

OLYMPIC STEEL INC
Form 10-Q
November 08, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the quarterly period ended September 30, 2018

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

For the transition period from _____ to _____

Commission File Number 0-23320

OLYMPIC STEEL, INC.

(Exact name of registrant as specified in its charter)

Ohio
(State or other jurisdiction of
incorporation or organization)

34-1245650
(I.R.S.Employer
Identification Number)

Edgar Filing: OLYMPIC STEEL INC - Form 10-Q

22901 Millcreek Boulevard, Suite 650, Highland Hills, OH 44122
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (216) 292-3800

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes (X) No ()

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer () Accelerated filer (X)
Non-accelerated filer () Smaller reporting company ()
Emerging growth company ()

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ()

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

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

Class	Outstanding as of November 8, 2018
Common stock, without par value	11,008,399

Olympic Steel, Inc.

Index to Form 10-Q

	Page No.
Part I. FINANCIAL INFORMATION	3
Item 1. Financial Statements	3
Consolidated Balance Sheets – September 30, 2018 and December 31, 2017 (unaudited)	3
Consolidated Statements of Comprehensive Income – for the three and nine months ended September 30, 2018 and 2017 (unaudited)	4
Consolidated Statements of Cash Flows – for the nine months ended September 30, 2018 and 2017 (unaudited)	5
Supplemental Disclosures of Cash Flow Information – for the nine months ended September 30, 2018 and 2017 (unaudited)	6
Notes to Unaudited Consolidated Financial Statements	7
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	19
Item 3. Quantitative and Qualitative Disclosures About Market Risk	30
Item 4. Controls and Procedures	31
Part II. OTHER INFORMATION	32
Item 6. Exhibits	32
SIGNATURES	33

Part I. FINANCIAL INFORMATION**Item 1. Financial Statements****Olympic Steel, Inc.****Consolidated Balance Sheets**

(in thousands)

	As of	
	September	December
	30, 2018	31, 2017
	(unaudited)	
Assets		
Cash and cash equivalents	\$4,267	\$3,009
Accounts receivable, net	213,422	132,737
Inventories, net (includes LIFO debit of \$662 as of September 30, 2018 and \$5,337 as of December 31, 2017)	366,198	275,307
Prepaid expenses and other	5,219	8,333
Assets held for sale	-	750
Total current assets	589,106	420,136
Property and equipment, at cost	398,524	376,710
Accumulated depreciation	(239,862)	(229,062)
Net property and equipment	158,662	147,648
Intangible assets, net	27,519	22,980
Other long-term assets	13,980	13,394
Total assets	\$789,267	\$604,158
Liabilities		
Current portion of long-term debt	\$-	\$930
Accounts payable	118,134	84,034
Accrued payroll	19,265	11,999
Other accrued liabilities	11,595	14,184
Total current liabilities	148,994	111,147
Credit facility revolver	304,484	196,235
Other long-term liabilities	12,724	12,048
Deferred income taxes	14,718	12,145
Total liabilities	480,920	331,575
Shareholders' Equity		
Preferred stock	-	-

Edgar Filing: OLYMPIC STEEL INC - Form 10-Q

Common stock	130,597	129,453
Treasury stock	(132)	(337)
Retained earnings	177,882	143,467
Total shareholders' equity	308,347	272,583
Total liabilities and shareholders' equity	\$789,267	\$604,158

The accompanying notes are an integral part of these consolidated statements.

Olympic Steel, Inc.**Consolidated Statements of Comprehensive Income**

(in thousands, except per share data)

	Three months ended		Nine months ended	
	September 30, 2018	2017	September 30, 2018	2017
	(unaudited)			
Net sales	\$456,976	\$331,442	\$1,285,491	\$1,022,530
Costs and expenses				
Cost of materials sold (excludes items shown separately below)	365,362	265,351	1,016,200	806,846
Warehouse and processing	25,330	20,531	72,579	65,870
Administrative and general	21,197	16,647	61,592	52,699
Distribution	12,552	10,574	38,077	31,507
Selling	7,373	6,797	21,708	19,804
Occupancy	2,348	2,150	7,200	6,651
Depreciation	3,953	3,883	12,141	12,516
Amortization	247	223	716	667
Total costs and expenses	438,362	326,156	1,230,213	996,560
Operating income	18,614	5,286	55,278	25,970
Other income (loss), net	17	(22)	(122)	(76)
Income before interest and income taxes	18,631	5,264	55,156	25,894
Interest and other expense on debt	2,923	1,966	7,579	5,380
Income before income taxes	15,708	3,298	47,577	20,514
Income tax provision	4,109	1,018	12,501	5,738
Net income and total comprehensive income	\$11,599	\$2,280	\$35,076	\$14,776
Earnings per share:				
Net income per share - basic	\$1.01	\$0.20	\$3.07	\$1.30
Weighted average shares outstanding - basic	11,444	11,386	11,427	11,384
Net income per share - diluted	\$1.01	\$0.20	\$3.07	\$1.30
Weighted average shares outstanding - diluted	11,446	11,386	11,427	11,384
Dividends declared per share of common stock	\$0.02	\$0.02	\$0.06	\$0.06

The accompanying notes are an integral part of these consolidated statements.

Olympic Steel, Inc.**Consolidated Statements of Cash Flows**

(in thousands)

	For the Nine Months Ended September 30,	
	2018	2017
	(unaudited)	
Cash flows from (used for) operating activities:		
Net income	\$35,076	\$14,776
Adjustments to reconcile net income to net cash from (used for) operating activities -		
Depreciation and amortization	13,199	13,872
Loss (gain) on disposition of property and equipment	29	(38)
Stock-based compensation	1,348	944
Other long-term assets	(825)	(1,264)
Other long-term liabilities	3,180	(1,523)
	52,007	26,767
Changes in working capital:		
Accounts receivable	(74,076)	(48,790)
Inventories	(76,122)	(25,697)
Prepaid expenses and other	4,176	710
Accounts payable	36,926	178
Change in outstanding checks	(10,039)	553
Accrued payroll and other accrued liabilities	3,995	(363)
	(115,140)	(73,409)
Net cash used for operating activities	(63,133)	(46,642)
Cash flows from (used for) investing activities:		
Acquisition of net assets	(21,907)	-
Capital expenditures	(20,366)	(6,470)
Proceeds from disposition of property and equipment	80	814
Net cash used for investing activities	(42,193)	(5,656)
Cash flows from (used for) financing activities:		
Credit facility revolver borrowings	428,782	310,734
Credit facility revolver repayments	(320,534)	(254,925)
Principal payment under capital lease obligation	(4)	-
Industrial revenue bond repayments	(930)	(895)
Credit facility fees and expenses	(70)	(125)
Proceeds from exercise of stock options (including tax benefits) and employee stock purchases	-	9
Dividends paid	(660)	(658)
Net cash from financing activities	106,584	54,140

Cash and cash equivalents:		
Net change	1,258	1,842
Beginning balance	3,009	2,315
Ending balance	\$4,267	\$4,157

The accompanying notes are an integral part of these consolidated statements.

Olympic Steel, Inc.

Supplemental Disclosures of Cash Flow Information

(in thousands)

**For the Nine
Months Ended
September 30,
2018 2017**
(unaudited)

Interest paid	\$7,171	\$4,691
Income taxes paid	\$8,216	\$7,918

The accompanying notes are an integral part of these consolidated statements. **Olympic Steel, Inc.**

Notes to Unaudited Consolidated Financial Statements

September 30, 2018

1. Basis of Presentation:

The accompanying consolidated financial statements have been prepared from the financial records of Olympic Steel, Inc. and its wholly-owned subsidiaries (collectively, Olympic or the Company), without audit and reflect all normal and recurring adjustments which are, in the opinion of management, necessary to fairly state the results of the interim periods covered by this report. Year-to-date results are not necessarily indicative of 2018 annual results and these financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2017. All intercompany transactions and balances have been eliminated in consolidation.

The Company operates in three reportable segments; carbon flat products, specialty metals flat products, and tubular and pipe products. The carbon flat products segment and the specialty metals flat products segments are at times consolidated and referred to as the flat products segments. Certain of the flat products segments' assets and resources are shared by the carbon and specialty metals segments and both segments' products are stored in the shared facilities and, in some locations, processed on shared equipment. Due to the shared assets and resources, certain of the flat products segment expenses are allocated between the carbon flat products segment and the specialty metals flat products segment based upon an established allocation methodology. Through its carbon flat products segment, the Company sells and distributes large volumes of processed carbon and coated flat-rolled sheet, coil and plate products, and fabricated parts. Through its specialty metals flat products segment, the Company sells and distributes processed aluminum and stainless flat-rolled sheet and coil products, flat bar products and fabricated parts. Through its acquisition of Berlin Metals, LLC (Berlin Metals) on April 2, 2018, the specialty metals flat products segment expanded its product offerings to include differing types of stainless flat-rolled sheet and coil and prime tin mill products. Through its tubular and pipe products segment, which consists of the Chicago Tube and Iron subsidiary (CTI), the Company distributes metal tubing, pipe, bar, valves and fittings and fabricate pressure parts supplied to various industrial markets.

Corporate expenses are reported as a separate line item for segment reporting purposes. Corporate expenses include the unallocated expenses related to managing the entire Company (i.e., all three segments), including payroll expenses for certain personnel, expenses related to being a publicly traded entity such as board of directors' expenses, audit expenses, and various other professional fees.

Impact of Recently Issued Accounting Pronouncements

In August, 2018, the Financial Account Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2018-15, “Intangibles – Goodwill and other – Internal-use software: Customer’s accounting for implementation costs incurred in a cloud computing arrangement that is a service contract”. This ASU aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). Accordingly, the ASU requires an entity (customer) in a hosting arrangement that is a service contract to follow the guidance in Subtopic 350-40 to determine which implementation costs to capitalize as an asset related to the service contract and which costs to expense. The ASU also requires the entity (customer) to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement, which includes reasonably certain renewals. For public business entities, this ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years with early adoption permitted. The Company early adopted ASU 2018-15 in the third quarter of 2018 and the adoption of this ASU did not materially impact the Company’s consolidated financial statements.

In August 2017, the FASB issued ASU No 2017-12, “Derivatives and Hedging”. This ASU aligns an entity’s risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. To meet that objective, the ASU expands and refines hedge accounting for both nonfinancial and financial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. This ASU also makes certain targeted improvements to simplify the application of hedge accounting guidance and ease the administrative burden of hedge documentation requirements and assessing hedge effectiveness. This ASU is the final version of proposed ASU 2016-310, “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities”, which has been deleted. For public business entities, this ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early application is permitted in any interim period after issuance of the ASU. All transition requirements and elections should be applied to hedging relationships existing (that is, hedging relationships in which the hedging instrument has not expired, been sold, terminated, or exercised or the entity has not removed the designation of the hedging relationship) on the date of adoption. The effect of adoption should be reflected as of the beginning of the fiscal year of adoption. The adoption of this ASU is not expected to materially impact the Company’s consolidated financial statements.

In May 2017, the FASB issued ASU No 2017-09, “Compensation – Stock Compensation (Topic 718)”. This ASU provides clarity and reduces both (1) diversity in practice and (2) cost and complexity when applying the guidance in Topic 718, Compensation – Stock Compensation, to a change to the terms or conditions of a share-based payment award. The ASU provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. This ASU is the final version of proposed ASU 2016-360, “Compensation—Stock Compensation (Topic 718)—Scope of Modification Accounting,” which has been deleted. The amendments in this ASU are effective for all entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The amendments in this ASU should be applied prospectively to an award modified on or after the adoption date. The adoption of this ASU did not materially impact the Company’s consolidated financial statements.

In August 2016, the FASB issued ASU No 2016-15, “Classification of certain cash receipts and cash payments”. This ASU addresses the following eight specific cash flow issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies (COLIs) (including bank-owned life insurance policies (BOLIs)); distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. The guidance will be effective for annual reporting periods beginning after December 15, 2017, and interim periods within those fiscal years with early adoption permitted. The adoption of this ASU did not materially impact the Company’s consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, “Leases,” which specifies the accounting for leases. The objective is to establish the principles that lessees and lessors shall apply to report useful information to users of financial statements about the amount, timing and uncertainty of cash flows arising from a lease. This ASU introduces the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous guidance. The guidance will be effective for annual reporting periods beginning after December 15, 2018 and interim periods within those fiscal years with early adoption permitted. The Company is in the process of evaluating the impact of the future adoption of this standard on the Company’s consolidated financial statements.

In August 2015, the FASB issued ASU 2015-14, “Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date,” which deferred the effective date of ASU 2014-09 for all entities by one year. This update is effective for public business entities for annual reporting periods beginning after December 15, 2017, including interim periods within those reporting periods. Earlier application was permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. ASU 2014-09 was to become effective for us beginning January 2017; however, ASU 2015-14 deferred our effective date until January 2018, which is when we adopted this standard. The ASU permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the modified retrospective method). The ASU also requires expanded disclosures relating to the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Additionally, qualitative and quantitative disclosures are required for customer contracts, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract.

The Company completed the process of evaluating the effect of the adoption and determined there were no material changes required to the reported revenues as a result of the adoption. Substantially all of the revenue arrangements consist of a single performance obligation to transfer goods. Based on the evaluation process and review of the contracts with customers, the timing and amount of revenue recognized based on ASU 2015-14 is consistent with the revenue recognition policy under previous guidance. The adoption of this ASU on January 1, 2018 using the modified retrospective approach applied to those contracts which were not completed as of January 1, 2018 did not have a material impact on the Company's consolidated financial statements. Comparative information has not been restated and continues to be reported under the accounting standard in effect for those periods. The impact of adopting ASU 606 was not material to the Company's consolidated financial statements as of and for the three and nine months ended September 30, 2018. See note 3.

2. Acquisitions:

On April 2, 2018, the Company acquired substantially all of the net assets of Berlin Metals, based in Hammond, Indiana, for \$21.9 million. Berlin Metals was founded in 1967 and is one of the largest North American service centers processing and distributing prime tin mill products and stainless steel strip in slit coil form. Berlin Metals is also a supplier of galvanized, light gauge cold rolled sheet and strip and other coated metals in coil forms, to customers in the building products, automotive and specialized industrial markets.

The acquisition is not considered significant and thus pro-forma information has not been provided. The acquisition was accounted for as a business combination and the assets were valued at fair market value. The table below summarizes the purchase price allocation of the fair market values of the assets acquired and liabilities assumed.

Details of Acquisition (in thousands)	As of April 2, 2018
Assets acquired	
Accounts receivable, net	6,609
Inventories	14,769
Property and equipment	2,898
Prepaid expenses and other	345
Intangible assets	5,255
Total assets acquired	29,876
Total liabilities assumed	(7,969)
Cash paid	\$21,907

The purchase price allocation presented above is based upon management's estimate of the fair value of the acquired assets and assumed liabilities using valuation techniques including income, cost and market approaches. The fair value estimates involve the use of estimates and assumptions, including, but not limited to, the timing and amounts of future cash flows, revenue growth rates, discount rates, and royalty rates.

As of the effective date of the acquisition, Berlin Metals' results are included in the Company's specialty metals flat products segment in the Company's 2018 financial results. Upon the acquisition, the Company entered into an amendment to its asset-based credit facility to include the eligible assets of Berlin Metals.

3. Revenue Recognition:

The Company provides metals processing, distribution and delivery of large volumes of processed carbon, coated flat rolled sheet, coil and plate products, aluminum, and stainless flat rolled products, prime tin mill products, flat bar products, metal tubing, pipe, bar, valves, fittings, and fabricated parts. The Company's contracts with customers are comprised of purchase orders with standard terms and conditions. Occasionally the Company may also have longer-term agreements with customers. Substantially all of the contracts with customers require the delivery of metals which represent single performance obligations that are satisfied upon transfer of control of the product to the customer.

Transfer of control is assessed based on the use of the product distributed and rights to payment for performance under the contract terms. Transfer of control and revenue recognition for substantially all of the Company's sales occur upon shipment or delivery of the product, which is when title, ownership and risk of loss pass to the customer and is based on the applicable shipping terms. The shipping terms depend on the customer contract. An invoice for payment is issued at time of shipment and terms are generally net 30 days. The Company has certain fabrication contracts in one business unit for which revenue is recognized over time as performance obligations are achieved. This fabrication business is not material to the Company's consolidated results.

Within the metals industry, revenue is frequently disaggregated by products sold. The table below disaggregates the Company's revenues by segment and products sold.

**Disaggregated Revenue by Products Sold
For the Three Months Ended
September 30, 2018**

	Carbon flat products	Specialty metals flat products	Tubular and pipe products	Total
Hot Rolled	34.0%	-	-	34.0%
Plate	13.4%	-	-	13.4%
Cold Rolled	5.1%	-	-	5.1%
Coated	7.1%	-	-	7.1%
Specialty	-	18.4%	-	18.4%
Pipe & Tube	-	-	17.9%	17.9%
Other	2.3%	1.8%	-	4.1%
Total	61.9%	20.2%	17.9%	100.0%

**Disaggregated Revenue by Products Sold
For the Nine Months Ended
September 30, 2018**

	Carbon flat products	Specialty metals flat products	Tubular and pipe products	Total
Hot Rolled	35.1%	-	-	35.1%
Plate	12.8%	-	-	12.8%
Cold Rolled	5.3%	-	-	5.3%
Coated	7.6%	-	-	7.6%
Specialty	-	18.5%	-	18.5%
Pipe & Tube	-	-	17.7%	17.7%
Other	1.7%	1.3%	-	3.0%
Total	62.5%	19.8%	17.7%	100.0%

4. Accounts Receivable:

Accounts receivable are presented net of allowances for doubtful accounts and unissued credits of \$3.5 million and \$2.8 million as of September 30, 2018 and December 31, 2017, respectively. The allowance for doubtful accounts is maintained at a level considered appropriate based on historical experience and specific customer collection issues that have been identified. Estimations are based upon a calculated percentage of accounts receivable, which remains fairly level from year to year, and judgments about the probable effects of economic conditions on certain customers, which can fluctuate significantly from year to year. The Company cannot guarantee that the rate of future credit losses will be similar to past experience. The Company considers all available information when assessing the adequacy of its allowance for doubtful accounts and unissued credits each quarter.

5. Inventories:

Inventories consisted of the following:

(in thousands)	Inventory as of	
	September 30, 2018	December 31, 2017
Unprocessed	\$306,147	\$225,187
Processed and finished	60,051	50,120
Totals	\$366,198	\$275,307

The Company values certain of its tubular and pipe products inventory at the last-in, first-out (LIFO) method. At September 30, 2018 and December 31, 2017, approximately \$53.9 million, or 14.7% of consolidated inventory, and \$48.1 million, or 17.5% of consolidated inventory, respectively, was reported under the LIFO method of accounting. The cost of the remainder of the tubular and pipe products inventory is determined using a weighted average rolling first-in, first-out (FIFO) method.

During the three and nine months ended September 30, 2018, the Company recorded \$2.7 million and \$4.7 million of LIFO expense, respectively, as the current projections anticipate increased pricing and volume of LIFO inventory for the remainder of the year. During the three and nine months ended September 30, 2017, the Company recorded \$0.7 million and \$1.5 million of LIFO expense, respectively.

If the FIFO method had been in use, inventories would have been \$0.7 million and \$5.3 million lower than reported at September 30, 2018 and December 31, 2017, respectively.

6. Goodwill and Intangible Assets:

The Company's intangible assets were recorded in connection with its April 2, 2018 acquisition of Berlin Metals and its 2011 acquisition of CTI. The intangible assets were evaluated on the premise of highest and best use to a market participant, primarily utilizing the income approach valuation methodology. The useful life of the customer relationships were determined to be fifteen years, based primarily on the consistent and predictable revenue source associated with the existing customer base, the present value of which extends through the fifteen year amortization period. The useful life of the trade names were determined to be indefinite primarily due to their history and reputation in the marketplace, the Company's expectation that the trade names will continue to be used, and the conclusion that there are currently no other factors identified that would limit its useful life. The Company will continue to evaluate the useful life assigned to our amortizable customer relationships in future periods.

Goodwill, by reportable segment, was as follows as of September 30, 2018 and December 31, 2017, respectively. The goodwill is deductible for tax purposes.

(in thousands)	Carbon Flat Products	Specialty Metals Flat Products	Tubular and Pipe Products	Total
Balance as of December 31, 2017	\$ -	\$ -	\$ -	\$-
Acquisitions	-	2,358	-	2,358
Impairments	-	-	-	-
Balance as of September 30, 2018	\$ -	\$ 2,358	\$ -	\$2,358

Intangible assets, net, consisted of the following as of September 30, 2018 and December 31, 2017, respectively:

As of September 30, 2018				
(in thousands)	Gross	Acquisitions	Accumulated	Intangible
	Carrying		Amortization	Assets,
	Amount			Net
Customer relationships - subject to amortization	\$13,332	\$ 640	\$ (6,465) \$ 7,507
Covenant not to compete - subject to amortization	-	157	(28) 129
Trade name - not subject to amortization	15,425	2,100	-	17,525
	\$28,757	\$ 2,897	\$ (6,493) \$ 25,161

As of December 31, 2017				
(in thousands)	Gross	Acquisitions	Accumulated	Intangible
	Carrying		Amortization	Assets,
	Amount			Net
Customer relationships - subject to amortization	\$13,332	\$ -	\$ (5,777) \$ 7,555
Trade name - not subject to amortization	15,425	-	-	15,425
	\$28,757	\$ -	\$ (5,777) \$ 22,980

The Company estimates that amortization expense for its intangible assets subject to amortization will be approximately \$1.0 million per year in each of the next five years.

7. Debt:

The Company's debt is comprised of the following components:

(in thousands)	As of	
	September 30, 2018	December 31, 2017
Asset-based revolving credit facility due December 8, 2022	\$ 304,484	\$ 196,235
Industrial revenue bond due April 1, 2018	-	930
Total debt	304,484	197,165
Less current amount	-	(930)
Total long-term debt	\$ 304,484	\$ 196,235

The Company's asset-based credit facility (the ABL Credit Facility) is collateralized by the Company's accounts receivable, inventory and personal property. The ABL Credit Facility consists of (i) a revolving credit facility of \$370 million, including a \$20 million sub-limit for letters of credit and (ii) a first in, last out revolving credit facility of up to \$30 million. Under the terms of the ABL Credit Facility, the Company may request additional commitments in the aggregate principal amount of up to \$200 million to the extent that existing or new lenders agree to provide such additional commitments. Revolver borrowings are limited to the lesser of a borrowing base, comprised of eligible receivables and inventories, or \$400 million in the aggregate. The ABL Credit Facility matures on December 8, 2022.

The ABL Credit Facility contains customary representations and warranties and certain covenants that limit the ability of the Company to, among other things: (i) incur or guarantee additional indebtedness (ii) pay distributions on, redeem or repurchase capital stock or redeem or repurchase subordinated debt (iii) make investments (iv) sell assets (v) enter into agreements that restrict distributions or other payments from restricted subsidiaries to the Company (vi) incur liens securing indebtedness (vii) consolidate, merge or transfer all or substantially all of its assets and (viii) engage in transactions with affiliates. In addition, the ABL Credit Facility contains a financial covenant which requires (i) if any commitments or obligations are outstanding and the Company's availability is less than the greater of \$30 million or 10.0% of the aggregate amount of revolver commitments (\$40.0 million at September 30, 2018) or 10.0% of the aggregate borrowing base (\$40.0 million at September 30, 2018), then the Company must maintain a ratio of Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA) minus certain capital expenditures and cash taxes paid to fixed charges of at least 1.00 to 1.00 for the most recent twelve fiscal month period.

The Company has the option to borrow under its revolver based on the agent's base rate plus a premium ranging from 0.00% to 1.50% or the London Interbank Offered Rate (LIBOR) plus a premium ranging from 1.25% to 2.75%.

As of September 30, 2018, the Company was in compliance with its covenants and had approximately \$93 million of availability under the ABL Credit Facility.

As of September 30, 2018, \$1.6 million of bank financing fees were included in “Prepaid expenses and other” and “Other long-term assets” on the accompanying Consolidated Balance Sheets. The financing fees are being amortized over the five-year term of the ABL Credit Facility and are included in “Interest and other expense on debt” on the accompanying Consolidated Statements of Comprehensive Income.

8. Derivative Instruments:

Metals swaps and embedded customer derivatives

During 2018 and 2017, the Company entered into nickel swaps indexed to the London Metal Exchange (LME) price of nickel with third-party brokers. The nickel swaps are accounted for as derivatives for accounting purposes. The Company entered into them to mitigate its customers’ risk of volatility in the price of metals. The outstanding nickel swaps mature in 2018. The swaps are settled with the brokers at maturity. The economic benefit or loss arising from the changes in fair value of the swaps is contractually passed through to the customer. The primary risk associated with the metals swaps is the ability of customers or third-party brokers to honor their agreements with the Company related to derivative instruments. If the customer or third-party brokers are unable to honor their agreements, the Company’s risk of loss is the fair value of the metals swaps.

These derivatives have not been designated as hedging instruments. The periodic changes in fair value of the metals and embedded customer derivative instruments are included in “Cost of materials sold” in the Consolidated Statements of Comprehensive Income. The Company recognizes derivative positions with both the customer and the third party for the derivatives and classifies cash settlement amounts associated with them as part of “Cost of materials sold” in the Consolidated Statements of Comprehensive Income. The cumulative change in fair value of the metals swaps that have not yet been settled are included in “Other accrued liabilities,” and the embedded customer derivatives are included in “Accounts receivable” on the Consolidated Balance Sheets at September 30, 2018. The cumulative change in fair value of the metals swaps that have not yet been settled are included in “Accounts receivable,” and the embedded customer derivatives are included in “Other accrued liabilities” on the Consolidated Balance Sheets at December 31, 2017.

Interest rate swap

CTI entered into an interest rate swap to reduce the impact of changes in interest rates on its Industrial Revenue Bond (IRB). The swap agreement was terminated in March 2018 upon repayment of the IRB. The periodic changes in fair value of the interest rate swap and cash settlement amounts associated with the interest rate swap are included in “Interest and other expense on debt” in the Consolidated Statements of Comprehensive Income.

There was no net impact from the nickel swaps or embedded customer derivative agreements to the Company’s Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2018 and 2017. The table below shows the total impact to the Company’s Consolidated Statements of Comprehensive Income through net income of the derivatives for the three and nine months ended September 30, 2018 and 2017.

	Net Gain (Loss)			
	Recognized			
	For the	For the		
	Three	Nine		
	Months	Months		
	Ended	Ended		
	September	September		
	30,	30,		
(in thousands)	2018	2017	2018	2017
Interest rate swap (CTI)	\$-	\$(6)	\$(5)	\$(24)
Metals swaps	(221)	156	14	79
Embedded customer derivatives	221	(156)	(14)	(79)
Total loss	\$-	\$(6)	\$(5)	\$(24)

9. Fair Value of Financial Instruments:

During the three months ended September 30, 2018, there were no transfers of financial assets between Levels 1, 2 or 3 fair value measurements. There have been no changes in the valuation methodologies since December 31, 2017. Following is a description of the valuation methodologies used for assets and liabilities measured at fair value as of September 30, 2018 and December 31, 2017:

Metals swaps and embedded customer derivatives – Determined by using Level 2 inputs that include the price of nickel indexed to the LME. The fair value is determined based on quoted market prices and reflects the estimated amounts the Company would pay or receive to terminate the nickel swaps.

Interest rate swaps – Based on the present value of the expected future cash flows, considering the risks involved, and using discount rates appropriate for the maturity date. Market observable Level 2 inputs are used to determine the present value of future cash flows.

The following table presents information about the Company's assets and liabilities that were measured at fair value on a recurring basis and indicates the fair value hierarchy of the valuation techniques utilized by the Company:

(in thousands)	Value of Items Recorded at Fair Value As of September 30, 2018			
	Level 1	Level 2	Level 3	Total
Assets:				
Metal swaps	\$-	\$ 32	\$ -	\$ 32
Total assets at fair value	\$-	\$ 32	\$ -	\$ 32
Liabilities:				
Embedded customer derivative	\$-	\$ 32	\$ -	\$ 32
Total liabilities recorded at fair value	\$-	\$ 32	\$ -	\$ 32

(in thousands)	As of September 30, 2018			
	Level 1	Level 2	Level 3	Total
Liabilities:				
Revolver	-	304,484	-	304,484
Total liabilities not recorded at fair value	\$-	\$304,484	\$ -	\$304,484

The value of the items not recorded at fair value represent the carrying value of the liabilities.

(in thousands)	As of December 31, 2017			
	Level 1	Level 2	Level 3	Total
Assets:				
Metals swaps	\$-	\$ 382	\$ -	\$ 382
Total assets at fair value	\$-	\$ 382	\$ -	\$ 382
Liabilities:				
Embedded customer derivatives	\$-	\$ 382	\$ -	\$ 382
Interest rate swap (CTI)	-	5	-	5
Total liabilities recorded at fair value	\$-	\$ 387	\$ -	\$ 387

(in thousands)	As of December 31, 2017			
	Level 1	Level 2	Level 3	Total

Liabilities:

IRB	\$930	\$-	\$	-	\$930
Revolver	-	196,235	-	196,235	
Total liabilities not recorded at fair value	\$930	\$196,235	\$	-	\$197,165

The fair value of the IRB was determined using Level 1 inputs. The carrying value and the fair value of the IRB that qualified as financial instruments were \$0.9 million at December 31, 2017.

The fair value of the revolver is determined using Level 2 inputs. The Level 2 fair value of the Company's long-term debt was estimated using prevailing market interest rates on debt with similar credit worthiness, terms and maturities.

10. Equity Plans:**Restricted Stock Units and Performance Share Units**

Pursuant to the Amended and Restated Olympic Steel 2007 Omnibus Incentive Plan (the Incentive Plan), the Company may grant stock options, stock appreciation rights, restricted shares, restricted share units, performance shares, and other stock- and cash-based awards to employees and directors of, and consultants to, the Company and its affiliates. Since adoption of the Incentive Plan, 1,000,000 shares of common stock have been authorized for equity grants.

On an annual basis the compensation committee of the Company's Board of Directors awards restricted stock units (RSUs), to each non-employee director as part of their annual compensation. The annual awards for 2018 and 2017 were \$80,000 and \$70,000, respectively. Subject to the terms of the Plan and the RSU agreement, the RSUs vest after one year of service (from the date of grant). The RSUs are not converted into shares of common stock until the director either resigns or is terminated from the board of directors.

On July 1, 2016, the Company created a new Senior Management Stock Incentive Program (the Plan) for certain participants. Under the Plan, each participant is awarded RSUs with a dollar value equal to 10% of the participant's base salary, up to an annual maximum of \$17,500. The RSUs have a five-year vesting period and the RSUs will convert into the right to receive shares of common stock upon a participant's retirement, or earlier upon the participant's death or disability or upon a change in control of the Company. The carbon and specialty metals flat products segments adopted the Plan on July 1, 2016 and the tubular and pipe products segment adopted the Plan on January 1, 2017.

Stock-based compensation expense recognized on RSUs for the three and nine months ended September 30, 2018 and 2017, respectively, is summarized in the following table:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
(in thousands, except per share data)				
RSU expense before taxes	\$181	\$141	\$463	\$408

RSU expense after taxes \$133 \$97 \$341 \$294

All pre-tax charges related to RSUs were included in the caption “Administrative and general” on the accompanying Consolidated Statements of Comprehensive Income.

The following table summarizes the activity related to RSUs for the nine months ended September 30, 2018:

	Number of Shares	Weighted Average Granted Price
Outstanding at December 31, 2017	469,068	\$ 20.11
Granted	84,283	22.33
Converted into shares	(19,097)	16.09
Forfeited	(6,709)	16.98
Outstanding at September 30, 2018	527,545	\$ 20.65
Vested at September 30, 2018	436,069	\$ 20.42

11. Income Taxes:

On December 22, 2017, the President of the United States signed into law the Tax Cuts and Jobs Act (Tax Act). The Tax Act, among other things, lowered the U.S. corporate income tax rate from 35% to 21% effective January 1, 2018.

While the Company has substantially completed its analysis of the income tax effects of the Tax Act and recorded a reasonable estimate of such effects, certain items related to the Tax Act may differ, possibly materially, due to further refinement of the calculations, changes in interpretations and assumptions made, additional guidance that may be issued by the U.S. government, and actions related to accounting policy decisions the Company may make as a result of the Tax Act. The Company will complete its analysis of these items over a one-year measurement period ending December 22, 2018, and any adjustment provided by the SEC under Staff Accounting Bulletin 118 during this measurement period will be included in net earnings from continuing operations as an adjustment to income tax expense (benefit) in the reporting period when such adjustments are determined.

For the three months ended September 30, 2018, the Company recorded an income tax provision of \$4.1 million, or 26.2% of pre-tax income, compared to \$1.0 million, or 30.9% of pre-tax income, for the three months ended September 30, 2017. For the nine months ended September 30, 2018, the Company recorded an income tax provision of \$12.5 million, or 26.3% of pre-tax income, compared to \$5.7 million, or 28.0%, for the nine months ended September 30, 2017. In the first quarter of 2017, the Company made an out-of-period adjustment to correct and record previously unrecognized deferred tax assets, and the associated tax benefit, related to a portion of the Supplemental Executive Retirement Plan (SERP) that had previously been considered non-deductible under Section 162(m) limitations in prior years. Due to the mandatory waiting period of six months prior to any SERP payment distribution, in 2017 the Company determined that the Section 162(m) non-deductibility limitations did not apply. The adjustment, which had accumulated since the inception of the SERP in 2005, resulted in an increase to after-tax income of \$1.9 million in 2017. The Company determined that this adjustment was not material to its current or prior period consolidated financial statements.

The tax provision or benefit for interim periods is determined using an estimate of the Company's annual effective tax rate, adjusted for discrete items that are taken into account in the relevant period. Each quarter the Company updates the estimate of the annual effective tax rate, and if the estimated tax rate changes, the Company makes a cumulative adjustment.

The quarterly tax provision and the quarterly estimate of the annual effective tax rate is subject to significant volatility due to several factors, including variability in accurately predicting the Company's pre-tax and taxable income and loss and the mix of jurisdictions to which they relate, changes in law and relative changes of expenses or losses for which tax benefits are not recognized. Additionally, the effective tax rate can be more or less volatile based on the amount of pre-tax income. For example, the impact of discrete items and non-deductible expenses on the effective tax rate is greater when the pre-tax income is lower.

12. Shares Outstanding and Earnings Per Share:

Earnings per share have been calculated based on the weighted average number of shares outstanding as set forth below:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
(in thousands, except per share data)				
Weighted average basic shares outstanding	11,444	11,386	11,427	11,384
Assumed issuance related to stock awards	2	-	-	-

Weighted average diluted shares outstanding	11,446	11,386	11,427	11,384
Net income	\$11,599	\$2,280	\$35,076	\$14,776
Basic earnings per share	\$1.01	\$0.20	\$3.07	\$1.30
Diluted earnings per share	\$1.01	\$0.20	\$3.07	\$1.30
Anti-dilutive securities outstanding	91	65	91	65

13. Segment Information:

The Company follows the accounting guidance that requires the utilization of a “management approach” to define and report the financial results of operating segments. The management approach defines operating segments along the lines used by the Company’s chief operating decision maker (CODM) to assess performance and make operating and resource allocation decisions. Our CODM evaluates performance and allocates resources based primarily on operating income (loss). Our operating segments are based primarily on internal management reporting.

The Company operates in three reportable segments; carbon flat products, specialty metals flat products, and tubular and pipe products. The flat products segments’ assets and resources are shared by the carbon and specialty metals segments and both segments’ products are stored in the shared facilities and, in some locations, processed on shared equipment. As such, total assets and capital expenditures are reported in the aggregate for the flat products segments. Due to the shared assets and resources, certain of the flat products segment expenses are allocated between the carbon flat products segment and the specialty metals flat products segment based upon an established allocation methodology. Through its carbon flat products segment, the Company sells and distributes large volumes of processed carbon and coated flat-rolled sheet, coil and plate products. Through its specialty metals flat products segment, the Company sells and distributes processed aluminum and stainless flat-rolled sheet and coil products, flat bar products and fabricated parts. Through its acquisition of Berlin Metals on April 2, 2018, the specialty metals flat products segment expanded its product offerings to include prime tin mill products. Through its tubular and pipe products segment, the Company distributes metal tubing, pipe, bar, valve and fittings and fabricates pressure parts supplied to various industrial markets.

Corporate expenses are reported as a separate line item for segment reporting purposes. Corporate expenses include the unallocated expenses related to managing the entire Company (i.e., all three segments), including compensation for certain personnel, expenses related to being a publicly traded entity such as board of directors' expenses, audit expenses, and various other professional fees.

The following table provides financial information by segment and reconciles the Company's operating income by segment to the consolidated income before income taxes for the three and nine months ended September 30, 2018 and 2017.

(in thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net sales				
Carbon flat products	\$282,810	\$215,843	\$802,995	\$669,817
Specialty metals flat products	92,153	57,554	255,037	173,789
Tubular and pipe products	82,013	58,045	227,459	178,924
Total net sales	\$456,976	\$331,442	\$1,285,491	\$1,022,530
Depreciation and amortization				
Carbon flat products	\$2,524	\$2,493	\$7,665	\$8,287
Specialty metals flat products	341	185	880	609
Tubular and pipe products	1,311	1,403	4,237	4,211
Corporate	24	25	75	76
Total depreciation and amortization	\$4,200	\$4,106	\$12,857	\$13,183
Operating income				
Carbon flat products	\$14,493	\$3,698	\$40,901	\$18,312
Specialty metals flat products	4,954	2,074	13,493	8,918
Tubular and pipe products	3,102	1,608	11,917	6,439
Corporate expenses	(3,935)	(2,094)	(11,033)	(7,699)
Total operating income	\$18,614	\$5,286	\$55,278	\$25,970
Other income (loss), net	17	(22)	(122)	(76)
Income before interest and income taxes	18,631	5,264	55,156	25,894
Interest and other expense on debt	2,923	1,966	7,579	5,380
Income before income taxes	\$15,708	\$3,298	\$47,577	\$20,514

(in thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Capital expenditures				
Flat products segments	\$4,980	\$1,110	\$15,289	\$4,292

Edgar Filing: OLYMPIC STEEL INC - Form 10-Q

Tubular and pipe products	1,505	891	4,598	2,178
Corporate	106	-	479	-
Total capital expenditures	\$6,591	\$2,001	\$20,366	\$6,470

17

(in thousands)	As of	
	September 30, 2018	December 31, 2017
Total assets		
Flat products segments	\$579,602	\$409,116
Tubular and pipe products	209,007	194,787
Corporate	658	255
Total assets	\$789,267	\$604,158

There were no material revenue transactions between the carbon flat products, specialty metals products, and tubular and pipe products segments.

The Company sells certain products internationally, primarily in Canada and Mexico. International sales are immaterial to the consolidated financial results and to the individual segments' results.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with our unaudited consolidated financial statements and accompanying notes contained herein and our consolidated financial statements, accompanying notes and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2017. The following Management's Discussion and Analysis of Financial Condition and Results of Operations contain forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from the results discussed in the forward-looking statements. Factors that might cause a difference include, but are not limited to, those discussed under Item 1A (Risk Factors) in our Annual Report on Form 10-K for the year ended December 31, 2017. The following section is qualified in its entirety by the more detailed information, including our financial statements and the notes thereto, which appear elsewhere in this Quarterly Report on Form 10-Q.

Forward-Looking Information

This Quarterly Report on Form 10-Q and other documents we file with the SEC contain various forward-looking statements that are based on current expectations, estimates, forecasts and projections about our future performance, business, our beliefs and management's assumptions. In addition, we, or others on our behalf, may make forward-looking statements in press releases or written statements, or in our communications and discussions with investors and analysts in the normal course of business through meetings, conferences, webcasts, phone calls and conference calls. Words such as "may," "will," "anticipate," "should," "intend," "expect," "believe," "estimate," "project," "plan" and "continue," as well as the negative of these terms or similar expressions, are intended to identify forward-looking statements, which are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those implied by such statements including, but not limited to:

- the recent fluctuations in metals pricing provides risks of falling metals prices and inventory devaluation;
- general and global business, economic, financial and political conditions;
- competitive factors such as the availability, global production levels and pricing of metals, industry shipping and inventory levels and rapid fluctuations in customer demand and metals pricing;
- cyclicality and volatility within the metals industry;
- fluctuations in the value of the U.S. dollar and the related impact on foreign steel pricing, U.S. exports, and foreign imports to the United States;
- the levels of imported steel in the United States and the tariffs initiated by the U.S. government in 2018 under Section 232 of the Trade Expansion Act of 1962 and newly imposed tariffs and duties on exported steel, U.S. trade policy and its impact on the U.S. manufacturing industry;
- the availability, and increased costs, of labor related to tighter employment markets;
- the availability and rising costs of transportation and logistical services;

rising interest rates and their impacts on our variable interest debt;
the successes of our efforts and initiatives to increase sales and earnings, maintain or improve working capital turnover and free cash flows, improve our customer service, and achieve cost savings;
our ability to generate free cash flow through operations and repay debt within anticipated time frames;
events or circumstances that could impair or adversely impact the carrying value of any of our assets;
risks and uncertainties associated with intangible assets, including impairment charges related to indefinite lived intangible assets;
events or circumstances that could adversely impact the successful operation of our processing equipment and operations;
the amounts, successes and our ability to continue our capital investments and strategic growth initiatives, including acquisitions and our business information system implementations;
our ability to successfully integrate Berlin Metals, LLC, or Berlin Metals, into our business and risks inherent with the Berlin Metals acquisition in the achievement of expected results, including whether the acquisition will be accretive and within the expected timeframe;
the success of our operational initiatives to improve our operating, cultural and management systems and reduce our costs;
the ability to comply with the terms of our asset-based credit facility;
the ability of our customers and third parties to honor their agreements related to derivative instruments;
customer, supplier and competitor consolidation, bankruptcy or insolvency;
reduced production schedules, layoffs or work stoppages by our own, our suppliers' or customers' personnel;
the impacts of union organizing activities and the success of union contract renewals;

the timing and outcomes of inventory lower of cost or market adjustments and last-in, first-out, or LIFO, income or expense;

the inflation or deflation existing within the metals industry, as well as product mix and inventory levels on hand, which can impact our cost of materials sold as a result of the fluctuations in the LIFO inventory valuation;

the ability of our customers (especially those that may be highly leveraged, and those with inadequate liquidity) to maintain their credit availability;

the adequacy of our existing information technology and business system software, including duplication and security processes;

the adequacy of our efforts to mitigate cyber security risks and threats;

access to capital and global credit markets;

our ability to pay regular quarterly cash dividends and the amounts and timing of any future dividends;

our ability to repurchase shares of our common stock and the amounts and timing of repurchases, if any;

unanticipated developments that could occur with respect to contingencies such as litigation, arbitration and environmental matters, including any developments that would require any increase in our costs for such contingencies; and

changes in laws or regulations or the manner of their interpretation or enforcement could impact our financial performance and restrict our ability to operate our business or execute our strategies.

Should one or more of these or other risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, intended, expected, believed, estimated, projected or planned. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to republish revised forward-looking statements to reflect the occurrence of unanticipated events or circumstances after the date hereof, except as otherwise required by law.

Overview

We are a leading metals service center that operates in three reportable segments; carbon flat products, specialty metals flat products, and tubular and pipe products. We provide metals processing and distribution services for a wide range of customers. Our carbon flat products segment's focus is on the direct sale and distribution of large volumes of processed carbon and coated flat-rolled sheet, coil and plate products and fabricated parts. Our specialty metals flat products segment's focus is on the direct sale and distribution of processed aluminum and stainless flat-rolled sheet and coil products, flat bar products and fabricated parts. Through the acquisition of Berlin Metals on April 2, 2018, our specialty metals flat products segment expanded its product offerings to include differing types of stainless flat-rolled sheet and coil and prime tin mill products. In addition, we distribute metal tubing, pipe, bar, valves and fittings and fabricate pressure parts supplied to various industrial markets. Products that require more value-added processing generally have a higher gross profit. Accordingly, our overall gross profit is affected by, among other things, product mix, the amount of processing performed, the demand for and availability of metals, and volatility in selling prices and material purchase costs. We also perform toll processing of customer-owned metals. We sell certain products internationally, primarily in Canada and Mexico. International sales are immaterial to our consolidated financial results and to the individual segments' results.

Our results of operations are affected by numerous external factors including, but not limited to: general and global business, economic, financial, banking and political conditions; fluctuations in the value of the U.S. dollar to foreign currencies, competition; metals pricing, demand and availability; transportation and energy costs; pricing and availability of raw materials used in the production of metals; global supply, the level of metals imported into the United States, tariffs, and inventory held in the supply chain; the availability, and increased costs of labor; customers' ability to manage their credit line availability; and layoffs or work stoppages by our own, our suppliers' or our customers' personnel. The metals industry also continues to be affected by the global consolidation of our suppliers, competitors and end-use customers.

Like other metals service centers, we maintain substantial inventories of metals to accommodate the short lead times and just-in-time delivery requirements of our customers. Accordingly, we purchase metals in an effort to maintain our inventory at levels that we believe to be appropriate to satisfy the anticipated needs of our customers based upon customer forecasts, historic buying practices, supply agreements with customers and market conditions. Our commitments to purchase metals are generally at prevailing market prices in effect at the time we place our orders. From time to time, we have entered into nickel swaps at the request of our customers in order to mitigate our customers' risk of volatility in the price of metals, and we have entered into metals hedges to mitigate our risk of volatility in the price of metals. We have no long-term, fixed-price metals purchase contracts. When metals prices decline, customer demands for lower prices and our competitors' responses to those demands could result in lower sale prices and, consequently, lower gross profits and earnings as we use existing metals inventory. When metals prices increase, competitive conditions will influence how much of the price increase we can pass on to our customers. To the extent we are unable to pass on future price increases in our raw materials to our customers, the net sales and gross profits of our business could be adversely affected.

At September 30, 2018, we employed approximately 1,765 people. Approximately 321 of the hourly plant personnel at the facilities listed below are represented by ten separate collective bargaining units. The table below shows the expiration dates of the collective bargaining agreements.

Facility	Expiration date
Hammond, Indiana	November 30, 2019
Locust, North Carolina	March 4, 2020
Romeoville, Illinois	May 31, 2020
Minneapolis coil, Minnesota	September 30, 2020
Duluth, Minnesota	December 22, 2020
Indianapolis, Indiana	January 29, 2021
St. Paul, Minnesota	May 25, 2021
Milan, Illinois	August 12, 2021
Minneapolis plate, Minnesota	March 31, 2022
Detroit, Michigan	August 31, 2022

We have never experienced a work stoppage and we believe that our relationship with employees is good. However, any prolonged work stoppages by our personnel represented by collective bargaining units could have a material adverse impact on our business, financial condition, results of operations and cash flows.

On April 2, 2018, we acquired all of the net assets of Berlin Metals, based in Hammond, Indiana. Berlin Metals was founded in 1967 and is one of the largest North American service centers processing and distributing prime tin mill products and stainless steel strip in slit coil form. Berlin Metals is also a supplier of galvanized, light gauge cold rolled sheet and strip and other coated metals in coil forms, to customers in the building products, automotive and specialized industrial markets.

The acquisition was accounted for as a business combination and the assets were valued at fair market value. The acquisition is not considered significant and Berlin Metals' results are included in our specialty metals flat products segment in our 2018 financial results. The acquisition is expected to be accretive to 2018 earnings.

Reportable Segments

We operate in three reportable segments; carbon flat products, specialty metals flat products and tubular and pipe products. The carbon flat products segment and the specialty metals flat products segment are at times consolidated and referred to as the flat products segment. Some of the flat products segments' assets and resources are shared by the carbon and specialty metals segments and both segments' products are stored in the shared facilities and, in some locations, processed on shared equipment. As such, total assets and capital expenditures are reported in the aggregate

for the flat products segments. Due to the shared assets and resources, certain of the flat products segment expenses are allocated between the carbon flat products segment and the specialty metals flat products segment based upon an established allocation methodology.

We follow the accounting guidance that requires the utilization of a “management approach” to define and report the financial results of operating segments. The management approach defines operating segments along the lines used by the chief operating decision maker, or CODM, to assess performance and make operating and resource allocation decisions. Our CODM evaluates performance and allocates resources based primarily on operating income. Our operating segments are based primarily on internal management reporting.

Due to the nature of the products sold in each segment, there are significant differences in the segments’ average selling price and the cost of materials sold. The tubular and pipe products segment generally has the highest average selling price among the three segments followed by the specialty metals flat products and carbon flat products segments. Due to the nature of the tubular and pipe products, we do not report tons sold or per ton information. Gross profit per ton is generally higher in the specialty metals flat products segment than the carbon flat products segment. Gross profit as a percentage of net sales is generally highest in the tubular and pipe products segment, followed by the carbon and specialty metals flat products segments.

Due to the differences in average selling prices, gross profit and gross profit percentage among the segments, a change in the mix of sales could impact total net sales, gross profit, and gross profit percentage. In addition, certain inventory in the tubular and pipe products segment is valued under the LIFO method. Adjustments to the LIFO inventory value are recorded to cost of materials sold and may impact the gross margin and gross margin percentage at the consolidated Company and tubular and pipe products segment levels.

Carbon flat products

The primary focus of our carbon flat products segment is on the direct sale and distribution of large volumes of processed carbon and coated flat-rolled sheet, coil and plate products and fabricated parts. We act as an intermediary between metals producers and manufacturers that require processed metals for their operations. We serve customers in most metals consuming industries, including manufacturers and fabricators of transportation and material handling equipment, construction and farm machinery, storage tanks, environmental and energy generation equipment, automobiles, military vehicles and equipment, as well as general and plate fabricators and metals service centers. We distribute these products primarily through a direct sales force.

Specialty metals flat products

The primary focus of our specialty metals flat products segment is on the direct sale and distribution of processed stainless and aluminum flat-rolled sheet and coil products, flat bar products and fabricated parts. Through its acquisition of Berlin Metals on April 2, 2018, our specialty metals flat products segment expanded its product offerings to include differing types of stainless flat-rolled sheet and coil and prime tin mill products. We act as an intermediary between metals producers and manufacturers that require processed metals for their operations. We serve customers in various industries, including manufacturers of food service and commercial appliances, agriculture equipment, transportation and automotive equipment. We distribute these products primarily through a direct sales force.

Combined, the carbon and specialty metals flat products segments have 21 strategically-located processing and distribution facilities in the United States and one in Monterrey, Mexico. Many of our facilities service both the carbon and the specialty metals flat products segments, and certain assets and resources are shared by the segments. Our geographic footprint allows us to focus on regional customers and larger national and multi-national accounts, primarily located throughout the midwestern, eastern and southern United States.

Tubular and pipe products

The tubular and pipe products segment consists of the Chicago Tube and Iron, or CTI, business, acquired in 2011. Through our tubular and pipe products segment, we distribute metal tubing, pipe, bar, valve and fittings and fabricate pressure parts supplied to various industrial markets. Founded in 1914, CTI operates from nine locations in the midwestern and southeastern United States. The tubular and pipe products segment distributes its products primarily through a direct sales force.

Corporate expenses

Corporate expenses are reported as a separate line item for segment reporting purposes. Corporate expenses include the unallocated expenses related to managing the entire Company (i.e., all three segments), including compensation for certain personnel, expenses related to being a publicly traded entity such as board of directors' expenses, audit expenses, and various other professional fees.

Results of Operations

Our results of operations are impacted by the market price of metals. Through the first seven months of 2018, metals prices increased significantly and changes to our net sales, cost of materials sold, gross profit, cost of inventory and profitability, were all impacted by industry metals pricing. The price increases resulted in metals pricing reaching its highest point in 10 years. The increases were driven by both the tariffs initiated by the U.S. government in 2018 under Section 232 of the Trade Expansion Act of 1962 (section 232 tariffs) and strong customer demand. During the last two months of the third quarter, market prices for metals declined from the prior months, but overall market prices for metal in the first nine months of 2018 were still higher than the first nine months of 2017. The pricing decline in the third quarter caused gross margin pressure as higher priced material was applied to orders. We expect the margin pressure to continue into the fourth quarter of 2018, and combined with less shipping days in the fourth quarter, we expect fourth quarter results to trail behind third quarter 2018 results, but to exceed the results of the fourth quarter of 2017.

Transactional or "spot" selling prices generally move in tandem with market price changes, while fixed selling prices typically lag and reset quarterly. Similarly, inventory costs (and, therefore, cost of materials sold) tend to move slower than market selling price changes due to mill lead times and inventory turnover impacting the rate of change in average cost. When average selling prices increase, and net sales increase, gross profit and operating expenses as a percentage of net sales will generally decrease.

Operating results for the third quarter of 2018 include the additional revenues and operating expenses resulting from the acquisition of Berlin Metals on April 2, 2018. Distribution expenses increased in the first nine months of 2018 across all segments as anticipated. The increase in distribution expense accounted for 27.0% of the consolidated operating expense increase. The increase is related to a shortage of drivers due to the stronger economy and more products being moved via truck, as well as limited driver hours per day resulting from the Electronic Log Device mandate by the Federal Motor Carrier Safety Administration issued in 2017.

During the second quarter of 2017, we announced the permanent closure of our carbon flat products segment's Siler City, North Carolina operation. The facility ceased operations in the third quarter of 2017. The land and building associated with the operation was sold in July 2018 at net book value. The operating loss related to the Siler City, North Carolina operation was immaterial in the first nine months of 2018 compared to \$1.2 million for the first nine months of 2017.

Consolidated Operations

The following table presents consolidated operating results for the periods indicated (dollars are shown in thousands):

	For the Three Months Ended				For the Nine Months Ended September			
	September 30, 2018		2017		2018		2017	
		% of net sales		% of net sales		% of net sales		% of net sales
Net sales	\$456,976	100.0	\$331,442	100.0	\$1,285,491	100.0	\$1,022,530	100.0
Cost of materials sold (a)	365,362	80.0	265,351	80.1	1,016,200	79.1	806,846	78.9
Gross profit (b)	91,614	20.0	66,091	19.9	269,291	20.9	215,684	21.1
Operating expenses (c)	73,000	16.0	60,805	18.3	214,013	16.6	189,714	18.6
Operating income	18,614	4.1	5,286	1.6	55,278	4.3	25,970	2.5
Other income (loss), net	17	0.0	(22)	0.0	(122)	(0.0)	(76)	(0.0)
Interest and other expense on debt	2,923	0.6	1,966	0.6	7,579	0.6	5,380	0.5
Income before income taxes	15,708	3.4	3,298	1.0	47,577	3.7	20,514	2.0
Income taxes	4,109	0.9	1,018	0.3	12,501	1.0	5,738	0.6
Net income	\$11,599	2.5	\$2,280	0.7	\$35,076	2.7	\$14,776	1.4

(a) Includes \$2,675 and \$4,675 of LIFO expense for the three and nine months ended September 30, 2018, respectively. Includes \$700 and \$1,475 of LIFO expense for the three and nine months ended September 30, 2017,

respectively.

(b) Gross profit is calculated as net sales less the cost of materials sold.

(c) Operating expenses are calculated as total costs and expenses less the cost of materials sold.

Net sales increased \$125.6 million, or 37.9%, to \$457.0 million in the third quarter of 2018 from \$331.4 million in the third quarter of 2017. The increase in net sales was due to a 28.6% increase in average selling prices and a 7.2% increase in sales volume during the third quarter of 2018 compared to the third quarter of 2017. Average selling prices increased sequentially from the second quarter of 2018 by approximately 8.4%. The average selling prices increased in all segments during the third quarter of 2018 compared to the third quarter of 2017 due to the increased market prices discussed above. Sales volumes increased in the specialty metals flat products segment due to the acquisition of Berlin Metals and increased customer demand, and in the carbon flat products and tubular and pipe products segments due to increased customer demand. Carbon flat products net sales were 61.9% of total net sales in the third quarter of 2018 compared to 65.1% of total net sales in the third quarter of 2017. Specialty metals flat products net sales were 20.2% of total net sales in the third quarter of 2018 compared to 17.4% of total net sales in the third quarter of 2017. Tubular and pipe products net sales were 17.9% of total net sales in the third quarter of 2018 compared to 17.5% of total net sales in the third quarter of 2017.

Net sales increased \$263.0 million, or 25.7%, to \$1.3 billion during the nine months ended September 30, 2018 from \$1.0 billion during the nine months ended September 30, 2017. The increase in net sales was due to a 21.1% increase in average selling prices and a 3.8% increase in sales volume during the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017. Average selling prices increased in all three operating segments during the first nine months of 2018 compared to the first nine months of 2017. Sales volumes increased in the specialty metals flat products segment due to the acquisition of Berlin Metals and increased customer demand, and in the tubular and pipe products segment due to increased customer demand. The decrease in tons sold in the carbon flat products segment is due to the strategic decision to eliminate low margin international trading sales and the closure of our North Carolina operation in the third quarter of 2017. Carbon flat products net sales were 62.5% of total net sales in the first nine months of 2018 compared to 65.5% of total net sales in the first nine months of 2017. Specialty metals flat products net sales were 19.8% of total net sales in the first nine months of 2018 compared to 17.0% of total net sales in the first nine months of 2017. Tubular and pipe products net sales were 17.7% of total net sales in the first nine months of 2018 compared to 17.5% of total net sales in the first nine months of 2017.

Cost of materials sold increased \$100.0 million, or 37.7%, to \$365.4 million in the third quarter of 2018 from \$265.4 million in the third quarter of 2017. Cost of materials sold increased \$209.3 million, or 25.9%, to \$1.0 billion during the nine months ended September 30, 2018 from \$806.8 million during the nine months ended September 30, 2017. The increase in cost of materials sold in the third quarter and first nine months of 2018 is primarily related to increased market metals pricing discussed above and increased sales volume.

As a percentage of net sales, gross profit (as defined in footnote (b) in the table above) increased to 20.0% in the third quarter of 2018 compared to 19.9% in the third quarter of 2017. As a percentage of net sales, gross profit decreased to 20.9% in the nine months ended September 30, 2018 compared to 21.1% in the nine months ended September 30, 2017. The decrease in the first nine months of 2018 gross profit as a percentage of net sales is due to the impact of higher average selling prices, as the average gross profit per ton increased in the first nine months of 2018 compared to the first nine months of 2017.

Operating expenses in the third quarter of 2018 increased \$12.2 million, or 20.1%, to \$73.0 million from \$60.8 million in the third quarter of 2017. As a percentage of net sales, operating expenses decreased to 16.0% in the third quarter of 2018 from 18.3% in the comparable 2017 period. Operating expenses increased \$4.3 million, \$3.9 million, \$2.2 million, and \$1.8 million in the carbon flat products, specialty metals flat products, tubular and pipe products and Corporate segments, respectively. Operating expenses increased in all categories, as reported on the Company's Consolidated Statements of Comprehensive Income. Operating expenses related to the newly acquired Berlin Metals on April 2, 2018 accounted for \$2.4 million, or 19.7%, of the operating expense increase. In addition, distribution expenses increased \$2.0 million, or 18.7%, and accounted for 16.2% of the total operating expense increase as discussed above. Variable operating expenses, such as warehouse and processing, increased as a result of increased sales volume and increased labor hours at our current operating facilities. Selling and administrative and general expenses increased as a result of labor expenses and increased variable based incentive compensation related to increased profitability.

Operating expenses in the first nine months of 2018 increased \$24.3 million, or 12.8%, to \$214.0 million from \$189.7 million in the first nine months of 2017. As a percentage of net sales, operating expenses decreased to 16.6% in the first nine months of 2018 from 18.6% for the first nine months of 2017. Operating expenses increased \$10.6 million, \$8.4 million, \$2.0 million, and \$3.3 million in the carbon flat products, specialty metals flat products, tubular and pipe products and Corporate segments, respectively. Operating expenses increased in all categories, except for depreciation expense, as reported on the Company's Consolidated Statements of Comprehensive Income. Operating expenses related to the newly acquired Berlin Metals on April 2, 2018 accounted for \$4.7 million, or 19.4%, of the operating expense increase. In addition, distribution expenses increased \$6.6 million, or 20.9%, and accounted for 27.0% of the total operating expense increase as discussed above. Variable operating expenses, such as warehouse and processing, increased as a result of increased sales volume and increased labor hours at our current operating facilities. Selling and administrative and general expenses increased as a result of labor expenses and increased variable based incentive compensation related to related to increased profitability.

Interest and other expense on debt totaled \$2.9 million, or 0.6% of net sales, in the third quarter of 2018 compared to \$2.0 million, or 0.6% of net sales, in the third quarter of 2017. Interest and other expense on debt totaled \$7.6 million, or 0.6% of net sales, for the first nine months of 2018 compared to \$5.4 million, or 0.5% of net sales, for the first nine months of 2017. Our effective borrowing rate, exclusive of deferred financing fees and commitment fees, was 3.6% for the first nine months of 2018 compared to 3.0% for the first nine months of 2017 due to the increase in LIBOR rates since 2017. Total average borrowings increased \$69 million, or 34.8%, from \$198 million in the first nine months of 2017 to \$267 million in the first nine months of 2018, primarily related to increased working capital needs, capital expenditures and the acquisition of Berlin Metals in 2018.

In the third quarter of 2018, income before income taxes totaled \$15.7 million compared to \$3.3 million in the third quarter of 2017. In the first nine months of 2018, income before income taxes totaled \$47.6 million compared to \$20.5 million in the first nine months of 2017.

An income tax provision of 26.2% was recorded in the third quarter of 2018, compared to 30.9% in the third quarter of 2017. An income tax provision of 26.3% was recorded in the first nine months of 2018, compared to 28.0% in the first nine months of 2017. During the quarter ended March 31, 2017, we made an out-of-period adjustment to correct and record previously unrecognized deferred tax assets, and the associated tax benefit, related to the SERP. The adjustment, which accumulated since the inception of the plan in 2005, resulted in an increase to after-tax income of \$1.9 million in the first quarter of 2017.

Our tax provision or benefit for interim periods is determined using an estimate of our annual effective tax rate, adjusted for discrete items that are considered in the relevant period. Each quarter, we update our estimate of the annual effective tax rate, and if our estimated tax rate changes, we make a cumulative adjustment. We expect our operational effective tax rate to approximate 26% to 28% on an annual basis in 2018, which is a decrease from the 2017 operational effective tax rate as a result of the Tax Cuts and Jobs Act signed into law in the fourth quarter of 2017.

Net income for the third quarter of 2018 totaled \$11.6 million or \$1.01 per basic and diluted share, compared to \$2.3 million, or \$0.20 per basic and diluted share for the third quarter of 2017. Net income for the first nine months of 2018 totaled \$35.1 million or \$3.07 per basic and diluted share, compared to \$14.8 million, or \$1.30 per basic and diluted share for the first nine months of 2017.

Segment Operations

Carbon flat products

The following table presents selected operating results for our carbon flat products segment for the periods indicated (dollars are shown in thousands, except for per ton information):

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2018	% of net sales	2017	% of net sales	2018	% of net sales	2017	% of net sales
Direct tons sold	258,671		256,550		816,819		822,330	
Toll tons sold	22,554		20,876		66,371		67,346	
Total tons sold	281,225		277,426		883,190		889,676	
Net sales	\$282,810	100.0	\$215,843	100.0	\$802,995	100.0	\$669,817	100.0
Average selling price per ton	1,006		778		909		753	
Cost of materials sold	225,407	79.7	173,560	80.4	632,326	78.7	532,383	79.5
Gross profit (a)	57,403	20.3	42,283	19.6	170,669	21.3	137,434	20.5
Operating expenses (b)	42,910	15.2	38,585	17.9	129,768	16.2	119,122	17.8
Operating income	\$14,493	5.1	\$3,698	1.7	\$40,901	5.1	\$18,312	2.7

- (a) Gross profit is calculated as net sales less the cost of materials sold.
- (b) Operating expenses are calculated as total costs and expenses less the cost of materials sold.

Tons sold by our carbon flat products segment increased 4 thousand tons, or 1.4%, to 281 thousand in the third quarter of 2018 from 277 thousand in the third quarter of 2017. Tons sold by our carbon flat products segment decreased 6 thousand tons, or 0.7% to 883 thousand in the first nine months of 2018 from 890 thousand in the first nine months of 2017. The decrease in tons sold is due to the strategic decision to eliminate low margin international trading sales and the closure of our North Carolina operation in the third quarter of 2017, which accounted for a decrease year-over-year of approximately 31 thousand tons. Excluding these strategic decisions, the carbon flat products segment experienced a 2.9% tonnage increase in the first nine months of 2018 compared to the first nine months of 2017. Customer demand was strong in the first nine months of 2018, and we expect similar year-over-year growth to continue into the fourth quarter of 2018.

Net sales in our carbon flat products segment increased \$67.0 million, or 31.0%, to \$282.8 million in the third quarter of 2018 from \$215.8 million in the third quarter of 2017. The increase in sales was due to a 29.3% increase in average selling prices and a 1.4% increase in sales volume during the third quarter of 2018 compared to the third quarter of 2017. Average selling prices in the third quarter of 2018 were \$1,006 per ton, compared with \$778 per ton in the third quarter of 2017, and \$918 per ton in the second quarter of 2018.

Net sales in our carbon flat products segment increased \$133.2 million, or 19.9%, to \$803.0 million in the first nine months of 2018 from \$669.8 million in the first nine months of 2017. The increase in sales was due to a 20.8% increase in average selling prices, offset by a 0.7% decrease in sales volume. Average selling prices in the first nine months of 2018 were \$909 per ton, compared with \$753 per ton in the first nine months of 2017.

Cost of materials sold increased \$51.8 million, or 29.9%, to \$225.4 million in the third quarter of 2018 from \$173.6 million in the third quarter of 2017. Cost of materials sold increased \$99.9 million, or 18.8%, to \$632.3 million in the first nine months 2018 from \$532.4 million in the first nine months of 2017. The increase was primarily due to the increased market price for metals discussed above.

As a percentage of net sales, gross profit (as defined in footnote (a) in the table above) increased to 20.3% in the third quarter of 2018 compared to 19.6% in the third quarter of 2017. Gross profit increased \$52 per ton to \$204 per ton in the third quarter of 2018 from \$152 per ton in the third quarter of 2017 and remained flat with the second quarter of 2018. As a percentage of net sales, gross profit increased to 21.3% in the first nine months of 2018 compared to 20.5% in the first nine months of 2017. Gross profit increased \$39 per ton to \$193 per ton in the first nine months of 2018 from \$154 per ton in the first nine months of 2017.

Operating expenses in the third quarter of 2018 increased \$4.3 million, or 11.2%, to \$42.9 million from \$38.6 million in the third quarter of 2017. As a percentage of net sales, operating expenses decreased to 15.2% for the third quarter of 2018 from 17.8% in the comparable 2017 period. Operating expenses in the first nine months of 2018 increased \$10.6 million, or 8.9%, to \$129.8 million from \$119.1 million in the first nine months of 2017. As a percentage of net sales, operating expenses decreased to 16.2% for the first nine months of 2018 from 17.9% in the comparable 2017 period. Variable operating expenses, such as warehouse and processing, increased as a result of increased sales volume and increased labor hours at our current operating facilities. Other operating expenses increased as a result of increased distribution expense discussed above, labor expenses and increased variable performance based incentive compensation related to increased profitability.

Operating income in the third quarter of 2018 totaled \$14.5 million, or 5.1% of net sales, compared to \$3.7 million, or 1.7% of net sales in the third quarter of 2017. Operating income in the first nine months of 2018 totaled \$40.9 million, or 5.1% of net sales, compared to \$18.3 million, or 2.7% of net sales in the first nine months of 2017.

Specialty metals flat products

The following table presents selected operating results for our specialty metals flat products for the periods indicated (dollars are shown in thousands, except for per ton information):

For the Three Months Ended September 30,			For the Nine Months Ended September 30,			
2018	2017		2018	2017		
% of net	% of net	% of net	% of net	% of net	% of net	

Edgar Filing: OLYMPIC STEEL INC - Form 10-Q

	sales		sales		sales		sales	
Direct tons sold	32,534		23,253		94,937		68,931	
Toll tons sold	4,072		-		5,338		54	
Total tons sold	36,606		23,253		100,275		68,985	
Net sales	\$92,153	100.0	\$57,554	100.0	\$255,037	100.0	\$173,789	100.0
Average selling price per ton	2,517		2,475		2,543		2,519	
Cost of materials sold	77,928	84.6	50,083	87.0	216,726	85.0	148,413	85.4
Gross profit (a)	14,225	15.4	7,471	13.0	38,311	15.0	25,376	14.6
Operating expenses (b)	9,271	10.0	5,397	9.4	24,818	9.7	16,458	9.5
Operating income	\$4,954	5.4	\$2,074	3.6	\$13,493	5.3	\$8,918	5.1

(a) Gross profit is calculated as net sales less the cost of materials sold.

(b) Operating expenses are calculated as total costs and expenses less the cost of materials sold.

Tons sold by our specialty metals flat products segment increased 13 thousand tons, or 57.4%, to 37 thousand in the third quarter of 2018 from 23 thousand in the third quarter of 2017. Tons sold by our specialty metals flat products segment increased 31 thousand tons, or 45.4%, to 100 thousand in the first nine months of 2018 from 69 thousand in the first nine months of 2017. The increase in tons sold is due to the acquisition of Berlin Metals on April 2, 2018 and improved customer demand in the markets we serve during the third quarter and first nine months of 2018.

Net sales in our specialty metals flat products segment increased \$34.6 million, or 60.1%, to \$92.2 million in the third quarter of 2018 from \$57.6 million in the third quarter of 2017. The increase in sales was due to the 57.4% volume increase discussed above and a 1.7% increase in the average selling prices during the third quarter of 2018 compared to the third quarter of 2017. Average selling prices in the third quarter of 2018 were \$2,517 per ton compared to \$2,475 per ton in the third quarter of 2017 and \$2,509 per ton in the second quarter of 2018.

Net sales in our specialty metals flat products segment increased \$81.2 million, or 46.8%, to \$255.0 million in the first nine months of 2018 from \$173.8 million in the first nine months of 2017. The increase in sales was due to the 45.4% increase in sales volume as discussed above and an 1.0% increase in the average selling prices in the first nine months of 2018 compared to the first nine months of 2017. Average selling prices in the first nine months of 2018 were \$2,543 per ton, compared with \$2,519 per ton in the first nine months of 2017.

Cost of materials sold increased \$27.8 million, or 55.6%, to \$77.9 million in the third quarter of 2018 from \$50.1 million in the third quarter of 2017. The increase was due to a 57.4% increase in sales volume, offset by a 1.2% decrease in cost of materials sold in the third quarter of 2018 compared to the third quarter in 2017. Cost of materials sold increased \$68.3 million, or 46.0%, to \$216.7 million in the first nine months of 2018 from \$148.4 million in the first nine months of 2017. The increase in cost of materials sold was due to a 45.4% increase in sales volume and a 0.5% increase in material cost during the first nine months of 2018 compared to the first nine months of 2017.

As a percentage of net sales, gross profit (as defined in footnote (a) in the table above) increased to 15.4% in the third quarter of 2018 from 13.0% in the third quarter of 2017. As a percentage of net sales, gross profit increased to 15.0% in the first nine months of 2018 from 14.6% in the first nine months of 2017.

Operating expenses in the third quarter of 2018 increased \$3.9 million, or 71.8%, to \$9.3 million from \$5.4 million in the third quarter of 2017. As a percentage of net sales, operating expenses increased to 10.0% of net sales for the third quarter of 2018 compared to 9.4% of net sales for the third quarter of 2017. Operating expenses in the first nine months of 2018 increased \$8.4 million, or 50.8%, to \$24.8 million from \$16.5 million in the first nine months of 2017. As a percentage of net sales, operating expenses increased to 9.7% of net sales for the first nine months of 2018 compared to 9.5% for the first nine months of 2017. Operating expenses increased due to the acquisition of Berlin Metals on April 2, 2018. Variable operating expenses, such as distribution and warehouse and processing increased as a result of higher sales volumes. Selling and administrative and general expenses increased primarily as a result of increased variable based incentive compensation related to the increased sales volume, gross profit and operating income.

Operating income in the third quarter of 2018 totaled \$5.0 million, or 5.4% of net sales, compared to \$2.1 million, or 3.6% of net sales, in the third quarter of 2017. Operating income in the first nine months of 2018 totaled \$13.5 million, or 5.3% of net sales, compared to operating income of \$8.9 million, or 5.1% of net sales, in the first nine months of 2017.

Tubular and pipe products

Edgar Filing: OLYMPIC STEEL INC - Form 10-Q

The following table presents selected operating results for our tubular and pipe products segment for the periods indicated (dollars are shown in thousands):

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2018	201		2018	2017			
		% of net sales		% of net sales		% of net sales		% of net sales
Net sales	\$82,013	100.0	\$58,045	100.0	\$227,459	100.0	\$178,924	100.0
Cost of materials sold (a)	62,027	75.6	41,708	71.9	167,148	73.5	126,050	70.4
Gross profit (b)	19,986	24.4	16,337	28.1	60,311	26.5	52,874	29.6
Operating expenses (c)	16,884	20.6	14,729	25.3	48,394	21.3	46,435	26.0
Operating income	\$3,102	3.8	\$1,608	2.8	\$11,917	5.2	\$6,439	3.6

Includes \$2,675 and \$4,675 of LIFO expense for the three and nine months ended September 30, 2018, (a) respectively. Includes \$700 and \$1,475 of LIFO expense for the three and nine months ended September 30, 2017, respectively.

(b) Gross profit is calculated as net sales less the cost of materials sold.

(c) Operating expenses are calculated as total costs and expenses less the cost of materials sold.

Net sales increased \$24.0 million, or 41.3%, to \$82.0 million in the third quarter of 2018 from \$58.0 million in the third quarter of 2017. The increase is a result of a 28.4% increase in sales volume and a 10.0% increase in average selling prices during the third quarter of 2018 compared to the third quarter of 2017. Net sales increased \$48.5 million, or 27.1% to \$227.5 million in the first nine months of 2018 from \$178.9 million in the first nine months of 2017. The increase in net sales is a result of a 22.4% increase in sales volume and a 3.8% increase in average selling prices during the first nine months of 2018 compared to the first nine months of 2017.

Cost of materials sold increased \$20.3 million, or 48.7%, to \$62.0 million in the third quarter of 2018 from \$41.7 million in the third quarter of 2017. During the third quarter of 2018, we recorded LIFO expense of \$2.7 million compared to \$0.7 million in the third quarter of 2017. Cost of materials sold increased \$41.1 million, or 32.6% to \$167.1 million in the first nine months of 2018 from \$126.1 million in the first nine months of 2017. During the first nine months of 2018, we recorded \$4.7 million of LIFO expense compared to \$1.5 million in the first nine months of 2017. The increase in cost of materials sold is a result of increased sales volumes, increased material costs and increased LIFO expense in 2018 compared to 2017.

As a percentage of net sales, gross profit (as defined in footnote (b) in the table above) decreased to 24.4% in the third quarter of 2018 from 28.1% in the third quarter of 2017. As a percentage of net sales, the \$2.7 million LIFO expense reduced gross profit by 3.3% in 2018 compared to the \$0.7 million LIFO expense in 2017 that reduced gross profit by 1.2%. As a percentage of net sales, gross profit decreased to 26.5% in the first nine months of 2018 compared to 29.6% in the first nine months of 2017. As a percentage of net sales, the \$4.7 million LIFO expense recorded in the nine months ended September 30, 2018 reduced gross profit by 2.1%, compared to the \$1.5 million LIFO expense recorded in the nine months ended September 30, 2017 that reduced gross profit by 0.8%.

Operating expenses in the third quarter of 2018 increased \$2.2 million, or 14.6%, to \$16.9 million from \$14.7 million in the third quarter of 2017. As a percentage of net sales, operating expenses decreased to 20.6% for the third quarter of 2018 compared to 25.3% for the third quarter of 2017. Operating expenses increased in the third quarter primarily as a result of increased distribution expense discussed above and increased labor hours and variable incentive compensation related to increased gross profit and operating income.

Operating expenses in the first nine months of 2018 increased \$2.0 million, or 4.0%, to \$48.4 million from \$46.4 million in the first nine months of 2017. As a percentage of net sales, operating expenses decreased to 21.3% in the first nine months of 2018 compared to 26.0% in the first nine months of 2017. Operating expenses increased in the first nine months of 2018 primarily as a result of increased distribution expense discussed above and increased labor hours and variable incentive compensation related to increased gross profit and operating income.

Operating income in the third quarter of 2018 totaled \$3.1 million, or 3.8% of net sales, compared to \$1.6 million, or 2.8% of net sales, in the third quarter of 2017. Operating income in the first nine months of 2018 totaled \$11.9 million, or 5.2% of net sales, compared to \$6.4 million, or 3.6% of net sales, in the first nine months of 2017.

Corporate expenses

Corporate expenses increased \$1.8 million, or 87.9%, to \$3.9 million in the third quarter of 2018 compared to \$2.1 million in the third quarter of 2017. Corporate expenses increased \$3.3 million, or 43.3%, to \$11.0 million in the first

nine months of 2018 compared to \$7.7 million in the first nine months of 2017. The increase in corporate expenses is primarily attributable to increased variable incentive compensation related to increased operating income, and the professional fees incurred in connection with the Berlin Metals acquisition on April 2, 2018.

Liquidity, Capital Resources and Cash Flows

Our principal capital requirements include funding working capital needs, purchasing, upgrading and acquiring processing equipment and facilities, making acquisitions and paying dividends. We use cash generated from operations, leasing transactions and borrowings under our credit facility to fund these requirements.

We believe that funds available under our existing asset-based credit facility (the ABL Credit Facility), lease arrangement proceeds and the sale of equity or debt securities, together with funds generated from operations, will be sufficient to provide us with the liquidity necessary to fund anticipated working capital requirements, capital expenditure requirements, our dividend payments and any business acquisitions over at least the next 12 months. In the future, we may, as part of our business strategy, acquire and dispose of assets or other companies in the same or complementary lines of business, or enter into or exit strategic alliances and joint ventures. Accordingly, the timing and size of our capital requirements are subject to change as business conditions warrant and opportunities arise.

Operating Activities

For the nine months ended September 30, 2018, we used \$63.1 million of net cash for operations, of which \$52.0 million was generated from operating activities and \$115.1 million was used for working capital investments. Net cash from operations during the nine months ended September 30, 2018 consisted primarily of net income of \$35.1 million. For the nine months ended September 30, 2017, we used \$46.6 million of net cash from operations, of which \$26.8 million was generated from operating activities and \$73.4 million was used for working capital investments. Net cash from operations during the nine months ended September 30, 2017 consisted primarily of net income of \$14.8 million.

Working capital at September 30, 2018 totaled \$440.1 million, a \$131.1 million increase from December 31, 2017. The increase was primarily attributable to a \$74.1 million increase in accounts receivable (resulting from higher sales prices and higher sales volumes experienced in the third quarter of 2018 compared to the fourth quarter of 2017) and a \$76.1 million increase in inventories (resulting from higher inventory levels and higher average inventory costs in the third quarter of 2018 compared to the fourth quarter of 2017) offset by a \$24.7 million increase in accounts payable and outstanding checks (related to the increased inventory purchases discussed above).

Investing Activities

Net cash used for investing activities was \$42.2 million during the nine months ended September 30, 2018, compared to \$5.7 million during the nine months ended September 30, 2017. Investment activities in 2018 includes the acquisition of Berlin Metals for \$21.9 million and \$20.4 million of capital expenditures, primarily attributable to a building expansion and additional processing equipment at our existing facilities. During 2018, we expect our capital spending to approximate \$25 million.

Financing Activities

During the nine months ended September 30, 2018, \$106.6 million of cash was generated from financing activities, which primarily consisted of \$108.2 million of net borrowings under our ABL Credit Facility to fund the continued rising metals prices and working capital needs and the acquisition of Berlin Metals on April 2, 2018 offset by the final Industrial Revenue Bond (IRB) payment of \$0.9 million and \$0.7 million of dividends paid. During the nine months ended September 30, 2017, \$54.1 million of cash was generated from financing activities, which primarily consisted of \$55.8 million of net borrowings under our ABL Credit Facility offset by a \$0.9 million IRB repayment and \$0.7 million of dividends paid.

Dividends paid were \$0.7 million for both the nine months ended September 30, 2018 and September 30, 2017. In November 2018, our Board of Directors approved a regular quarterly dividend of \$0.02 per share, which will be paid on December 17, 2018 to shareholders of record as of December 3, 2018. Regular dividend distributions in the future are subject to the availability of cash, and continuing determination by our board of directors that the payment of dividends remains in the best interest of our shareholders.

Stock Repurchase Program

In 2015, our Board of Directors authorized a stock repurchase program of up to 550,000 shares of our issued and outstanding common stock, which could include open market repurchases, negotiated block transactions, accelerated stock repurchases or open market solicitations for shares, all or some of which may be effected through Rule 10b5-1 plans. Repurchased shares will be held in our treasury, or canceled and retired as our Board may determine from time to time. Any repurchases of common stock are subject to the covenants contained in the ABL Credit Facility. Under the ABL Credit Facility, we may repurchase common stock and pay dividends up to \$5.0 million in the aggregate during any trailing twelve months without restrictions. Purchases in excess of \$5.0 million require us to (i) maintain availability in excess of 20% of the aggregate revolver commitments (\$80.0 million at September 30, 2018) or (ii) to maintain availability equal to or greater than 15% of the aggregate revolver commitments (\$60.0 million at September 30, 2018) and we must maintain a pro-forma ratio of EBITDA, minus certain capital expenditures and cash taxes paid to fixed charges of at least 1.00 to 1.00. The timing and amount of any repurchases under the stock repurchase program will depend upon several factors, including market and business conditions, and limitations under the ABL Credit Facility, and repurchases may be discontinued at any time.

No share repurchases were made during the nine months ended September 30, 2018.

Debt Arrangements

Our ABL Credit Facility is collateralized by our accounts receivable, inventory and personal property. The ABL Credit Facility consists of (i) a revolving credit facility of \$370 million, including a \$20 million sub-limit for letters of credit and (ii) a first in, last out revolving credit facility of up to \$30 million. Under the terms of the ABL Credit Facility, we may request additional commitments in the aggregate principal amount of up to \$200 million to the extent that existing or new lenders agree to provide such additional commitments. Revolver borrowings are limited to the lesser of a borrowing base, comprised of eligible receivables, inventories and personal property, or \$400 million in the aggregate. The ABL Credit Facility matures on December 8, 2022.

The ABL Credit Facility contains customary representations and warranties and certain covenants that limit our ability to, among other things: (i) incur or guarantee additional indebtedness (ii) pay distributions on, redeem or repurchase capital stock or redeem or repurchase subordinated debt (iii) make investments (iv) sell assets (v) enter into agreements that restrict distributions or other payments from restricted subsidiaries to us (vi) incur liens securing indebtedness (vii) consolidate, merge or transfer all or substantially all of our assets and (viii) engage in transactions with affiliates. In addition, the ABL Credit Facility contains a financial covenant which requires: (i) if any commitments or obligations are outstanding and our availability is less than the greater of \$30 million or 10.0% of the aggregate amount of revolver commitments (\$40.0 million at September 30, 2018), or 10.0% of the aggregate borrowing base (\$40.0 million at September 30, 2018) then we must maintain a ratio of EBITDA minus certain capital expenditures and cash taxes paid to fixed charges of at least 1.00 to 1.00 for the most recent twelve fiscal month period.

We have the option to borrow under our revolver based on the agent's base rate plus a premium ranging from 0.00% to 1.50% or the London Interbank Offered Rate, or LIBOR, plus a premium ranging from 1.25% to 2.75%.

As of September 30, 2018, we were in compliance with our covenants and had approximately \$93 million of availability under the ABL Credit Facility.

As of September 30, 2018, \$1.6 million of bank financing fees were included in "Prepaid expenses and other" and "Other long-term assets" on the accompanying Consolidated Balance Sheets. The financing fees are being amortized over the five-year term of the ABL Credit Facility and are included in "Interest and other expense on debt" on the accompanying Consolidated Statements of Comprehensive Income.

On March 1, 2018, we made the final \$0.9 million payment on our IRB and the letter of credit and fixed interest rate swap associated with the IRB were terminated.

Critical Accounting Policies

This Management's Discussion and Analysis of Financial Condition and Results of Operations is based on the consolidated financial statements included in this Quarterly Report on Form 10-Q, which have been prepared in conformity with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements. We monitor and evaluate our estimates and assumptions, based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results could differ from these estimates under different assumptions or conditions.

We review our financial reporting and disclosure practices and accounting practices quarterly to ensure they provide accurate and transparent information relative to the current economic and business environment. For further information regarding the accounting policies that we believe to be critical accounting policies that affect our more significant judgments and estimates used in preparing our consolidated financial statements, see Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2017.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our principal raw materials are carbon, coated and stainless steel, and aluminum, prime tin mill, pipe and tube, flat rolled coil, sheet and plate that we typically purchase from multiple primary metals producers. The metals industry as a whole is cyclical and, at times, pricing and availability of metals can be volatile due to numerous factors beyond our control, including general domestic and international economic conditions, the levels of metals imported into the United States, labor costs, sales levels, competition, levels of inventory held by other metals service centers, consolidation of metals producers, new global capacity by metals producers, higher raw material costs for the producers of metals, import duties and tariffs, including the Section 232 tariffs initiated by the U.S. government in 2018, and currency exchange rates. This volatility can significantly affect the availability and cost of raw materials for us.

We, like many other metals service centers, maintain substantial inventories of metals to accommodate the short lead times and just-in-time delivery requirements of our customers. Accordingly, we purchase metals in an effort to maintain our inventory at levels that we believe to be appropriate to satisfy the anticipated needs of our customers based upon historic buying practices, supply agreements with customers and market conditions. Our commitments to purchase metals are generally at prevailing market prices in effect at the time we place our orders. We have no long-term, fixed-price metals purchase contracts. When metals prices increase, competitive conditions will influence how much of the price increase we can pass on to our customers. To the extent we are unable to pass on future price increases in our raw materials to our customers, the net sales and profitability of our business could be adversely affected. When metals prices decline, customer demands for lower prices and our competitors' responses to those demands could result in lower sale prices and, consequently, lower gross profits and inventory lower of cost or market adjustments as we sell existing inventory. Significant or rapid declines in metals prices or reductions in sales volumes could adversely impact our ability to remain in compliance with certain financial covenants in our credit facility, as well as result in us incurring inventory or intangible asset impairment charges. Changing metals prices therefore could significantly impact our net sales, gross profits, operating income and net income.

Rising metals prices, like we experienced in the first half of 2018, result in higher working capital requirements for us and our customers. Some customers may not have sufficient credit lines or liquidity to absorb significant increases in the price of metals. While we have generally been successful in the past in passing on producers' price increases and surcharges to our customers, there is no guarantee that we will be able to pass on price increases to our customers in the future. Declining metals prices, which we experienced in the third quarter of 2018, have generally adversely affected our net sales and net income, while increasing metals prices have generally favorably affected our net sales and net income.

Approximately 48% and 46% of our consolidated net sales during the first nine months of 2018 and 2017, respectively, were directly related to industrial machinery and equipment manufacturers and their fabricators.

Inflation generally affects us by increasing the cost of employee wages and benefits, transportation services, processing equipment, energy and borrowings under our credit facility. General inflation, excluding increases in the price of metals and increased labor and distribution expense, has not had a material effect on our financial results during the past two years. We expect transportation expenses to continue to increase significantly in excess of general inflation in 2018 due to a shortage of truck drivers and the Electronic Log Device mandate by the Federal Motor Carrier Safety Administration issued in 2017.

We are exposed to the impact of fluctuating metals prices and interest rate changes. During 2018 and 2017, we entered into metals swaps at the request of customers. These derivatives have not been designated as hedging instruments. For certain customers, we enter into contractual relationships that entitle us to pass-through the economic effect of trading positions that we take with other third parties on our customers' behalf.

Our primary interest rate risk exposure results from variable rate debt. We have the option to enter into 30- to 180-day fixed base rate LIBOR loans under the ABL Credit Facility.

Item 4. Controls and Procedures

The evaluation required by Rule 13a-15(e) of the Securities Exchange Act of 1934 of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this Quarterly Report on Form 10-Q has been carried out under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer. These disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in reports that are filed with or submitted to the SEC is: (i) accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures and (ii) recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2018, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting that occurred during the third quarter of 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. OTHER INFORMATION

Items 1, 1A, 2, 3, 4 and 5 of this Part II are either inapplicable or are answered in the negative and are omitted pursuant to the instructions to Part II.

Item 6. Exhibits

<u>Exhibit</u>	<u>Description of Document</u>	<u>Reference</u>
31.1	<u>Certification of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>	Filed herewith
31.2	<u>Certification of the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>	Filed herewith
32.1	<u>Certification of the Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>	Furnished herewith
32.2	<u>Certification of the Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>	Furnished herewith
101.INS	XBRL Instance Document	
101.SCH	XBRL Taxonomy Extension Schema Document	
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	
101.DEF	XBRL Taxonomy Extension Definition	
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

OLYMPIC STEEL, INC.
(Registrant)

Date: November 8, 2018 By: /s/ Michael D. Siegal
Michael D. Siegal
Chairman of the Board and Chief
Executive Officer

By: /s/ Richard T. Marabito
Richard T. Marabito
Chief Financial Officer
(Principal Financial and Accounting Officer)