QUANEX CORP
Form 10-K
December 15, 2006

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

FORM 10-K

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended October 31, 2006
or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
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)	*(Zip code)*

Registrant s telephone number, including area code: **(713) 961-4600**

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

Title of each class	**Name of each exchange on which registered**
Common Stock, $.50 par value	New York Stock Exchange, Inc.
Rights to Purchase Series A Junior Participating Preferred Stock	New York Stock Exchange, Inc.

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 þ No o

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 o No þ

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 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 definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 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 Act). Yes o No þ
The aggregate market value of the voting common equity held by non-affiliates as of April 30, 2006, computed by reference to the closing price for the Common Stock on the New York Stock Exchange, Inc. on that date, was $1,604,349,249. Such calculation assumes only the registrant s officers and directors were affiliates of the registrant.
At December 11, 2006, there were outstanding 37,031,301 shares of the registrant s Common Stock, $.50 par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement, to be filed with the Commission within 120 days of October 31, 2006, for its Annual Meeting of Stockholders to be held on February 22, 2007, are incorporated herein by reference in Part III of this Annual Report.

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PART I

Item 1. *Business*

General

Quanex was organized in 1927 as a Michigan corporation under the name Michigan Seamless Tube Company. The Company reincorporated in Delaware in 1968 under the same name and then changed its name to Quanex Corporation in 1977. The Company s executive offices are located at 1900 West Loop South, Suite 1500, Houston, Texas 77027. References made to the Company or Quanex include Quanex Corporation and its subsidiaries unless the context indicates otherwise.

The Company s businesses are focused on two end markets, vehicular products and building products, and are managed on a decentralized basis. The businesses are presented as three reportable segments: Vehicular Products, Engineered Building Products and Aluminum Sheet Building Products. Each business has administrative, operating and marketing functions. The Company measures each business s return on investment and seeks to reward superior performance with incentive compensation, which is a significant portion of total compensation for salaried employees. Intercompany sales are conducted on an arms-length basis. Operational activities and policies are managed by corporate officers and key division executives. Also, a small corporate staff provides corporate accounting, financial and treasury management, tax, legal, internal audit, information technology and human resource services to the operating divisions.

Quanex is a technological leader in the production of engineered carbon and alloy steel bars, heat treated bars, aluminum flat-rolled products, flexible insulating glass spacer systems, extruded profiles, and precision-formed metal and wood products which primarily serve the North American vehicular products and building products markets. The Company uses state-of-the-art manufacturing technologies, low-cost production processes, and engineering and metallurgical expertise to provide customers with specialized products for specific applications. Quanex believes these capabilities also provide the Company with unique competitive advantages. The Company s growth strategy is focused on the continued development of its two target markets, vehicular products and building products, and protecting, nurturing and growing its core businesses that serve those markets.

Business Developments

In the Company s Vehicular Products segment, rotary centrifugal continuous casters are used at two of the steel bar plants (Fort Smith, Arkansas and Jackson, Michigan), each with an in-line manufacturing process to produce bearing grade quality, seam-free, engineered carbon and alloy steel bars that enable Quanex to participate in higher margin niches of the vehicular products bar market. Over the past ten years, the Company has invested approximately $340 million through internal growth and an acquisition (MACSTEEL Monroe) to enhance its steel bar manufacturing and refining processes, to improve rolling and finishing capability, and to expand shipping capacity from 550 thousand tons to approximately 1.2 million tons per year. Approximately 75% of tonnage shipped has some value-added operation performed to the bars. Phases I through VII and IX of the MACSTEEL expansions have been completed.

The Phase VIII capital project announced in September 2004 is on schedule for completion in December 2006. Phase VIII will increase the annual capacity of the Fort Smith, Arkansas facility by approximately 40,000 tons, thereby increasing total engineered bar shipping capacity to close to 1.3 million tons. In addition to an increase in capacity, the Phase VIII modernization will improve production flow and further enhance metallurgical quality. Specifically included in the project are upgrades to the rotary continuous caster, direct rolling mill, and metallurgical refining areas.

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In February 2005, the Company announced the Phase IX capital project which called for the construction of a value-added bar processing center at MACSTEEL Monroe to eliminate outside processing for straightening, heat treating, testing, and bar turning services. The project included the installation of two straightening and testing lines, two heat treat furnaces and a MACPLUS bar turning line, all housed in a new building. The project was completed in September 2006.

On January 27, 2006, the Company completed the sale of Temroc Metals, Inc. (Temroc), located in Hamel, Minnesota. The business produced aluminum extrusions and fabricated products primarily for the recreational vehicle market.

Manufacturing Processes, Markets, and Product Sales by Business Segment

Quanex has 22 manufacturing facilities in 12 states in the United States. These facilities feature efficient plant design and flexible manufacturing processes, enabling the Company to produce a wide variety of custom engineered products and materials for the vehicular products and building products markets. The Company is able to maintain minimal levels of finished goods inventories at most locations because it typically manufactures products upon order to customer specifications.

The majority of the Company s products are sold into the vehicular products and building products markets. The primary market drivers are North American light vehicle builds, heavy duty truck builds, residential housing starts and remodeling expenditures.

For financial information regarding each of Quanex s business segments, see Management s Discussion and Analysis of Financial Condition and Results of Operations herein and Note 11 to the Consolidated Financial Statements. For net sales of the Company by major product lines see Note 11 to the Consolidated Financial Statements. For the years ended October 31, 2006, 2005, and 2004, no one customer accounted for 10% or more of the Company s sales.

Vehicular 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 Company s MACSTEEL engineered steel bar operations, which represent the majority of the segment s sales and operating income, include three plants, one located in Arkansas and two in Michigan, which in aggregate are capable of shipping 1.2 million tons of hot rolled and cold finished, engineered, carbon and alloy steel bars annually. The Company believes that it has the only two bar plants in North America using rotary continuous casting technology. The highly automated continuous casting and direct charge rolling at these plants substantially reduce labor and energy costs by eliminating the intermittent steps that characterize manufacturing operations at most other steel mills.

MACSTEEL produces various grades of customized, engineered steel bars by melting steel scrap and casting it through both static and rotary continuous casters. Prior to casting, molten steel benefits from secondary refining processes that include argon stirring, ladle refining, and vacuum arc degassing. These processes enable the production of higher quality, cleaner steel. The Company believes that it is the lowest cost producer of engineered carbon and alloy steel bars in North America, in part because its average energy cost per produced ton are significantly lower than those of its competitors; at the two plants that utilize continuous rotary casting technology, bars move directly from the continuous caster to the rolling mill before cooling to ambient temperature, thereby reducing the need for costly reheating. Its highly automated manufacturing processes enable the Company to produce finished steel bars using approximately 1.5 man-hours of labor per ton.

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Bar products are custom manufactured primarily for customers within the vehicular product markets serving the passenger car, light truck, sport utility vehicle, heavy truck, off-road and farm equipment industries. These customers use engineered steel bars in critical applications such as camshafts, crankshafts, gears, wheel spindles and hubs, bearing components, steering components, hydraulic mechanisms and seamless tube production.

Vehicular Products also includes two additional, complementary value-added business units. One is a heat-treating plant in Indiana that uses custom designed, in-line equipment to provide tube and bar quench and tempering and related value-added processes such as complete metallurgical testing and cut-to-length just-in-time delivery. This plant primarily serves customers in the vehicular products and energy markets. The other, located in Wisconsin, treats steel bars and tubes using the patented Nitrotec process to improve the metal s corrosion and wear resistance properties while providing a more environmentally friendly, non-toxic alternative to chrome plating. Their primary end market is the mobile fluid power applications in the vehicular products market.

Engineered Building Products Segment

The Engineered Building Products segment is comprised of six fabricated metal components operations, two facilities producing wood fenestration (door and window) products, three vinyl extrusion facilities, a flexible insulating glass spacer operation and a facility that produces glass spacer installation equipment. The segment s operations produce window and door components and products for original equipment manufacturers (OEMs) that serve the building and remodeling markets. Products include flexible insulating glass spacer systems, window and patio door screens, window cladding frames, residential exterior products and engineered vinyl and composite door and window frames and custom window grilles and trim in a variety of woods for the home improvement, residential, and light commercial construction markets.

The extrusion operations use highly automated production facilities to manufacture vinyl profiles and composites, the window and door structural frames used by high-end fenestration OEMs. The value added capabilities include frame design, tooling design and fabrication, laser welding, roll forming, poly laminating, stamping, and end-product assembly to produce a variety of fenestration products. In addition, the insulating glass sealant business uses composite and laminating technology to produce highly engineered window spacer products used to separate two panes of glass in a window sash to improve its thermal performance. Engineered Products customers end-use applications include windows, window screens, sills, cladding, doors, exterior door thresholds, astragals, patio door systems, and custom hardwood architectural moldings. Key success factors range from design and development expertise to flexible, world class quality manufacturing capability and just-in-time delivery.

Aluminum Sheet Building Products Segment

The Aluminum Sheet Building Products segment is comprised of an aluminum sheet casting operation and three stand-alone aluminum sheet finishing operations. Aluminum sheet finishing capabilities include reducing coil to specific gauge, annealing, slitting and custom coating. Customer end-use applications include exterior housing trim, fascias, roof edgings, soffits, downspouts, gutters, trim, and trim coils. The product is packaged and delivered just-in-time for use by various customers in the building and construction markets, as well as other capital goods and transportation markets.

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The Company s aluminum mini-mill uses an in-line casting process that can produce approximately 400 million pounds of reroll (hot-rolled aluminum sheet) annually. The mini-mill converts aluminum scrap to reroll through melting, continuous casting, and in-line hot rolling processes. It also has shredding and blending capabilities, including two rotary barrel furnaces and a dross recovery system that broaden its use of raw materials, allowing it to melt lesser grades of scrap, while improving raw material yields. Delacquering equipment improves the quality of the raw material before it reaches the primary melt furnaces by burning off combustibles in the scrap. In addition, scrap is blended using computerized processes to most economically achieve the desired molten aluminum alloy composition. The Company believes its production capabilities result in a significant manufacturing advantage and savings from reduced raw material costs, optimized scrap utilization, reduced unit energy cost and lower labor costs.

Raw Materials and Supplies

The Vehicular Products segment s operations purchase their principal raw material, steel scrap, on the open market. Collection and transportation of raw materials to the Company s plants can be adversely affected by extreme weather conditions. Prices for the steel scrap also vary in relation to the general business cycle and global demand.

The Engineered Building Products segment s operations purchase a diverse range of raw materials, which include coated and uncoated aluminum sheet, wood (both hardwood and softwood), polyvinyl chloride and epoxy resin. In most cases the raw materials are available from several suppliers at market prices. One exception is aluminum sheet which is purchased from the Aluminum Sheet Building Products segment at prices based upon arms-length transactions. Sole sourcing arrangements are entered into from time to time if beneficial savings can be realized and only when it is determined that a vendor can reliably supply all of the Company s raw material requirements.

The Aluminum Sheet Building Products segment s most significant raw material is aluminum scrap purchased on the open market, where availability and delivery can be adversely affected by, among other things, extreme weather conditions. Firm fixed price forward purchases matched to firm fixed price forward sales are used on a limited basis to hedge against fluctuations in the price of aluminum scrap required to manufacture products for fixed-price sales contracts. To a lesser extent, aluminum ingot futures contracts are bought and sold on the London Metal Exchange to hedge aluminum scrap requirements.

Backlog

At October 31, 2006, Quanex s backlog of orders to be shipped in the next twelve months was approximately $298 million, comprised of $263 million for the Vehicular Products segment, $10 million for the Engineered Building Products segment, and $25 million for the Aluminum Sheet Building Products segment. This compares to approximately $330 million at October 31, 2005, comprised of $273 million for the Vehicular Products segment, $15 million for the Engineered Building Products segment, and $42 million for the Aluminum Sheet Building Products segment. The decrease from October 31, 2006 to October 31, 2005 is directly related to the reduced demand within both the vehicular products and building products markets. Because many of the markets in which Quanex operates have short lead times, the Company does not believe that backlog figures are reliable indicators of annual sales volume or operating results.

Competition

The Company s products are sold under highly competitive conditions. Quanex competes with a number of companies, some of which have greater financial resources. Competitive factors include product quality, price, delivery, and the ability to manufacture to customer specifications. The amounts of engineered steel bars, aluminum mill sheet products, engineered products and extruded products manufactured by the Company represent a small percentage of annual domestic production.

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MACSTEEL s operations compete with several large non-integrated steel producers. Although these producers may be larger and have greater resources than the Company, Quanex believes that the technology used at the Company s facilities permits it to compete effectively in the markets it serves.

The operations of the Engineered Building Products segment compete with a range of small and midsize metal, vinyl and wood fabricators and wood molding facilities. The Company also competes against sealant firms and insulated glass panel fabricators. Competition is primarily based on regional presence, custom engineering, product development, quality, service and price. The operations also compete with in-house operations of vertically integrated fenestration OEMs.

The Aluminum Sheet Building Products segment competes with small to large aluminum sheet manufacturers, some of which are divisions or subsidiaries of major corporations with substantially greater resources than the Company. The Company competes in coil-coated and mill finished products, primarily on the basis of the breadth of product lines, the quality and responsiveness of its services, and price.

Sales and Distribution

The Company has sales organizations with sales representatives in many parts of the United States. Engineered steel bars are primarily sold to tier-one or tier-two suppliers through the Company s direct sales force and a limited number of manufacturers representatives. The Engineered Building Products segment s products are sold primarily to OEMs through company direct sales force, along with the limited use of distributors to market wood moldings. The Aluminum Sheet Building Products segment s products are sold to both OEM and distribution customers through both direct and indirect sales groups.

Seasonal Nature of Business

Sales for both the Engineered Building Products and Aluminum Sheet Building Products segment s products are seasonal. The winter weather typically reduces homebuilding and home improvement activity. These segments typically experience their lowest sales during the Company s first fiscal quarter. Profits tend to be lower in quarters with lower sales because a high percentage of manufacturing overhead and operating expense is due to labor and other costs that are generally semi-variable throughout the year.

Sales for the Vehicular Products segment are generally not seasonal. However, due to the number of holidays in the Company s first fiscal quarter, sales have historically been lower in this period as some customers reduce production schedules. As a result of reduced production days combined with the effects of seasonality, the Company generally expects that, absent unusual activity, its lowest sales will occur in the first fiscal quarter.

Service Marks, Trademarks, Trade Names, and Patents

The Company s federally registered trademarks or service marks include QUANEX, QUANEX and design, SEAM-FREE and design, NITROSTEEL, MACGOLD, MACSTEEL, MACSTEEL THE MIGHTY MITE and design, MAC+, MACPLUS, ULTRA-BAR, TRUSEAL TECHNOLOGIES, EDGETHERM, INSULEDGE, COLONIAL CRAFT, MIKRON, MIKRONWOOD, MIKRONWOOD A PAINTABLE COMPOSITE and design, M design, MIKRONBLEND, MIKRON BLEND and design, SPECTUSBLEND, SPECTUS BLEND and design, K2 MIKRON and design, BUILDER & REMODELER EXECUTIVE, WINDOW EXECUTIVE, HOMESHIELD, HOMESHIELD and design, STORM SEAL, MACPRIME, Seam-Free, NITRO-100, NITROSTEEL, and THE BEST ALLOY & SPECIALTY BARS marks. The trade name Nichols Aluminum is used in connection with the sale of the Company s aluminum mill sheet products. The HOMESHIELD, COLONIAL CRAFT, MACSTEEL, TRUSEAL TECHNOLOGIES, MIKRON and QUANEX word and design marks and associated trade names are considered valuable in the conduct of the Company s business. The business conducted by the Company generally does not depend upon patent protection other than at its vinyl extrusion and window sealant business units. Although the Company holds numerous patents, the proprietary process technology that the Company has developed is also the source of considerable competitive advantage.

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Research and Development

Expenditures for research and development of new products or services during the last three years were not significant. Although not technically defined as research and development, a significant amount of time, effort and expense is devoted to (a) custom engineering which qualifies the Company s products for specific customer applications and (b) developing superior, proprietary process technology.

Environmental Matters

Quanex is subject to extensive laws and regulations concerning the discharge of materials into the environment and the remediation of chemical contamination. To satisfy such requirements, Quanex must make capital and other expenditures on an ongoing basis. The cost of environmental matters has not had a material adverse effect on Quanex s operations or financial condition in the past, and management is not aware of any existing conditions that it currently believes are likely to have a material adverse effect on Quanex s operations, financial condition, or cash flow.

Remediation

Under applicable state and federal laws, the Company may be responsible for, among other things, all or part of the costs required to remove or remediate wastes or hazardous substances at locations Quanex has owned or operated at any time. The Company is currently participating in environmental investigations or remediation at several such locations.

From time to time, Quanex also has been alleged to be liable for all or part of the costs incurred to clean up third-party sites where it is alleged to have arranged for disposal of hazardous substances. At present, the Company is involved at several such facilities.

Total environmental reserves and corresponding recoveries for Quanex s current plants, former operating locations, and disposal facilities were as follows:

	October 31,	
	2006	2005
	(In thousands)	
Current[1]	$ 2,591	$ 2,146
Non-current	14,186	17,784
Total environmental reserves	$ 16,777	$ 19,930
Receivable for recovery of remediation costs[2]	$ 7,192	$ 11,052

Approximately $3.6 million of the October 31, 2006 reserve represents administrative costs; the balance represents estimated costs for investigation, studies, cleanup, and treatment. As discussed below, the reserve includes net present values for certain fixed and reliably determinable components of the Company s remediation liabilities. Without such discounting, the Company s estimate of its environmental liabilities as of October 31, 2006 would be $18.6 million. An associated $7.2 million undiscounted recovery from indemnitors of remediation costs at one plant site is recorded as of October 31, 2006.

[1] Reported in Accrued liabilities on the Consolidated Balance Sheets

[2] Reported in Other current assets and Other

assets on the
Consolidated
Balance Sheets

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The Company s Nichols Aluminum-Alabama, Inc. (NAA) subsidiary operates a plant in Decatur, Alabama that is subject to an Alabama Hazardous Wastes Management and Minimization Act Post-Closure Permit. Among other things, the permit requires NAA to remediate, as directed by the state, historical environmental releases of wastes and waste constituents. Consistent with the permit, NAA has undertaken various studies of site conditions and, during the first quarter 2006, started a phased program to treat in place free product petroleum that had been released to soil and groundwater. Based on its studies to date, which remain ongoing, NAA currently expects remediation costs at the Decatur plant to be $6.7 million or approximately 39% of the Company s total environmental reserve. NAA was acquired through a stock purchase in which the sellers agreed to indemnify Quanex and NAA for environmental matters related to the business and based on conditions initially created or events initially occurring prior to the acquisition. Environmental conditions are presumed to relate to the period prior to the acquisition unless proved to relate to releases occurring entirely after closing. The limit on indemnification is $21.5 million excluding legal fees. In accordance with the indemnification, the indemnitors paid the first $1.5 million of response costs and have been paying 90% of ongoing costs. Based on experience to date, estimated cleanup costs going forward, and costs incurred to date as of October 31, 2006, the Company expects to recover from the shareholders $7.2 million. Of that, $5.9 million is recorded in Other assets, and the balance is reflected in Other current assets. As discussed in Note 1 under Reclassifications, this obligation and associated receivable are reported separately on a gross basis in the Company s balance sheet; all prior periods have been reclassified to correspond to the current period presentation.

During the fourth fiscal quarter of 2006, the Company increased the reserve for its MACSTEEL plant in Jackson, Michigan $5.4 million to $5.9 million, so that it now represents 35% of the Company s total environmental reserve. The increase reflects completion of studies supporting selection of an interim remedy to address the impact of a historical plant landfill and slag cooling and sorting operation on groundwater. Based on those studies, the Company is proceeding with preparation of design plans for submittal to the Michigan Department of Environmental Quality of a hydraulic barrier (sheet pile wall) and groundwater extraction and treatment system to prevent impacted groundwater migration. The primary component of the reserve is for the estimated cost of operating the groundwater extraction and treatment system for the interim remedy over the next 10 years. The Company has estimated the annual cost of operating the system to be approximately $0.5 million. These operating costs and certain other components of the Jackson reserve have been discounted utilizing a discount rate of 4.6% and an estimated inflation rate of 2.0%. Without discounting, the Company s estimate of its Jackson remediation liability as of October 31, 2006 would be $6.6 million. In addition to the $5.9 million reserve, the Company anticipates incurring a capital cost of $4.4 million to construct the sheet pile wall and install the groundwater extraction and treatment system. Depending on the effectiveness of the interim remedy, the results of future operations, and regulatory concurrences, the Company may incur additional costs to implement a final site remedy and may pay costs beyond the ten-year time period currently projected for operation of the interim remedy.

Approximately 17% or $2.8 million of the Company s total environmental reserve is currently allocated to cleanup work related to Piper Impact. During the first quarter of 2005, the Company sold the operating assets of the Piper Impact business, including its only active plant on Barkley Drive in New Albany, Mississippi. In the fourth fiscal quarter of 2005, the Company sold the location on Highway 15 in New Albany where Piper Impact previously had operated a plant (the Highway 15 location), but as part of the sale retained environmental liability for pre-closing contamination there. The Company voluntarily implemented a state-approved remedial action plan at the Highway 15 location that includes natural attenuation together with a groundwater collection and treatment system. The Company has estimated the annual cost of operating the existing system to be approximately $0.1 million and has assumed that the existing system will continue to be effective. The primary component of the reserve is the estimated operational cost over the next 28 years, which was discounted to a net present value using a discount rate of 4.7% and an estimated inflation rate of 2.0%. The aggregate undiscounted amount of the estimated Piper Impact remediation costs as of October 31, 2006 is $3.9 million. The Company continues to monitor conditions at the Highway 15 location and to evaluate performance of the remedy.

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The final remediation costs and the timing of the expenditures at the NAA plant, Jackson plant, Highway 15 location, and other sites for which the Company has remediation obligations will depend upon such factors as the nature and extent of contamination, the cleanup technologies employed, the effectiveness of the cleanup measures that are employed, and regulatory concurrences. While actual remediation costs therefore may be more or less than amounts accrued, the Company believes it has established adequate reserves for all probable and reasonably estimable remediation liabilities. It is not possible at this point to reasonably estimate the amount of any obligation for remediation in excess of current accruals because of uncertainties as to the extent of environmental impact, cleanup technologies, and concurrence of governmental authorities. The Company currently expects to pay the accrued remediation reserve through at least fiscal 2034, although some of the same factors discussed earlier could accelerate or extend the timing.

During the third quarter of 2005, the United States Department of Justice filed a complaint against the Company for recovery of cleanup costs incurred at the Jepscor Superfund site in Dixon, Illinois. The United States Environmental Protection Agency indicated that it had incurred approximately $2.6 million to remove processing residue and other materials from that former metal recovery plant. Of the Jepscor site s former owners, operators, and many customers, the government asserted liability for cleanup only against the Company. During the fourth fiscal quarter of 2005, the Company and the Department of Justice reached a tentative agreement to settle this matter. In May 2006, the parties successfully finalized that settlement, pursuant to which the Company paid $1.0 million of the government s cleanup costs. Such amount had been reserved for during fiscal 2005.

Compliance

Quanex incurred expenses of approximately $3.0 million and capitalized an additional $1.0 million during fiscal 2006 in order to comply with existing environmental regulations. This compares to $4.7 million of expense and $2.9 million of capital incurred during fiscal 2005. For fiscal 2007, the Company estimates expenses at its facilities will be approximately $3.5 million for continuing environmental compliance. In addition, the Company estimates that capital expenditures for environmental compliance in fiscal 2007 will be approximately $4.6 million, which includes $4.4 million for construction of the Jackson plant sheet pile wall and installation of the groundwater extraction and treatment system. Future expenditures relating to environmental matters will necessarily depend upon the application to Quanex and its facilities of future regulations and government decisions. Quanex will continue to have expenditures beyond fiscal 2007 in connection with environmental matters, including control of air emissions, control of water discharges and plant decommissioning costs. It is not possible at this time to reasonably estimate the amount of those expenditures, except as discussed above due to uncertainties about emission levels, control technologies, the positions of governmental authorities, the application of requirements to Quanex, and, as to decommissioning, settlement dates. Based upon its experience to date, Quanex does not believe that its compliance with environmental requirements will have a material adverse effect on its operations or financial condition.

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Employees

The Company had 4,200 employees at October 31, 2006 and approximately 4,100 at December 11, 2006. Of the total employed, approximately 34% are covered by collective bargaining agreements. The TruSeal Technologies collective bargaining agreement expires on December 16, 2006. A new agreement has not yet been ratified. Following is a table of collective bargaining agreements currently in place.

Facility	Expires	Union	Covered Employees at 10/31/06
TruSeal Technologies	Dec. 2006	United Steelworkers of America	200
Nichols Aluminum Davenport/Casting	Nov. 2007	International Brotherhood of Teamsters	253
MACSTEEL Monroe	Dec. 2007	United Automobile Workers International Union of America	273
MACSTEEL Arkansas	Jan. 2008	United Steelworkers of America	282
MACSTEEL Jackson	Feb. 2008	United Steelworkers of America	230
Nichols Aluminum-Lincolnshire	Jan. 2009	International Association of Machinists and Aerospace Workers	94
Nichols Aluminum Alabama	May 2011	United Steelworkers of America	93

Financial Information about Foreign and Domestic Operations

For financial information on the Company s foreign and domestic operations, see Note 11 of the Financial Statements contained in this Annual Report on Form 10-K.

Communication with the Company

The Company s website is www.quanex.com. Quanex invites inquiries to the Company and its Board of Directors. Interested persons may contact the appropriate individual or department by choosing one of the options below.

General

Investor Information:

For Investor Relations matters or to obtain a printed copy of the Company Code of Ethics, Corporate Governance Guidelines or charters for the Audit, Compensation and Management Development, and Nominating and Corporate Governance Committees of the Board of Directors, send a request to the Company s principal address below or inquiry@quanex.com. This material may also be obtained from the Company website at www.quanex.com by following the Corporate Governance link.

The Company s required Securities Exchange Act filings such as annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports are available free of charge through the Company s website, as soon as reasonably practicable after they have been filed with or furnished to the Securities and Exchange Commission (SEC) pursuant to Section 13(a) or 15(d) of the Securities and Exchange Act of 1934 (the 1934 Act). Forms 3, 4 and 5 filed with respect to equity securities under Section 16(a) of the 1934 Act are also available on the Company s website. All of these materials are located at the Financial Information link. They can also be obtained free of charge upon request to inquiry@quanex.com or to the Company s principal address: Quanex Corporation, 1900 West Loop South, Suite 1500, Houston, TX 77027.

Communications with the Company s Board of Directors:

Persons wishing to communicate to the Company s Board of Directors or specified individual directors may do so by sending them in care of Raymond A. Jean, The Chairman of the Board of Directors, at the Company s principal

address below or hotline@quanex.com.

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Hotline

Accounting Issues:

Persons who have concerns or complaints regarding questionable accounting, internal accounting controls or auditing matters may submit them to the Senior Vice President Finance & Chief Financial Officer at the Company s principal address or hotline@quanex.com.

Such communications will be kept confidential to the fullest extent possible. If the individual is not satisfied with the response, they may contact the Audit Committee of the Board of Directors of the Company. If concerns or complaints require confidentiality, then this confidentiality will be protected, subject to applicable laws.

Reporting Illegal or Unethical Behavior:

Employees, officers and directors who suspect or know of violations of the Company Code of Business Conduct or Ethics, or illegal or unethical business or workplace conduct by employees, officers or directors have an obligation to report it. If the individuals to whom such information is conveyed are not responsive, or if there is reason to believe that reporting to such individuals is inappropriate in particular cases, then the employee, officer or director may contact the Chief Compliance Officer, Chief Financial Officer, Director of Internal Audit, or any corporate officer in person, by telephone, letter to the Company s principal address or e-mail below. Quanex also encourages persons who are not affiliated with the Company to report any suspected illegal or unethical behavior.

1) **By Letter**
   Quanex Corporation
   1900 West Loop South, Suite 1500
   Houston, Texas 77027

2) **By Telephone**
   Direct Telephone (713) 877 5349
   Toll Free Telephone (800) 231 8176
   Toll Free HOTLINE (888) 704 8222

3) **By Electronic Mail HOTLINE**
   hotline@quanex.com

Such communications will be kept confidential to the fullest extent possible. If the individual is not satisfied with the response, they may contact the Nominating and Corporate Governance Committee of the Board of Directors of the Company. If concerns or complaints require confidentiality, then this confidentiality will be protected, subject to applicable laws.

Item 1A. ***Risk Factors***

In addition to the factors discussed elsewhere in this report and in Management s Discussion and Analysis of Financial Condition and Results of Operations, the following are some of the potential risk factors that could cause our actual results to differ materially from those projected in any forward-looking statements. You should carefully consider these factors, as well as the other information contained in this document, when evaluating your investment in our securities. Any of the following risks could have material adverse effects on our financial condition, operating results and cash flow. The below list of important factors is not all-inclusive or necessarily in order of importance.

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If the Company s raw materials or energy were to become unavailable or to significantly increase in price, the Company might not be able to timely produce products for our customers or maintain our profit levels.

Quanex requires substantial amounts of raw materials, substantially all of which are purchased from outside sources. The Company does not have long-term contracts for the supply of most of our raw materials. The availability and prices of raw materials may be subject to curtailment or change due to new laws or regulations, suppliers allocations to other purchasers or interruptions in production by suppliers. For example, the Company experienced a steep increase in costs for steel and aluminum scrap in fiscal 2004 due to a global rebound in manufacturing in addition to increased demand from China and other consumers for scrap metal. In addition, the operation of the Company s facilities requires substantial amounts of electric power and natural gas. Any change in the supply of, or price for, these raw materials could affect our ability to timely produce products for the Company s customers. Although the Company has contractual arrangements with many of our customers that permit us to increase prices in response to increased raw material costs, in times of rapidly rising raw material prices the adjustments will lag the current market price creating material volatility in top and bottom line results.

Portions of our business are generally cyclical in nature. Lowered vehicle production, fewer housing starts, reduced remodeling expenditures or weaknesses in the economy could significantly reduce our revenue, net earnings and cash flow.

Demand for the Company s products is cyclical in nature and sensitive to general economic conditions. The Company s business supports cyclical industries such as the automotive and construction industries.

The demand for the Vehicular Products Segment s products is largely dependent on the North American production level of vehicles. The markets for these products have historically been cyclical because new vehicle demand is dependent on, among other things, consumer spending and is tied closely to the overall strength of the economy. Declines in vehicle production could significantly reduce our net earnings. The segment s sales are also impacted by retail inventory levels and their customers production schedules. If its OEM customers significantly reduce their inventory levels and reduce their orders from us, the segment s performance could be impacted.

The primary drivers of the Engineered Building Products and Aluminum Sheet Building Products segments are housing starts and remodeling expenditures. The building and construction industry is cyclical and seasonal, and product demand is based on numerous factors such as interest rates, general economic conditions, consumer confidence and other factors beyond our control. Declines in housing starts and remodeling expenditures due to such factors could significantly reduce the segments net earnings.

The Company is subject to various environmental requirements, and compliance with, or liabilities under, existing or future environmental laws and regulations could significantly increase the Company s costs of doing business.

The Company is subject to extensive federal, state and local laws and regulations concerning the discharge of materials into the environment and the remediation of chemical contamination. To satisfy such requirements, the Company must make capital and other expenditures on an ongoing basis. For example, environmental agencies continue to develop regulations implementing the Federal Clean Air Act. Depending on the nature of the regulations adopted, the Company may be required to incur additional capital and other expenditures in the next several years for air pollution control equipment, to maintain or obtain operating permits and approvals, and to address other air emission-related issues. Future expenditures relating to environmental matters will necessarily depend upon the application to Quanex and its facilities of future regulations and government decisions. It is likely that the Company will be subject to increasingly stringent environmental standards and the additional expenditures related to compliance with such standards. Furthermore, if the Company fails to comply with applicable environmental regulations, the Company could be subject to substantial fines or penalties and to civil and criminal liability.

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Under applicable state and federal laws, the Company also may be responsible for, among other things, all or part of the costs required to remove or remediate wastes or hazardous substances at locations the Company has owned or operated at any time. The Company is currently involved in environmental investigations or remediation at several such locations. From time to time, the Company also has been alleged to be liable for all or part of the costs incurred to clean up third-party sites where it is alleged to have arranged for disposal of hazardous substances. While the Company has established reserves for such liabilities, such reserves may not be adequate to cover the ultimate cost of remedial measures required by environmental authorities. The discovery of previously unknown contamination, inadequate performance of a remedy or the imposition of new clean-up requirements at any site for which Quanex is responsible could require the Company to incur additional costs or become subject to significant new or increased liabilities.

The Company may not be able to successfully identify, manage or integrate future acquisitions, and if the Company is unable to do so, it is unlikely to sustain its historical growth rates and profitability.

Historically, Quanex has grown through a combination of internal growth and external expansion through acquisitions, such as its December 2003 acquisitions of TruSeal Technologies and MACSTEEL Monroe and its December 2004 acquisition of Mikron Industries. Although Quanex is actively pursuing its growth strategy both in its domestic target markets and overseas and expect to continue doing so in the future, the Company cannot provide any assurance that it will be able to identify appropriate acquisition candidates or, if it does, that it will be able to successfully negotiate the terms of an acquisition, finance the acquisition or integrate the acquired business effectively and profitably into its existing operations. Integration of future acquired businesses could disrupt the Company s business by diverting management s attention away from day-to-day operations. Further, failure to successfully integrate any acquisition may cause significant operating inefficiencies and could adversely affect the Company s profitability. Consummating an acquisition could require the Company to raise additional funds through additional equity or debt financing. Additional equity financing could depress the market price of Quanex common stock. In addition, the Company s ability to access the credit markets in the future to obtain additional financing, if needed, could be influenced by the its ability to meet current covenant requirements associated with its existing credit agreement, its credit rating, or other factors.

The Company operates in competitive markets, and the Company s business will suffer if it is unable to adequately address potential downward pricing pressures and other factors that may reduce its operating margins.

The principal markets that Quanex serves are highly competitive. Competition is based primarily on the precision and range of achievable tolerances, quality, price and the ability to meet delivery schedules dictated by customers. The Company s competition in the markets in which it participates comes from companies of various sizes, some of which have greater financial and other resources than Quanex does and some of which have more established brand names in the markets Quanex serves. Any of these competitors may foresee the course of market development more accurately than the Company, develop products that are superior to the Company s products, have the ability to produce similar products at a lower cost than the Company, or adapt more quickly than the Company to new technologies or evolving customer requirements. Increased competition could force the Company to lower its prices or to offer additional services at a higher cost to the Company, which could reduce its gross profit and net income.

Original Equipment Manufacturers (OEMs) have significant pricing leverage over suppliers and may be able to achieve price reductions over time, which will reduce the Company s profits.

The Company s products are sold primarily to OEMs, and to a much lesser extent, sold through distributors. There is substantial and continuing pressure from OEMs in all industries to reduce the prices they pay to suppliers. Quanex attempts to manage such downward pricing pressure, while trying to preserve its business relationships with its OEM customers, by seeking to reduce its production costs through various measures, including purchasing raw materials and components at lower prices and implementing cost-effective process improvements. However, the Company s suppliers may resist pressure to lower their prices and may seek to impose price increases. If the Company is unable to offset OEM price reductions through these measures, its gross margins and profitability could be adversely affected. In addition, OEMs have substantial leverage in setting purchasing and payment terms, including the terms of accelerated payment programs under which payments are made prior to the account due date in return for an early

payment discount.

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The Company could lose customers and the related revenues due to the transfer of manufacturing capacity by its customers out of the United States to lower cost regions of the world.

Manufacturing activity in the United States has been on the decline over the past several years. One of the reasons for this decline is the migration by U.S. manufacturers to other regions of the world that offer lower cost labor forces. The combined effect is that U.S. manufacturers can reduce product costs by manufacturing and assembling in other regions of the world and then importing those products to the United States. Some of the Company s customers have shifted production to other regions of the world and there can be no assurance that this trend will not continue. The Company will lose customers and revenues if its customers locate in areas that the Company chooses not to serve or that it cannot economically serve.

If the Company s relationship with its employees were to deteriorate, the Company could be faced with labor shortages, disruptions or stoppages, which could shut down certain of its operations, reducing its revenue, net earnings, and cash flows.

The Company s operations rely heavily on its employees, and any labor shortage, disruption or stoppage caused by poor relations with its employees and/or renegotiation of labor contracts could shut down certain of its operations. Approximately 34% of the Company s employees are covered by collective bargaining agreements which expire between 2006 and 2011. It is possible that the Company could become subject to additional work rules imposed by agreements with labor unions, or that work stoppages or other labor disturbances could occur in the future, any of which could impact financial results. Similarly, any failure to negotiate a new labor agreement when required might result in a work stoppage that could reduce our operating margins and income.

In addition, many OEMs and their suppliers have unionized work forces. Work stoppages or slowdowns experienced by OEMs or their suppliers could result in slowdowns or closures of assembly plants where Quanex products are included in assembled vehicles. In the event that one or more of the Company s customers experiences a material work stoppage, such work stoppage could prevent the customers from purchasing Quanex products.

Changes in regulatory requirements or new technologies may render the Company s products obsolete or less competitive.

Changes in legislative, regulatory or industry requirements or in competitive technologies may render certain of the Company s products obsolete or less competitive, preventing the Company from selling them at profitable prices, or at all. The Company s ability to anticipate changes in technology and regulatory standards and to successfully develop and introduce new and enhanced products on a timely and cost-efficient basis will be a significant factor in our ability to remain competitive. The Company s business may, therefore, require significant ongoing and recurring additional capital expenditures and investments in research and development. The Company may not be able to achieve the technological advances necessary for it to remain competitive or certain of its products may become obsolete. The Company is also subject to the risks generally associated with new product introductions and applications, including lack of market acceptance, delays in product development and failure of products to operate properly.

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Equipment failures, delays in deliveries or catastrophic loss at any of the Company s manufacturing facilities could lead to production curtailments or shutdowns that prevent the Company from producing its products.

An interruption in production capabilities at any of the Company s facilities as a result of equipment failure or other reasons could result in the Company s inability to produce its products, which would reduce its sales and earnings for the affected period. In addition, Quanex generally manufactures its products only after receiving the order from the customer and thus does not hold large inventories. In the event of a stoppage in production at any of our manufacturing facilities, even if only temporary, or if Quanex experiences delays as a result of events that are beyond its control, delivery times could be severely affected. Any significant delay in deliveries to the Company s customers could lead to increased returns or cancellations and cause us to lose future sales. The Company s manufacturing facilities are also subject to the risk of catastrophic loss due to unanticipated events such as fires, explosions or violent weather conditions. The Company has in the past and may in the future experience plant shutdowns or periods of reduced production as a result of equipment failure, delays in deliveries or catastrophic loss, which could have a material adverse effect on our results of operations or financial condition. Although the Company has obtained property damage and business interruption insurance, the Company may not have adequate insurance to compensate it for all losses that result from any of these events.

The Company s business involves complex manufacturing processes that may result in costly accidents or other disruptions of its operations.

The Company s business involves complex manufacturing processes. Some of these processes involve high pressures, temperatures, hot metal and other hazards that present certain safety risks to workers employed at its manufacturing facilities. Although the Company employs safety procedures in the design and operation of its facilities, the potential exists for accidents involving death or serious injury. The potential liability resulting from any such accident, to the extent not covered by insurance, could cause the Company to incur unexpected cash expenditures, thereby reducing the cash available to it to operate its business. Such an accident could disrupt operations at any of the Company s facilities, which could adversely affect its ability to deliver product to its customers on a timely basis and to retain its current business.

Flaws in the design or manufacture of the Company s products could cause future product liability or warranty claims for which it does not have adequate insurance or affect its reputation among customers.

The Company s products are essential components in vehicles, buildings and other applications where problems in the design or manufacture of our products could result in property damage, personal injury or death. While the Company believes that its liability insurance is adequate to protect it from future product liability and warranty liabilities, its insurance may not cover all liabilities or be available in the future at a cost acceptable to the Company. In addition, if any of the Company s products prove to be defective, it may be required in the future to participate in a recall involving such products. A successful claim brought against us in excess of available insurance coverage, if any, or a requirement to participate in any product recall, could significantly reduce the Company s profits or negatively affect its reputation with customers.

The Company s success depends upon its ability to develop new products and services, integrate acquired products and services and enhance its existing products and services.

The Company has continuing programs designed to develop new products and to enhance and improve its products. Quanex is expending resources for the development of new products in all of its segments. The successful development of its products and product enhancements are subject to numerous risks, both known and unknown, including: 1) unanticipated delays; 2) access to capital; 3) budget overruns; 4) technical problems; and 5) other difficulties that could result in the abandonment or substantial change in the design, development and commercialization of these new products.

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Given the uncertainties inherent with product development and introduction, the Company cannot provide assurance that any of its product development efforts will be successful on a timely basis or within budget, if at all. Failure to develop new products and product enhancements on a timely basis or within budget could harm the Company s business and prospects.

The Company has a risk that its goodwill and indefinite-lived intangible assets may be impaired and result in a charge to income.

The purchase method of accounting for business combinations requires the Company to make use of estimates and judgments to allocate the purchase price paid for acquisitions to the fair value of the net tangible and identifiable intangible assets. The Company performs a goodwill impairment test annually as of August 31. In addition, goodwill would be tested more frequently if changes in circumstances or the occurrence of events indicates that a potential impairment exists. The Company tests for impairment of its goodwill using a two-step approach as prescribed in SFAS 142. The first step of the Company s goodwill impairment test compares the fair value of each reporting unit with its carrying value including assigned goodwill. The second step of the Company s goodwill impairment test is required only in situations where the carrying value of the reporting unit exceeds its fair value as determined in the first step. In such instances, the Company compares the implied fair value of goodwill to its carrying value. The implied fair value of goodwill is determined by allocating the fair value of a reporting unit to all of the assets and liabilities of that unit as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the price paid to acquire the reporting unit. The excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill. An impairment loss is recorded to the extent that the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill. The Company primarily uses the present value of future cash flows to determine fair value and validates the result against the market approach. Future cash flows are typically based upon appropriate future periods for the businesses and an estimated residual value. Management judgment is required in the estimation of future operating results and to determine the appropriate residual values. The residual values are determined by reference to an exchange transaction in an existing market for that asset. Future operating results and residual values could reasonably differ from the estimates and could require a provision for impairment in a future period which would result in a charge to income from operations in the year of the impairment with a resulting decrease in our recorded net worth.

The Company may not be able to protect its intellectual property.

A significant amount of time, effort and expense is devoted to (a) custom engineering which qualifies our products for specific customer applications and (b) developing superior, proprietary process technology. The Company relies on a combination of copyright, patent, trade secrets, confidentiality procedures and contractual commitments to protect its proprietary information. Despite the Company s efforts, these measures can only provide limited protection. Unauthorized third parties may try to copy or reverse engineer portions of the Company s products or otherwise obtain and use the Company s intellectual property. Any patents owned by the Company may be invalidated, circumvented or challenged. Any of the Company s pending or future patent applications, whether or not being currently challenged, may not be issued with the scope of the claims the Company seeks, if at all. In addition, the laws of some countries do not provide the same level of protection of the Company s proprietary rights as do the laws of the United States. If the Company cannot protect its proprietary information against unauthorized use, it may not remain competitive.

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The Company may not be able to repay or repurchase the principal amount of its debentures when required.
At maturity, the entire outstanding principal amount of Convertible Senior Debentures due 2034 (the Debentures) will become due and payable by the Company. In addition, on May 15 of 2011, 2014, 2019, 2024 and 2029 or if certain designated events occur, holders of the Debentures may require the Company to repurchase their Debentures for cash. If the holders require Quanex to repurchase the Debentures or in the event a fundamental change occurs, the Company will be required to purchase all or any part of the holder s Debentures at a purchase price equal to 100% of their principal amount, plus accrued and unpaid interest (including contingent interest and additional interest, if any) to, but not including, the date of purchase. It is possible that Quanex will not have sufficient funds at the time of repurchase to make the required repurchases of the Debentures or that restrictions in its other indebtedness may not allow these repurchases. The Company failure to purchase the Debentures would be a default under the indenture that governs them.

The Company has the ability to issue additional equity securities, which would lead to dilution of its issued and outstanding common stock.
The issuance of additional equity securities or securities convertible into equity securities, as well as the conversion of the debentures or any other securities convertible into equity securities, would result in dilution of existing stockholders equity interests in Quanex. The Company is authorized to issue, without stockholder approval, 1,000,000 shares of preferred stock, no par value per share, in one or more series, which may give other stockholders dividend, conversion, voting, and liquidation rights, among other rights, which may be superior to the rights of holders of our common stock. The Company s board of directors has the authority to issue, without vote or action of stockholders, shares of preferred stock in one or more series, and has the ability to fix the rights, preferences, privileges and restrictions of any such series. Any such series of preferred stock could contain dividend rights, conversion rights, voting rights, terms of redemption, redemption prices, liquidation preferences or other rights superior to the rights of holders of our common stock. The Company s board of directors has no present intention of issuing any such preferred series, but reserves the right to do so in the future. In addition, the Company is authorized, by prior shareholder approval, to issue up to 50,000,000 shares of common stock, $.50 par value per share, of which 37,031,301 shares were outstanding as of December 11, 2006. Quanex is authorized to issue, without stockholder approval, securities convertible into either common stock or preferred stock.

Item 1B. ***Unresolved Staff Comments***

None.

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Item 2. ***Properties***

The following table lists Quanex s principal properties together with their locations, general character and the industry segment which uses the facility. Listed facilities are owned by the Company, unless indicated otherwise. See Item 1, Business, for discussion of the capacity of various facilities.

Location	Principal Products
Vehicular Products Segment	
Fort Smith, Arkansas	Special bar quality engineered steel
Jackson, Michigan	Special bar quality engineered steel
Monroe, Michigan	Special bar quality engineered steel
Huntington, Indiana	Heat treating
Pleasant Prairie, Wisconsin	Bar finishing
Engineered Building Products Segment	
Rice Lake, Wisconsin	Fenestration products
Chatsworth, Illinois	Fenestration products (two plants)
Hood River, Oregon	Fenestration products
Richmond, Indiana	Fenestration products
Solon, Ohio	Insulated flexible spacer research & sales
Barbourville, Kentucky	Insulated flexible spacer
Luck, Wisconsin	Fenestration products
Richmond, Kentucky	Vinyl extrusions
Winnebago, Illinois	Vinyl extrusions
Mounds View, Minnesota	Fenestration products
Leased (expires 2008)	
Kent, Washington	Vinyl extrusions (two plants)
Leased (leases expiring 2007, 2008, 2010 and 2011)	
Dubuque, Iowa	Fenestration products
Leased (expires 2008)	
Cleveland, Ohio	Insulated glass assembly equipment
Leased (expires 2006)	
Aluminum Sheet Building Products Segment	
Lincolnshire, Illinois	Aluminum sheet finishing
Davenport, Iowa	Aluminum sheet and finishing (two plants)
Decatur, Alabama	Aluminum sheet finishing
Owned and leased (expires 2018)	
Executive Offices	
Houston, Texas	Corporate Office
Leased (expires 2010)	

The Company believes that its properties are generally in good condition, are well maintained, and are generally suitable and adequate to carry on the Company s business. In fiscal 2006, the Company s vehicular products focused facilities operated at approximately 90% of capacity, while the building products focused facilities operated at approximately 75% of capacity.

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Item 3. ***Legal Proceedings***

On September 6, 2006, the Michigan Department of Environmental Quality sent to the Company a proposed administrative consent order with respect to alleged past violations of air emission requirements. The proposed order sought payment of a civil penalty in the amount of approximately $162,000. The parties have reached an agreement in principle pursuant to which the penalty would be reduced to $139,000. Quanex expects to finalize and execute the consent order in the first or second quarter of fiscal 2007. For additional discussion of environmental issues, see Item 1 and Item 8, Note 17 to the Consolidated Financial Statements. For additional discussion of the Company s pending tax case see Note 17 to the Consolidated Financial Statements.

Item 4. ***Submission of Matters to Vote of Security Holders***

None.

PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

Quanex s common stock, $.50 par value, is traded on the New York Stock Exchange, under the ticker symbol NX. The following tables present the quarterly common stock cash dividends and the high and low closing prices for the Company s common stock during each fiscal quarter within the two most recent fiscal years. Share amounts set forth below and elsewhere in this report have been adjusted to reflect the results of the March 2006 and December 2004 three-for-two stock splits in the form of a stock dividend.

Quarterly Common Stock Cash Dividends

Paid during the Quarter Ended	**2006**	**2005**
January	$ 0.1033	$ 0.0900
April	0.1200	0.0900
July	0.1200	0.0900
October	0.1400	0.1033
Total	$ 0.4833	$ 0.3733

Quarterly Common Stock Sales Price (High & Low Closing Price)

Quarter Ended	**2006**	**2005**
January	$ 41.67	$ 35.15
	32.50	22.52
April	47.28	41.33
	38.83	31.46
July	44.72	41.09
	35.11	31.18
October	36.90	44.15
	29.25	36.26

The terms of Quanex s revolving credit agreement do not specifically limit the total amount of dividends or other distributions to its shareholders.

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There were approximately 3,447 holders of Quanex common stock (excluding individual participants in securities positions listings) on record as of December 11, 2006.

Issuer Purchases of Equity Securities

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 purchased 1,573,950 treasury shares at an average price of $37.06 during the year ended October 31, 2006; no purchases were made during the fourth quarter of 2006. As of October 31, 2006, the number of shares in treasury was reduced to 1,200,617 resulting primarily from stock option exercises. No shares were purchased during fiscal 2005. At October 31, 2005 there were no shares of treasury stock.

Equity Compensation Plan Information

The following table summarizes as of October 31, 2006, certain information regarding equity compensation to our employees, officers, directors and other persons under our equity compensation plans.

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,184,314	$ 25.70	2,575,422
Equity compensation plans not approved by security holders[1]	141,647	14.28	
Total	1,325,961	$ 24.48	2,575,422

(1) The Quanex Corporation 1997 Key Employee Stock Plan was approved by the Company s Board of Directors in October 1997. This plan provides for the granting of stock options to eligible persons

employed by the Company who are not executive officers of the Company. Under the plan, the total number of stock options which may be granted is 900,000 shares. Stock options may be granted at not less than the fair market value (as defined in the plan) on the date the options are granted and generally become exercisable over three years in one-third annual increments. The options expire ten years after the date of grant. The Board of Directors may amend, terminate or suspend the plan at any time. This plan was terminated at the December 2005 Board of Directors meeting.

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Item 6. ***Selected Financial Data***

The following selected consolidated financial data for the years ended October 31, 2002 through October 31, 2006 is derived from the Company s audited consolidated financial statements. The operating results data includes reclassifications to conform to current period presentations with no impact on net income. All periods have been adjusted on a retroactive basis to give effect for the Company s March 2006 and December 2004 three-for-two stock splits in the form of a stock dividend. The data set forth should be read in conjunction with the Company s consolidated financial statements and accompanying notes to the consolidated financial statements included in Item 8 of this Form 10-K. The historical information is not necessarily indicative of the results to be expected in the future.

Glossary of Terms

The exact definitions of commonly used financial terms and ratios vary somewhat among different companies and investment analysts. The following list gives the definition of certain financial terms that are used in this report:

Asset turnover: Net sales divided by the average of beginning of year and end of year total assets.

Working capital: Current assets less current liabilities.

Current ratio: Current assets divided by current liabilities.

Return on common stockholders equity: Net income attributable to common stockholders divided by the average of beginning of year and end of year common stockholders equity.

Return on investment: The sum of net income and the after-tax effect of interest expense less capitalized interest divided by the sum of the beginning of year and end of year averages for short and long-term debt and stockholders equity.

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Selected Financial Data 2002 2006

	Fiscal years ended October 31,				
	2006	2005[1][2]	2004[1]	2003[1]	2002[1]
	(thousands, except per share data)				
Selected Operating Results Data:					
Net sales	$ 2,032,572	$ 1,969,007	$ 1,437,897	$ 878,409	$ 831,569
Operating income[3]	251,394	292,775	98,997	64,887	79,431
Income from continuing operations[4]	160,313	177,233	57,428	43,646	53,276
Income (loss) from discontinued operations, net of tax[5]	(130)	(22,073)	(2,961)	(759)	2,206
Net income [3][4][5]	$ 160,183	$ 155,160	$ 54,467	$ 42,887	$ 55,482
Percent of net sales	7.9%	7.9%	3.8%	4.9%	6.7%
Diluted Earnings Per Share Data:					
Income from continuing operations	$ 4.09	$ 4.50	$ 1.53	$ 1.18	$ 1.50
Net income	$ 4.08	$ 3.95	$ 1.45	$ 1.16	$ 1.56
Cash dividends declared	$ 0.4833	$ 0.3733	$ 0.3111	$ 0.2978	$ 0.2844
Financial Position Year End:					
Total assets	$ 1,202,152	$ 1,114,778	$ 940,054	$ 697,211	$ 728,573
Asset turnover	1.8	1.9	1.8	1.2	1.1
Working capital	242,196	143,043	144,057	95,157	104,336
Current ratio	2.2 to 1	1.7 to 1	1.7 to 1	1.7 to 1	1.8 to 1
Total debt	$ 133,401	$ 135,921	$ 128,926	$ 17,542	$ 73,140
Stockholders equity	758,515	656,742	500,707	445,159	421,395
Total capitalization	$ 891,916	$ 792,663	$ 629,633	$ 462,701	$ 494,535
Cash provided by operating activities	$ 190,271	$ 249,120	$ 124,237	$ 102,840	$ 81,111
Cash provided by (used for) investing activities	(65,539)	(240,737)	(213,090)	(22,500)	(29,808)
Cash provided by (used for) financing activities	(68,716)	(462)	108,478	(76,515)	(3,765)
Depreciation and amortization	71,657	65,987	49,921	40,647	38,635
Capital expenditures, net	72,262	50,792	18,713	24,411	30,353
Other Data:					
Total debt as a percent of capitalization	15.0%	17.1%	20.5%	3.8%	14.8%
Return on investment percent	19.4%	22.6%	10.6%	9.3%	12.9%
Return on common stockholders equity percent	22.6%	26.8%	11.5%	9.9%	15.8%
Average number of employees	4,356	4,124	2,975	2,408	2,351
Net sales per average employee	$ 467	$ 477	$ 483	$ 365	$ 354
Backlog for shipment in next 12 months	$ 298,000	$ 330,000	$ 489,000	$ 162,000	$ 169,000

(1) During the fourth quarter of 2005, the Company committed to a plan to sell its Temroc business. In the first quarter of 2005, the Company sold its Piper Impact business and in the fourth quarter of 2004 sold its Nichols Aluminum Golden business. Accordingly, the assets and liabilities of Temroc, Piper Impact and Nichols Aluminum Golden are reported as discontinued operations in the Consolidated Balance Sheets for all periods presented, and their operating results are reported as discontinued operations in the Consolidated Statements of Income for all periods presented (see Note 18).

(2) In December 2004, the Company acquired Mikron and accounted

for the acquisition under the purchase method of accounting. Accordingly, Mikron s estimated fair value of assets acquired and liabilities assumed in the acquisition and the results of operations are included in the Company s consolidated financial statements as of the effective date of the acquisition. For more information see Note 2 of the consolidated financial statements in Item 8 of this Form 10-K.

(3) Included in operating income are gains on sale of land of $0.5 million and $0.4 million in fiscal 2004 and 2003, respectively.

(4) Fiscal 2003 and 2002 include gains associated with retired executive life insurance proceeds of $2.2 million and $9.0 million,

respectively. This represents the excess of life insurance proceeds over (a) the cash surrender value and (b) liabilities to beneficiaries of deceased executives, on whom the Company held life insurance policies.

(5) Includes effects in fiscal 2005 of Temroc s $13.1 million (pretax and after-tax) asset impairment charge in accordance with SFAS 142 and SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144).

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

General

The discussion and analysis of the Company s financial condition and results of operations should be read in conjunction with the Selected Financial Data and the Consolidated Financial Statements of the Company and the accompanying notes.

Private Securities Litigation Reform Act

Certain of the statements contained in this document and in documents incorporated by reference herein, including those made under the caption Management s Discussion and Analysis of Results of Operations and Financial Condition are forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. Generally, the words expect, believe, intend, estimate, anticipate, project, will and similar expressi forward-looking statements, which generally are not historical in nature. All statements which address future operating performance, events or developments that we expect or anticipate will occur in the future, including statements relating to volume, sales, operating income and earnings per share, and statements expressing general optimism about future operating results, are forward-looking statements. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our Company s historical experience and our present projections or expectations. As and when made, management believes that these forward-looking statements are reasonable. However, caution should be taken not to place undue reliance on any such forward-looking statements since such statements speak only as of the date when made and there can be no assurance that such forward-looking statements will occur. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Factors exist that could cause the Company s actual results to differ materially from the expected results described in or underlying the Company s forward-looking statements. Such factors include domestic and international economic activity, prevailing prices of steel and aluminum scrap and other raw material costs, the rate of change in prices for steel and aluminum scrap, energy costs, interest rates, construction delays, market conditions, particularly in the vehicular, home building and remodeling markets, any material changes in purchases by the Company s principal customers, labor supply and relations, environmental regulations, changes in estimates of costs for known environmental remediation projects and situations, world-wide political stability and economic growth, the Company s successful implementation of its internal operating plans, acquisition strategies and integration, performance issues with key customers, suppliers and subcontractors, and regulatory changes and legal proceedings. Accordingly, there can be no assurance that the forward-looking statements contained herein will occur or that objectives will be achieved. All written and verbal forward-looking statements attributable to the Company or persons acting on its behalf are expressly qualified in their entirety by such factors. For more information, please see Item 1A, Risk Factors .

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Results of Operations

Summary Information as % of Sales

	Fiscal Year Ended October 31,*					
	2006		2005		2004	
	Dollar Amount	% of Sales	Dollar Amount	% of Sales	Dollar Amount	% of Sales
	(Dollars in millions)					
Net sales	$ 2,032.6	100%	$ 1,969.0	100%	$ 1,437.9	100%
Cost of sales	1,617.4	80	1,513.0	77	1,225.8	85
Selling, general and administrative	92.7	5	97.8	5	63.7	4
Depreciation and amortization	71.1	3	65.4	3	49.4	4
Operating income	251.4	12	292.8	15	99.0	7
Interest expense	(4.8)		(9.3)	(1)	(6.0)	(1)
Other, net	4.2		0.1		0.3	
Income tax expense	(90.5)	(4)	(106.4)	(5)	(35.9)	(2)
Income from continuing operations	$ 160.3	8%	$ 177.2	9%	$ 57.4	4%

* All periods presented exclude Nichols Aluminum Golden, Piper Impact and Temroc, which are included in discontinued operations.

Overview

Fiscal 2006 was a record year with net sales exceeding $2.0 billion for the first time in the Company s history. Both of the primary markets on which the Company focuses, the vehicular products and the building products markets, experienced difficulties over the course of fiscal 2006 when compared to the much stronger performance of those markets over the past few years. Notwithstanding these difficulties, the Company managed to outperform its primary markets by focusing on the controllable factors.

Fiscal 2006 was a year of declining demand while maintaining relatively strong spreads (sales price less material costs) at the Company s process businesses. Record net sales of $2.0 billion were an increase of 3.2% over fiscal 2005 s record level, attributable to strong base metal prices and the full year impact of the Mikron acquisition, offset by reduced demand. The 3.2% increase in net sales resulted from a 12.5% increase in Mikron net sales and a 2.0% increase in net sales across all of the other businesses.

Business Segments

Business segments are reported in accordance with Statement of Financial Accounting Standards (SFAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131). SFAS 131 requires that the Company disclose certain information about its operating segments, where operating segments are defined as

components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker (CODM) in deciding how to allocate resources and in assessing performance . Generally, financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments.

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Quanex has three reportable segments covering two customer-focused markets; the vehicular products and building products markets. The Company s reportable segments are Vehicular Products, Engineered Building Products, and Aluminum Sheet Building Products. The Vehicular Products segment produces engineered steel bars for the light vehicle, heavy duty truck, agricultural, defense, capital goods, recreational and energy markets. The Vehicular Products segment s primary market drivers are North American light vehicle builds and, to a lesser extent, heavy duty truck builds. The Engineered Building Products segment produces engineered products and components serving the window and door industry, while the Aluminum Sheet Building Products segment produces mill finished and coated aluminum sheet serving the broader building products markets and secondary markets such as recreational vehicles and capital equipment. The main market drivers of the building products focused segments are residential housing starts and remodeling expenditures.

During the fourth quarter of fiscal 2006, certain internal reporting relationships were changed that resulted in the Company s CODM assessing financial performance and allocating resources at a level of the organization below the segments to include each of the operating divisions. For financial reporting purposes three of the Company s five operating divisions, Homeshield, TruSeal and Mikron, have been aggregated into the Engineered Building Products reportable segment. The remaining two divisions, MACSTEEL and Nichols Aluminum, are reported as separate reportable segments with the Corporate & Other comprised of corporate office expenses and certain inter-division eliminations. The sale of products between segments is recognized at market prices. The financial performance of the operations is based upon operating income. The segments follow the accounting principles described in the Summary of Significant Accounting Principles. Note that the three reportable segments value inventory on a FIFO basis and the LIFO reserve relating to those operations accounted for under the LIFO method of inventory valuation is computed on a consolidated basis in a single pool and treated as a corporate expense. Prior periods have been adjusted to reflect the current presentation.

Vehicular Products Three Years Ended October 31, 2006

The Vehicular Products segment s primary market drivers are North American light vehicle production (approximately 65% of sales) and Class 8 heavy duty truck production (approximately 10% of sales). Calendar 2006 North American vehicle builds are expected to be some 15.8 million, 3.1% below the 16.3 million in calendar 2005. The segment s addition of new programs helped it to overcome the market decline, thereby resulting in flat volume compared to fiscal 2005. Fiscal 2005 was considered to have been a year of relatively strong demand, particularly in the first half of the year, when demand for the segment s engineered steel bar products outstripped our ability to fully supply customers. While the segment benefited from higher base selling prices in fiscal 2006, steel scrap costs were much less volatile than the falling prices experienced in the previous year.

The following table sets forth selected operating data for the Vehicular Products segment:

	Years Ended October 31, (Dollars in millions)			% Change	
	2006	2005	2004[1]	2006 vs. 2005	2005 vs. 2004
Net sales	$ 988.8	$ 1,017.2	$ 798.6	(2.8)%	27.4%
Cost of sales	782.3	772.6	677.1	1.3	14.1
Selling, general and administrative	17.8	21.2	16.6	(16.0)	27.7
Depreciation and amortization	34.1	32.7	30.9	4.3	5.8
Operating income	$ 154.6	$ 190.7	$ 74.0	(18.9)%	157.7%
Operating income margin	15.6%	18.7%	9.3%		

(1) Fiscal 2004 includes MACSTEEL

Monroe s operations beginning January 1, 2004	

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Net sales for fiscal 2006 were 2.8% lower than fiscal 2005 due to a 3.2% decline in the average selling price, directly attributable to lower scrap surcharges, which was only partially offset by a 0.5% increase in volume. Net sales for fiscal 2005 were higher than fiscal 2004 by 27.4% due to the combination of a 34.0% increase in average selling prices (including surcharges), increased sales as a result of two additional months of business at MACSTEEL Monroe during fiscal 2005 (acquired December 31, 2003), offset by a 10.6% decline in volume excluding MACSTEEL Monroe.

Fiscal 2006 volume was lower in the first half of the year versus the tough comparison of 2005, but outpaced fiscal 2005 in the second half of the year largely as a result of new programs. Fiscal 2005 volumes dropped from the strong levels that had persisted for several years primarily as a result of reduced end-use demand in the second half of the year and inventory draw-downs. Near-term volumes are anticipated to be lower than recent comparative periods in light of production cutbacks announced by several of the major automotive manufacturers. Over time, end-use demand is expected to increase, influenced, in part, by the overall driver aged population growth. The Company continues to focus on consistently improving productivity as well as enhancing its value-added offerings in an effort to meet the anticipated higher demand over time. Future volume increases will also be based upon the Company s ability to increase content per vehicle as well as continued sales growth with the New American Manufacturers (NAMs) which continue to take share from the former Big 3 manufacturers.

Average selling prices decreased from 2005 to 2006 primarily due to the reduction of steel scrap surcharges from fiscal 2005 s all time high surcharges. Although surcharges were lower in 2006, base prices held steady from 2005 to 2006. Leading up to fiscal 2006 average selling prices increased over the preceding three years primarily as the result of three items. First, the Company is always focused on continuing to increase sales of the segment s value-added products. As the mix of value-added sales increases, so does the average sales price. The second contributing factor to the average selling price increases are underlying base price increases that were realized in 2005. The largest contributing factor for the increase from fiscal 2004 to 2005 is the overall price increases resulting from higher steel scrap surcharges. Steel scrap raw material prices increased dramatically over the last half of calendar 2003 and into fiscal 2004. As a result of the steel scrap raw material price increases, surcharges were triggered on January 1, 2004 and have been adjusted since then (see further discussion of surcharge lag in Commodity Price Risk of Item 7A). Steel scrap price surcharges have been a component of the Company s MACSTEEL sales contracts for many years and will remain in effect as long as steel scrap prices remain at current levels.

The 18.9% decrease in operating income from fiscal 2005 to fiscal 2006 resulted from average selling prices decreasing by more than the decrease in raw material costs coupled with a 28% increase in utility costs that were only partially offset by the reduced selling, general and administrative expenses. The 157.7% increase in operating income from fiscal 2004 to 2005 resulted from the increases in average selling prices offset by higher raw material costs. At MACSTEEL, average selling prices held as raw material costs fell during fiscal 2005. During fiscal 2005 raw material costs steadily declined for the first three fiscal quarters followed by an increase during the fiscal fourth quarter. Fiscal 2005 selling, general and administrative expenses were higher than both fiscal 2004 and fiscal 2006 primarily due to increased incentives for the year coupled with a $3.1 million increase in the reserve for doubtful accounts receivable due to Jernberg Industries, Inc. and Delphi, which filed for bankruptcy during the year. The increased depreciation expense in 2005 and again in 2006 relate to the capital spending that has occurred over the past few years to increase the segment s valued added capacity. Depreciation expense is expected to increase in the next year, impacted by the MACSTEEL Phase VIII and Phase IX capital expansions.

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The operating income margin decrease from fiscal 2005 to 2006 resulted from the items that impacted operating income discussed above. Note that in the 1st quarter of fiscal 2006 the Company converted approximately 85% of the accounts, representing approximately 70% of shipments, to a monthly surcharge mechanism from a quarterly surcharge mechanism. The impact of the surcharge change reduces the volatility created by the inherent lag built into the quarterly surcharge mechanism. As examples, fiscal 2005 benefited from the surcharge lag in a period when raw material prices were decreasing, whereas fiscal 2004 was hurt by the surcharge lag in a period when raw material prices increased. Under the quarterly surcharge mechanism, as raw material prices rise, the Company experiences short term compression of the operating margin since the surcharges are adjusted on a quarterly basis based upon raw material indexes from the previous three months. Declines in raw material costs will increase the margin in the short term as the surcharge reductions lag behind. Based upon the inherent lag of surcharge pricing, the Company s margins were compressed during fiscal 2004 and expanded during fiscal 2005. The operating income margins experienced in fiscal 2004 are therefore believed to be below normal levels and the operating income margins realized during fiscal 2005 are not sustainable over the long-term. The operating income margins realized in fiscal 2006 are closer to expected normal levels due in large part to the change in the surcharge mechanism combined also with the lower volatility in raw material scrap prices during the year.

Engineered Building Products & Aluminum Sheet Building Products Three Years Ended October 31, 2006

Both the Engineered Building Products segment and Aluminum Sheet Building Products segment reported record net sales and the Aluminum Sheet Building Products segment reported record operating income in fiscal 2006. Both segments primary market drivers are North American new housing starts and remodeling activity. The primary drivers were both down for 2006 compared to a very strong 2005, with housing starts estimated to be down almost 12% calendar 2006 over 2005. The Engineered Building Products segment is comprised of three divisions: Homeshield, TruSeal and Mikron. The Engineered Building Products segment benefited from a full year of net sales from Mikron, a leading supplier of vinyl window profiles, which was acquired in December 2004. Homeshield and TruSeal net sales increased 3.4% in a down market. The operations were negatively impacted over the latter half of the year as housing starts and remodeling expenditures declined sharply. While the annual rate of housing starts is expected to end down 12% versus 2005, the rate in the last couple of months of the Company s fiscal year was down in the 20% range. The Aluminum Sheet Building Products segment benefited from higher selling prices and increased spreads offset partially by the drop in demand.

The following table sets forth selected operating data for the two reportable segments within Building Products, Engineered Building Products (Engineered BP) and Aluminum Sheet Building Products (Aluminum Sheet BP):

	Years Ended October 31, (Dollars in millions)			% Change	
	2006	2005[1]	2004[2]	2006 vs. 2005	2005 vs. 2004
Engineered BP net sales	$ 524.6	$ 487.6	$ 240.2	7.6%	103.0%
Aluminum Sheet BP net sales	539.8	484.1	419.7	11.5	15.3
Net sales	1,064.4	971.7	659.9	9.5	47.2
Cost of sales	842.5	759.3	548.1	11.0	38.5
Selling, general and administrative	50.5	48.5	30.5	4.1	59.0
Depreciation and amortization	36.7	32.5	18.2	12.9	78.6
Engineered BP operating income	52.5	59.2	39.7	(11.3)	49.1
Aluminum Sheet BP operating income	82.2	72.2	23.4	13.9	208.5
Operating income	$ 134.7	$ 131.4	$ 63.1	2.5%	108.2%
Engineered BP operating income margin	10.0%	12.1%	16.5%		

Aluminum Sheet BP operating income margin	15.2%	14.9%	5.6%
Operating income margin	12.7%	13.5%	9.6%

(1) Mikron s results of operations have been included beginning December 10, 2004 (fiscal 2005).

(2) TruSeal s results of operations have been included beginning January 1, 2004 (fiscal 2004).

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The Engineered Building Products segment s increase in net sales from 2004 to 2005 and 2006 has been influenced by the acquisitions of TruSeal in January 2004 and Mikron in December 2004. Homeshield s net sales increased 3.4% in fiscal 2006 and 4.9% in fiscal 2005. These net sales increases resulted from a continuous expansion of new products coupled with increased sales of existing products. Fenestration component sales were robust in fiscal 2005 as a result of increased housing starts as well as strong remodeling and renovation activity, whereas fiscal 2006 s increase was primarily a result of new product introductions.

The increased net sales at the Aluminum Sheet Building Products segment from 2004 to 2005 and 2006 resulted from a combination of higher average selling prices and lower volumes. Aluminum sheet volume decreased 4.3% in fiscal 2006 as building and construction markets declined at a much higher rate. Fiscal 2005 volumes declined slightly due to inventory draw-downs of aluminum sheet that resulted from pre-buying that occurred early in the year in a period of allocation. The increased aluminum sheet selling prices during fiscal 2005 and 2006 were a result of reduced industry capacity which combined with strong demand during the first half of 2005 to put upward pressure on pricing. Aluminum sheet selling prices are correlated with aluminum prices on the London Metal Exchange (LME). During fiscal 2006, LME aluminum prices increased sharply in the first part of the fiscal year and retreated to a lesser extent in the latter half of the fiscal year which resulted in a similar trend of the Aluminum Sheet Building Products segment s average selling price. The Company continues to increase the mix of value-added products across the segment which should mitigate the expected margin pressure due to moderation in demand.

Fiscal 2005 housing starts were fueled by relatively low mortgage rates. Mortgage rates increased during fiscal 2006 as expected which contributed to the decline in housing starts along with the housing affordability index becoming unfavorable. Mortgage rates are not expected to rise noticeably in the next year and home sales and starts of new units are expected to stabilize following the substantial correction which began in the second quarter of 2006. Additionally, the building products focused businesses are expected to benefit from the less volatile demand from remodeling and renovation activity which comprises an estimated 40% of these businesses sales. The Company is focused on working closely with customers to be a part of their new product development which is an important component to increasing revenue. Generally, demographics for long-term housing demand are favorable when factoring the population increase, immigration and an increase in vacation homes. These coupled with an increase in the average-sized home should benefit the segment over the long-term. Furthermore, the Company s presence in the vinyl and composite window market, which represents the fastest growing window segment, should continue to fuel growth over a long time frame.

Operating income declined at the Company s Engineered Building Products segment in 2006 due to a combination of factors. Material costs, particularly those having natural gas and oil as feed stocks, increased coupled with increased energy and labor costs. The labor costs will be brought in line in fiscal 2007, as the operations will be staffed to more closely match demand. This was difficult during fiscal 2006 as the market was transitioning to lower levels. Contributing to the decline in operating income for fiscal 2006 was a protracted labor organization effort at one of the Mikron facilities which resulted in reduced productivity and margins. The effort recently concluded in the Company s favor and improvements in productivity and margins are expected. All of the aforementioned factors led to the corresponding decreases in operating income margin.

Spread is a key determinant of profitability for the Aluminum Sheet Building Products segment. The spread between the Company s selling price and raw material price expanded in both fiscal 2005 and fiscal 2006 even with the rise in raw material costs. This increase in spread was the primary contributor to the increase in operating income margin from 5.6% in fiscal 2004 to 15.2% in fiscal 2006. The increased spread was partially offset by a 39.3% increase in utility costs in fiscal 2006. While the spreads realized during fiscal 2006 are expected to moderate over time, the move to higher energy costs has enhanced the segment s competitive advantage because as a scrap based producer of aluminum, recycling aluminum only consumes 5% of the energy required to produce primary aluminum from bauxite, an aluminum containing ore.

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Corporate and Other Three Years Ended October 31, 2006

	Years Ended October 31, (Dollars in millions)			$ Change	
	2006	2005	2004	2006 vs. 2005	2005 vs. 2004
Net sales	$ (20.6)	$ (19.9)	$ (20.6)	$ (0.7)	$ 0.7
Cost of sales	(7.4)	(18.9)	0.6	11.5	(19.5)
Selling, general and administrative	24.4	28.1	16.6	(3.7)	11.5
Depreciation and amortization	0.3	0.2	0.3	0.1	(0.1)
Operating income (expense)	$ (37.9)	$ (29.3)	$ (38.1)	$ (8.6)	$ 8.8

Corporate and other operating expenses, not included in the operating segments mentioned above, include the consolidated LIFO inventory adjustments (calculated on a combined pool basis), corporate office expenses and inter-segment eliminations. As a result of raw material cost increases during fiscal 2004 and fiscal 2006, the Company incurred expense of $20.4 million and $13.1 million, respectively, in the form of a LIFO inventory adjustment. The pool of average raw material costs was only slightly lower at the end of fiscal 2005 compared to the end of fiscal 2004 and as a result the Company recognized $0.1 million of income due to the reduction of the LIFO inventory adjustment. Fluctuations associated with the LIFO inventory adjustment tend to comprise a majority of the change from year to year in corporate and other expenses. For the year ended October 31, 2005, the Company incurred $8.2 million of external consulting fees and external audit fees associated with the implementation of the Sarbanes-Oxley Act. Comparatively little external consulting fees were incurred in fiscal 2006 related to the company s ongoing compliance with the Sarbanes-Oxley Act. Offsetting the reduction in consultant fees was $4.0 million of stock option expense in fiscal 2006 which was not required to be recorded in prior years; in prior years potential stock option expense was disclosed in a footnote to the financial statements.

Other Items Three Years Ended October 31, 2006

Interest expense for fiscal 2006 was $4.8 million compared to $9.3 million in fiscal 2005 and $6.0 million in fiscal 2004. The increase from 2004 to 2005 is a result of a full year of interest on the Company s 2.5% Convertible Senior Debentures combined with higher interest rates incurred during fiscal 2005. The pattern of borrowings and subsequent repayments against the revolving credit agreement were similar in both fiscal 2004 and 2005 as funds were borrowed in the first quarter of each year to fund acquisitions and paid off during the year. The decrease from 2005 to 2006 resulted from the fact that the borrowings against the Company s revolving credit agreement used to fund the Mikron acquisition had been repaid by the end of fiscal 2005. No amounts were borrowed against the revolving credit facility during fiscal 2006, thereby reducing the amount of interest expense.

Other, net (on the income statement) for fiscal 2006 was income of $4.2 million compared to income of $0.1 million in fiscal 2005 and income of $0.3 million in fiscal 2004. Other, net includes interest income and changes associated with the cash surrender value of life insurance. The increase in fiscal 2006 partly relates to interest income earned on the cash and equivalents balance that accumulated during 2006.

Income (loss) from discontinued operations, net of taxes for fiscal 2006 was a loss of $0.1 million compared to a loss of $22.1 million in fiscal 2005 compared to a loss of $3.0 million for fiscal 2004. During fiscal 2005, the Company recorded a goodwill impairment charge for Temroc of $13.1 million. The Temroc impairment combined with an additional loss on the sale of Piper Impact comprised the difference between fiscal 2004 and fiscal 2005. See Note 18 for further information regarding the composition of discontinued operations.