal 2005 to $41 per share for the same period of 2006.

Table of Contents

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Proforma Effect Prior to the Adoption of SFAS 123R

The following table presents the proforma effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation prior to the adoption of SFAS 123R during the three and nine month period ending July 31, 2005 (in thousands except per share amounts).

	Three Months Ended July 31, 2005	Nine Months Ended July 31, 2005
Net income, as reported	$ 44,715	$ 123,935
Add: Restricted stock compensation, net of forfeitures included in reported net income, net of tax	202	363
Deduct: Total stock-based employee compensation (restricted stock amortization and stock option expense determined under SFAS 123 fair value based method), net of related tax effects	(744)	(1,886)
Pro forma net income	$ 44,173	$ 122,412
Earnings per common share:		
Basic as reported	$ 1.18	$ 3.29
Basic pro forma	$ 1.17	$ 3.25
Diluted as reported	$ 1.13	$ 3.17
Diluted pro forma	$ 1.12	$ 3.13

Disclosures for the three and nine months ended July 31, 2006 are not presented as the amounts are recognized in the consolidated financial statements.

2006 Omnibus Incentive Plan

At the Company s annual meeting in February 2006, the Company s stockholders approved the Quanex Corporation 2006 Omnibus Incentive Plan (the 2006 Plan). The 2006 Plan provides for the granting of stock options, stock appreciation rights, restricted stock, restricted stock units, performance stock awards, performance unit awards, annual incentive awards, other stock-based awards and cash-based awards. The 2006 Plan is administered by the Compensation Committee of the Board and allows for immediate, graded or cliff vesting options, but options must be exercised no later than ten years from the date of grant. The aggregate number of shares of common stock authorized for grant under the 2006 Plan is 2,625,000. Any officer, key employee and / or non-employee director of the Company or any of its affiliates is eligible for awards under the 2006 Plan. The initial awards granted under the 2006 Plan were during the third fiscal quarter of 2006; these awards provided for three-year vesting with service as the vesting condition.

QUANEX CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

A summary of stock option activity under the 2006 Plan during the nine months ended July 31, 2006 is presented below:

	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (000's)
Outstanding at October 31, 2005				
Granted	23,250	$ 37.13		
Exercised				
Cancelled	(2,000)	39.32		
Expired				
Outstanding at July 31, 2006	21,250	$ 36.93	9.9	$ 0
Exercisable at July 31, 2006				

A summary of the nonvested stock option shares under the 2006 Plan during the nine months ended July 31, 2006 is presented below:

	Shares	Weighted-Average Grant-Date Fair Value Per Share
Nonvested at October 31, 2005		
Granted	23,250	$ 11.96
Vested		
Forfeited	(2,000)	$ 12.97
Nonvested at July 31		