

Quanex Building Products CORP  
Form 10-Q  
September 07, 2018

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

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FORM 10-Q

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(Mark One)

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

For the quarterly period ended July 31, 2018

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number 1-33913

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QUANEX BUILDING PRODUCTS CORPORATION  
(Exact name of registrant as specified in its charter)

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DELAWARE 26-1561397  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)  
1800 West Loop South, Suite 1500, Houston, Texas 77027  
(Address of principal executive offices and zip code)  
Registrant's telephone number, including area code: (713) 961-4600

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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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a 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. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) 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 period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Securities Act.

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

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

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Class	Outstanding at September 4, 2018
Common Stock, par value \$0.01 per share	35,164,811

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QUANEX BUILDING PRODUCTS CORPORATION

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

QUANEX BUILDING PRODUCTS CORPORATION  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(Unaudited)

	July 31, 2018	October 31, 2017
	(In thousands, except share amounts)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 12,400	\$ 17,455
Accounts receivable, net of allowance for doubtful accounts of \$447 and \$333	80,236	79,411
Inventories, net (Note 2)	87,105	87,529
Prepaid and other current assets	8,636	7,406
Total current assets	188,377	191,801
Property, plant and equipment, net of accumulated depreciation of \$283,811 and \$264,047	205,304	211,131
Goodwill (Note 3)	221,587	222,194
Intangible assets, net (Note 3)	127,071	139,778
Other assets	9,184	8,975
Total assets	\$ 751,523	\$ 773,879
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 44,871	\$ 44,150
Accrued liabilities	31,693	38,871
Income taxes payable (Note 7)	2,405	2,192
Current maturities of long-term debt (Note 4)	16,120	21,242
Total current liabilities	95,089	106,455
Long-term debt (Note 4)	193,654	218,184
Deferred pension and postretirement benefits (Note 6)	6,612	4,433
Deferred income taxes (Note 7)	16,765	21,960
Other liabilities	15,640	16,000
Total liabilities	327,760	367,032
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, no par value, shares authorized 1,000,000; issued and outstanding - none	—	—
Common stock, \$0.01 par value, shares authorized 125,000,000; issued 37,433,817 and 37,508,877, respectively; outstanding 35,139,713 and 34,838,134, respectively	374	375
Additional paid-in-capital	253,806	255,719
Retained earnings	240,025	225,704
Accumulated other comprehensive loss	(27,601)	(25,076)
Less: Treasury stock at cost, 2,294,104 and 2,670,743 shares, respectively	(42,841)	(49,875)
Total stockholders' equity	423,763	406,847
Total liabilities and stockholders' equity	\$ 751,523	\$ 773,879
The accompanying notes are an integral part of the financial statements.		

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QUANEX BUILDING PRODUCTS CORPORATION  
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
 (Unaudited)

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2018	2017	2018	2017
	(In thousands, except per share amounts)			
Net sales	\$239,821	\$229,367	\$645,699	\$634,406
Cost and expenses:				
Cost of sales (excluding depreciation and amortization)	185,610	176,758	508,791	494,647
Selling, general and administrative	24,190	20,478	72,049	74,839
Restructuring charges	243	864	851	3,083
Depreciation and amortization	12,691	13,915	39,274	43,701
Operating income	17,087	17,352	24,734	18,136
Non-operating (expense) income:				
Interest expense	(2,641 )	(2,575 )	(7,584 )	(7,126 )
Other, net	(62 )	46	150	572
Income before income taxes	14,384	14,823	17,300	11,582
Income tax (expense) benefit	(3,631 )	(4,608 )	2,536	(3,631 )
Net income	\$10,753	\$10,215	\$19,836	\$7,951
Basic income per common share	\$0.31	\$0.30	\$0.57	\$0.23
Diluted income per common share:	\$0.31	\$0.29	\$0.56	\$0.23
Weighted-average common shares outstanding:				
Basic	34,840	34,224	34,766	34,141
Diluted	35,120	34,924	35,125	34,771
Cash dividends per share	\$0.04	\$0.04	\$0.12	\$0.12

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

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QUANEX BUILDING PRODUCTS CORPORATION  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME  
 (Unaudited)

	Three Months Ended July 31, 2018		Nine Months Ended July 31, 2018	
	2017	2018	2017	2018
	(In thousands)			
Net income	\$10,753	\$10,215	\$19,836	\$7,951
Other comprehensive (loss) income:				
Foreign currency translation adjustments (loss) gain	(7,650 )	4,698	(1,828 )	11,274
Change in pension from net unamortized gain tax (expense)	—	—	(697 )	—
Other comprehensive (loss) income	(7,650 )	4,698	(2,525 )	11,274
Comprehensive income	\$3,103	\$14,913	\$17,311	\$19,225

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

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QUANEX BUILDING PRODUCTS CORPORATION  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW  
 (Unaudited)

	Nine Months Ended July 31, 2018      2017 (In thousands)	
Operating activities:		
Net income	\$19,836	\$7,951
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	39,274	43,701
Stock-based compensation	1,002	4,305
Deferred income tax	(5,788 )	(1,847 )
Other, net	404	1,136
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	(1,247 )	6,923
Decrease (increase) in inventory	310	(8,576 )
Increase in other current assets	(1,242 )	(379 )
Increase (decrease) in accounts payable	1,161	(3,145 )
Decrease in accrued liabilities	(7,565 )	(11,327 )
Increase in income taxes payable	231	4,349
Increase in deferred pension and postretirement benefits	2,179	2,537
Increase in other long-term liabilities	210	1,226
Other, net	(312 )	(389 )
Cash provided by operating activities	48,453	46,465
Investing activities:		
Acquisitions, net of cash acquired	—	(8,497 )
Capital expenditures	(21,098 )	(27,098 )
Proceeds from disposition of capital assets	260	1,232
Cash used for investing activities	(20,838 )	(34,363 )
Financing activities:		
Borrowings under credit facilities	33,500	53,500
Repayments of credit facility borrowings	(62,750 )	(74,125 )
Repayments of other long-term debt	(1,394 )	(2,240 )
Common stock dividends paid	(4,202 )	(4,127 )
Issuance of common stock	3,767	6,379
Payroll tax paid to settle shares forfeited upon vesting of stock	(960 )	(976 )
Cash used for financing activities	(32,039 )	(21,589 )
Effect of exchange rate changes on cash and cash equivalents	(631 )	(248 )
Decrease in cash and cash equivalents	(5,055 )	(9,735 )
Cash and cash equivalents at beginning of period	17,455	25,526
Cash and cash equivalents at end of period	\$12,400	\$15,791
The accompanying notes are an integral part of the financial statements.		

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QUANEX BUILDING PRODUCTS CORPORATION  
 CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
 (Unaudited)

Nine Months Ended July 31, 2018	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Stockholders' Equity
	(In thousands, no per share amounts shown except in verbiage)					
Balance at October 31, 2017	\$375	\$255,719	\$225,704	\$ (25,076 )	\$(49,875)	\$ 406,847
Net income	—	—	19,836	—	—	19,836
Foreign currency translation adjustment	—	—	—	(1,828 )	—	(1,828 )
Common dividends (\$0.12 per share)	—	—	(4,202 )	—	—	(4,202 )
Change in pension from net unamortized gain tax (expense)	—	—	—	(697 )	—	(697 )
Stock-based compensation activity:						
Expense related to stock-based compensation	—	1,002	—	—	—	1,002
Stock options exercised	—	(149 )	(1,274 )	—	5,190	3,767
Restricted stock awards granted	—	(1,371 )	—	—	1,371	—
Performance share awards vested	—	(473 )	—	—	473	—
Other	(1 )	(922 )	(39 )	—	—	(962 )
Balance at July 31, 2018	\$374	\$253,806	\$240,025	\$ (27,601 )	\$(42,841)	\$ 423,763

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



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QUANEX BUILDING PRODUCTS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Nature of Operations and Basis of Presentation

Quanex Building Products Corporation is a component supplier to original equipment manufacturers (OEMs) in the building products industry. These components can be categorized as window and door (fenestration) components and kitchen and bath cabinet components. Examples of fenestration components include: (1) energy-efficient flexible insulating glass spacers, (2) extruded vinyl profiles, (3) window and door screens, and (4) precision-formed metal and wood products. We also manufacture cabinet doors and other components for OEMs in the kitchen and bathroom cabinet industry. In addition, we provide certain other non-fenestration components and products, which include solar panel sealants, trim moldings, vinyl decking, fencing, water retention barriers, and conservatory roof components. We have organized our business into three reportable business segments. For additional discussion of our reportable business segments, see Note 14, "Segment Information." We use low-cost, short lead-time production processes and engineering expertise to provide our customers with specialized products for their specific window, door, and cabinet applications. We believe these capabilities provide us with unique competitive advantages. We serve a primary customer base in North America and the United Kingdom, and also serve customers in international markets through our operating plants in the United Kingdom and Germany, as well as through sales and marketing efforts in other countries.

Unless the context indicates otherwise, references to "Quanex", the "Company", "we", "us" and "our" refer to the consolidated business operations of Quanex Building Products Corporation and its subsidiaries.

The accompanying interim condensed consolidated financial statements include the accounts of Quanex Building Products Corporation. All intercompany accounts and transactions have been eliminated in consolidation. These financial statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) have been condensed or omitted pursuant to such rules and regulations. The condensed consolidated balance sheet as of October 31, 2017 was derived from audited financial information, but does not include all disclosures required by U.S. GAAP. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto, included in our Annual Report on Form 10-K for the fiscal year ended October 31, 2017. In our opinion, the accompanying financial statements contain all adjustments (which consist of normal recurring adjustments, except as disclosed herein) necessary to fairly present our financial position, results of operations and cash flows for the interim periods. The results of operations for the periods presented are not necessarily indicative of the results to be expected for the full year or for any future periods. In preparing financial statements, we make informed judgments and estimates that affect the reported amounts of assets and liabilities as of the date of the financial statements and affect the reported amounts of revenues and expenses during the reporting period. We review our estimates on an on-going basis, including those related to impairment of long lived assets and goodwill, contingencies and income taxes. Changes in facts and circumstances may result in revised estimates and actual results may differ from these estimates.

Restructuring

We accrue one-time severance costs pursuant to an approved plan of restructuring at the communication date, when affected employees have been notified of the potential severance and sufficient information has been provided for the employee to calculate severance benefits, in the event the employee is involuntarily terminated. In addition, we accrue costs associated with the termination of contractual commitments including operating leases at the time the lease is terminated pursuant to the lease provisions or in accordance with another agreement with the landlord. Otherwise, we continue to recognize operating lease expense through the cease-use date. After the cease-use date, we determine if our operating lease payments are at market. We assume sublet of the facility at the market rate. To the extent our lease obligations exceed the fair value rentals, we discount to arrive at the present value and record a liability. If the facility is not sublet, we expense the amount of the rental in the current period. For other costs directly related to the restructuring effort, such as equipment moving costs, we expense in the period incurred.

We closed a kitchen and bathroom cabinet door business in Mexico in October 2016 and another plant in Lansing, Kansas in September 2017. We closed two United States vinyl operations plants in November 2016 and January 2017. Pursuant to these restructuring efforts, we expensed \$0.2 million and \$0.9 million during the three and nine months ended July 31, 2018 respectively, and \$0.9 million and \$3.1 million, respectively, for the comparable prior year periods. Our facility lease obligations were deemed to be at fair market value and we have not yet negotiated exit from our remaining lease obligations at two of these facilities. We expect to continue to incur costs related to these operating leases and other costs associated with these restructuring efforts during fiscal 2018.

In 2017, we evaluated the remaining depreciable lives of property, plant and equipment that will be abandoned or otherwise disposed as of the plant closures and recorded a change in estimate associated with the remaining useful lives of these assets. We

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

recorded accelerated depreciation of \$1.0 million and \$3.9 million related to this change in estimate for the three and nine months ended July 31, 2017, respectively. In addition, we evaluated the remaining service lives of intangible assets with defined lives associated with our United States vinyl extrusion business and recorded a change in estimate associated with the remaining useful lives of a customer relationship intangible and a utility process intangible asset which resulted in an increase in amortization expense of \$0.3 million and \$1.6 million for the three and nine months ended July 31, 2017, respectively. We do not expect to incur incremental depreciation and amortization expense in fiscal 2018 associated with these restructuring efforts.

**Acquisitions**

As more fully described in our Annual Report on Form 10-K for the year ended October 31, 2017, on November 7, 2016, we paid \$8.5 million pursuant to an earn-out provision for the acquisition of HLP. We have included this earn-out payment under the caption "Acquisitions, net of cash acquired" in the accompanying cash flow statement for the nine months ended July 31, 2017.

**Related Parties**

We are party to operating leases associated with HLP for which a former owner, who is now our employee, has an ownership interest. These leases include our primary operating facilities, a finished goods warehouse, a mixing plant, and a manufacturing facility. The lease for the manufacturing facility which has a 20-year term began in 2007, the lease for the manufacturing facility which has a 15-year term began in 2012, the lease for the mixing plant has a 13.5-year term which began in 2013, and the lease for the warehouse has a 20-year life which began in 2017. We have recorded rent expense pursuant to these agreements of approximately \$0.8 million and \$1.9 million, for the three and nine months ended July 31, 2018, respectively and \$0.3 million and \$0.9 million, respectively, for the comparable prior year periods. Commitments under these lease arrangements are included in our operating and capital lease commitments as disclosed in our Annual Report on Form 10-K for the year ended October 31, 2017.

**2. Inventories**

Inventories consisted of the following at July 31, 2018 and October 31, 2017:

	July 31, 2018	October 31, 2017
	(In thousands)	
Raw materials	\$50,564	\$ 50,472
Finished goods and work in process	40,615	40,087
Supplies and other	1,846	2,655
Total	93,025	93,214
Less: Inventory reserves	5,920	5,685
Inventories, net	\$87,105	\$ 87,529

Fixed costs related to excess manufacturing capacity, if any, have been expensed in the period they were incurred and, therefore, are not capitalized into inventory.

Our inventories at July 31, 2018 and October 31, 2017 were valued using the following costing methods:

	July 31, 2018	October 31, 2017
	(In thousands)	
LIFO	\$5,389	\$ 4,444
FIFO	81,716	83,085
Total	\$87,105	\$ 87,529

During interim periods, we estimate a LIFO reserve based on our expectations of year-end inventory levels and costs. If our calculations indicate that an adjustment at year-end will be required, we may record a proportionate share of this amount during the period. At year-end, we calculate the actual LIFO reserve and record an adjustment for the difference between the annual calculation and any estimates recognized during the interim periods. Because the interim projections are subject to many factors beyond our control, the results could differ significantly from the year-end LIFO calculation. We did not record an interim LIFO reserve adjustment for the nine months ended July 31, 2018 and 2017.

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

For inventories valued under the LIFO method, replacement cost exceeded the LIFO value by approximately \$1.1 million at July 31, 2018 and October 31, 2017.

## 3. Goodwill and Intangible Assets

## Goodwill

The change in the carrying amount of goodwill for the nine months ended July 31, 2018 was as follows:

	Nine Months Ended July 31, 2018 (In thousands)	
Beginning balance as of November 1, \$ 2017		222,194
Foreign currency translation adjustment	(607	)
Balance as of the end of the period	\$	221,587

At our last annual test date, August 31, 2017, we evaluated the recoverability of goodwill at each of our five reportable units with goodwill balances and determined that our goodwill was not impaired. For the reporting unit included in our NA Cabinet Components operating segment, we performed the first step of the goodwill impairment test at March 31, 2018, as our annual long-range planning effort produced lower forecasted results compared to the prior year's process, a potential indicator of impairment. We determined the fair value of this reporting unit exceeded its carrying value by approximately 4.5% as of March 31, 2018, a reduction from the 5.2% cushion at our August 31, 2017 testing date. As of July 31, 2018, there were no further indicators of impairment. Should our actual results for our NA Cabinet Components operating segment be lower than expected in the future, the corresponding goodwill could become impaired and the impairment could be material. The goodwill impairment testing process is more fully described in our Annual Report on Form 10-K for the year ended October 31, 2017. For a summary of the change in the carrying amount of goodwill by segment, see Note 13, "Segment Information", included herewith.

## Identifiable Intangible Assets

Amortizable intangible assets consisted of the following as of July 31, 2018 and October 31, 2017:

	July 31, 2018		October 31, 2017	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
	(In thousands)			
Customer relationships	\$154,768	\$ 56,744	\$155,230	\$ 48,479
Trademarks and trade names	55,912	31,972	56,058	29,509
Patents and other technology	22,304	17,197	22,624	16,146
Total	\$232,984	\$ 105,913	\$233,912	\$ 94,134

Pursuant to a change in estimate with regard to the remaining service lives of certain intangible assets, we recorded incremental amortization expense of \$0.3 million and \$1.6 million for the three and nine months ended July 31, 2017. See additional disclosure at Note 1, "Nature of Operations, Basis of Presentation and Significant Accounting Policies -

Restructuring."

During the nine months ended July 31, 2018, we retired identifiable intangible assets of \$0.3 million related to patents and other technology.

We had aggregate amortization expense related to intangible assets for the three and nine months ended July 31, 2018 of \$4.0 million and \$12.2 million, respectively, and \$4.4 million and \$14.3 million, respectively, for the comparable prior year periods.

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Estimated remaining amortization expense, based on current intangible balances, for each of the fiscal years ending October 31, is as follows (in thousands):

	Estimated Amortization Expense
2018 (remaining three months)	\$ 3,993
2019	15,361
2020	14,304
2021	12,583
2022	11,959
Thereafter	68,871
Total	\$ 127,071

## 4. Debt and Capital Lease Obligations

Debt consisted of the following at July 31, 2018 and October 31, 2017:

	July 31, 2018	October 31, 2017
	(In thousands)	
Revolving Credit Facility	\$66,000	\$84,000
Term Loan A	127,500	138,750
Capital lease obligations and other	17,945	18,764
Unamortized deferred financing fees	(1,671 )	(2,088 )
Total debt	\$209,774	\$239,426
Less: Current maturities of long-term debt	16,120	21,242
Long-term debt	\$193,654	\$218,184

As more fully described in our Annual Report on Form 10-K for the year ended October 31, 2017, we maintain a \$450.0 million credit agreement comprising a \$150.0 million Term Loan A and a \$300.0 million revolving credit facility (collectively, the "Credit Agreement"), with Wells Fargo Bank, National Association, as Agent, Swingline Lender and Issuing Lender, and Bank of America, N.A. serving as Syndication Agent. The Credit Agreement has a five-year term, maturing on July 29, 2021, and requires interest payments calculated, at our election and depending upon our Consolidated Leverage Ratio, at either a Base Rate plus an applicable margin or the LIBOR Rate plus an applicable margin. In addition, we are subject to commitment fees for the unused portion of the Credit Agreement. The applicable margin and commitment fees are outlined in the following table:

Pricing Level	Consolidated Leverage Ratio	Commitment Fee	LIBOR Rate Loans	Base Rate Loans
I	Less than or equal to 1.50 to 1.00	0.200%	1.50%	0.50%
II	Greater than 1.50 to 1.00, but less than or equal to 2.25 to 1.00	0.225%	1.75%	0.75%
III	Greater than 2.25 to 1.00, but less than or equal to 3.00 to 1.00	0.250%	2.00%	1.00%
IV	Greater than 3.00 to 1.00	0.300%	2.25%	1.25%

In the event of default, outstanding borrowings would accrue interest at the Default Rate, as defined, whereby the obligations will bear interest at a per annum rate equal to 2% above the total per annum rate otherwise applicable. The term loan portion of the Credit Agreement requires quarterly principal payments on the last business day of each fiscal quarter in accordance with a stated repayment schedule. Required aggregate principal repayments total \$15.0 million for the succeeding twelve-month period, and are included in the accompanying condensed consolidated balance sheet under the caption

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

“Current Maturities of Long-term Debt.” No stated principal payments are required under the revolving credit portion of the Credit Agreement, except upon maturity.

The Credit Agreement contains a: (1) Consolidated Fixed Charge Coverage Ratio requirement whereby we must not permit the Consolidated Fixed Charge Coverage Ratio, as defined, to be less than 1.10 to 1.00, and (2) Consolidated Leverage Ratio requirement, as summarized by period in the following table:

Period	Maximum Ratio
January 31, 2017 through January 30, 2018	3.25 to 1.00
January 31, 2018 and thereafter	3.00 to 1.00

In addition to maintaining these financial covenants, the Credit Agreement also limits our ability to enter into certain business transactions, such as to incur indebtedness or liens, to acquire businesses or dispose of material assets, make restricted payments, pay dividends and other transactions as further defined in the Credit Agreement. Substantially all of our domestic assets, with the exception of real property, are utilized as collateral for the Credit Agreement.

As of July 31, 2018, we had \$193.5 million of borrowings outstanding under the Credit Agreement (reduced by unamortized debt issuance costs of \$1.7 million), \$5.3 million of outstanding letters of credit and \$17.9 million outstanding primarily under capital leases. We had \$228.6 million available for use under the Credit Agreement at July 31, 2018. Outstanding borrowings under the Credit Agreement accrue interest at 4.08% per annum. Our weighted average borrowing rate for borrowings outstanding during the nine months ended July 31, 2018 and 2017 was 3.70% and 2.87%, respectively. We were in compliance with our debt covenants as of July 31, 2018.

**Other Debt Instruments**

Historically, we have maintained certain capital lease obligations related to equipment purchases. On February 20, 2017, we entered into a capital lease for warehouse space at HLP with a related-party company that is owned by our employee, the former owner of HLP. This new warehouse was anticipated at the time of the HLP acquisition in June 2015, and the lease was negotiated at arms-length. The lease accrues interest at 3.57% per annum, and extends for a twenty-year period through the year 2036. We recorded the leased asset at inception at fair value of \$16.6 million and recorded a corresponding liability for our obligation under this lease. We are recognizing interest expense using the effective interest method over the term. Our cash commitments under this lease are £0.9 million per year for an aggregate of £17.8 million (or approximately \$23.4 million). The cost and accumulated depreciation of property, plant and equipment under all outstanding capital leases at July 31, 2018 was \$22.9 million and \$3.2 million, respectively, including \$16.8 million and \$1.3 million, respectively, related to the HLP warehouse lease. Our total obligations under capital leases and other total \$17.9 million at July 31, 2018, of which \$1.6 million is classified in the current portion of long-term debt and \$16.3 million is classified as long-term debt on the accompanying unaudited condensed consolidated balance sheet. These obligations accrue interest at an average rate of 3.59%, and extend through the year 2036.

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 5. Retirement Plans

## Pension Plan

Our non-contributory, single employer defined benefit pension plan covers a majority of our employees in the United States excluding employees of recent acquisitions. Employees of acquired companies may be covered after a transitional period. The net periodic pension cost for this plan for the three and nine months ended July 31, 2018 and 2017 was as follows:

	Three Months Ended July 31, 2018		Nine Months Ended July 31, 2017	
	2018	2017	2018	2017
	(In thousands)			
Service cost	\$960	\$949	\$2,932	\$2,845
Interest cost	279	215	847	642
Expected return on plan assets	(543 )	(466 )	(1,630 )	(1,397 )
Amortization of net loss	7	144	49	430
Net periodic benefit cost	\$703	\$842	\$2,198	\$2,520

During 2017, we contributed \$3.6 million to fund our plan, and we expect to make a contribution to our plan in September 2018 of approximately \$0.8 million, which is in line with our policy to make the minimum annual contributions required while maintaining 100% percent funding.

## Other Plans

We also have a supplemental benefit plan covering certain executive officers and key employees and a non-qualified deferred compensation plan covering members of the Board of Directors and certain key employees. As of July 31, 2018 and October 31, 2017, our liability under the supplemental benefit plan was approximately \$3.9 million and \$3.4 million, respectively. The liability associated with the deferred compensation plan was approximately \$3.8 million and \$4.0 million as of July 31, 2018 and October 31, 2017, respectively. We record the current portion of liabilities associated with these plans under the caption "Accrued Liabilities," and the long-term portion under the caption "Other Liabilities" in the accompanying condensed consolidated balance sheets.

## 6. Warranty Obligations

We accrue warranty obligations as we recognize revenue associated with certain products. We make provisions for our warranty obligations based upon historical experience of costs incurred for such obligations adjusted, as necessary, for current conditions and factors. There are significant uncertainties and judgments involved in estimating our warranty obligations, including changing product designs, differences in customer installation processes and future claims experience which may vary from historical claims experience. Therefore, the ultimate amount we incur as warranty costs in the near and long-term may not be consistent with our current estimate.

A reconciliation of the activity related to our accrued warranty, including both the current and long-term portions (reported in accrued liabilities and other liabilities, respectively, on the accompanying condensed consolidated balance sheet) follows:

Nine  
Months  
Ended

	July 31, 2018 (In thousands)
Beginning balance as of November 1, 2017	\$ 323
Change in accrual for preexisting warranties	(11 )
Warranty costs paid	(15 )
Total accrued warranty as of the end of the period	\$ 297
Less: Current portion of accrued warranty	143
Long-term portion of accrued warranty	\$ 154

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 7. Income Taxes

To determine our income tax expense or benefit for interim periods, consistent with accounting standards, we apply the estimated annual effective income tax rate to year-to-date results. Our estimated annual effective tax rates for the nine months ended July 31, 2018 and 2017 were 23.7% and 31.4%, respectively, excluding discrete items. The change in the annual rate was due largely to the effect of the Tax Cuts and Jobs Act (the Act) which was signed into law on December 22, 2017.

The Act reduced our federal income tax statutory rate from 35.0% to 23.3% for the fiscal year ending October 31, 2018. Discrete items contributing to the income tax benefit for the nine months ended July 31, 2018 included \$7.7 million for the re-measurement of our deferred income tax assets and liabilities due to the decrease in the federal corporate income tax rate, a benefit of \$0.2 million for the true up of our accruals and related deferred taxes from prior year filings and settled tax audits, and a charge of \$0.1 million related to the vesting or exercise of equity-based compensation awards, partially offset by a tax expense of \$1.2 million for the one-time mandatory transition tax on deemed repatriation of previously tax-deferred and unremitted foreign earnings.

The following table reconciles our effective income tax benefit rate to the federal statutory rate of 23.3% and 35.0% for the nine months ended July 31, 2018 and 2017, respectively:

	Nine months ended July 31,	
	2018	2017
United States tax at statutory rate	23.3 %	35.0 %
State and local income tax	2.8	1.5
Non-United States income tax	(0.7 )	(7.8 )
Other permanent differences	(1.8 )	1.9
Deferred rate impact of enactment of tax reform	(44.9)	—
Tax impact of stock based compensation	0.8	—
Impact of deemed repatriation	7.1	—
Return to actual adjustments	(1.3 )	0.8
Effective tax benefit rate	(14.7)%	31.4 %

The United States statutory rate of 23.3% reflects the period November 1, 2017 to December 31, 2017 at the previous 35.0% rate and the period January 1, 2018 to October 31, 2018 at the new 21.0% rate.

Given the significance of the Act, the SEC staff issued Staff Accounting Bulletin No. 118 (SAB 118), which allows registrants to record provisional amounts during a one year “measurement period”. During the measurement period, impacts of the Act are expected to be recorded at the time a reasonable estimate for all or a portion of the effects can be made, and provisional amounts can be recognized and adjusted as information becomes available, prepared or analyzed. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements. If a company cannot determine a provisional estimate to be included in the financial statements, it should continue to apply ASC 740 on the basis of the provisions of the tax laws that were in effect immediately before the enactment of the Act.

As of July 31, 2018, we have not completed the accounting for the tax effects of the Act. However, we have made an initial assessment of the Act and recorded a discrete benefit of \$6.5 million during the nine months ended July 31, 2018. We believe that our assessment of the re-measurement of our deferred income tax assets and liabilities to be

complete, while we consider our tax expense related to the one-time mandatory transition tax on deemed repatriation of previously tax-deferred and unremitted foreign earnings and our tax benefit of stock based compensation to be provisional. At this time, our estimate does not reflect changes in current interpretations of compensation deduction limitations, effects of any state tax law changes and uncertainties regarding interpretations that may arise as a result of federal tax reform. Any additional impact of the enactment of the Act will be recorded as they are identified during the one-year measurement period provided for in SAB 118.

In light of the Act, we repatriated \$2.8 million of excess cash from our insulating glass spacer division in the United Kingdom during the nine months ended July 31, 2018. This was repatriation of excess cash that was a portion of the one-time mandatory transition tax discussed above. We will continue to evaluate our foreign cash position and may repatriate additional foreign earnings in the future. With the exception of the one-time mandatory transition tax on deemed repatriation of previously tax-deferred and

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QUANEX BUILDING PRODUCTS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

unremitted foreign earnings, we do not anticipate any material tax impact from any potential repatriation of previously unremitted foreign earnings.

As of July 31, 2018, our liability for uncertain tax positions (UTP) of \$0.6 million relates to certain state tax items regarding the interpretation of tax laws and regulations. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. The final outcome of the future tax consequences of legal proceedings, if any, as well as the outcome of competent authority proceedings, changes in regulatory tax laws, or interpretation of those tax laws could impact our financial statements. We are subject to the effect of these matters occurring in various jurisdictions. The disallowance of the UTP would not materially affect the annual effective tax rate. We do not believe any of the UTP at July 31, 2018 will be recognized within the next twelve months.

We evaluate the likelihood of realization of our deferred tax assets by considering both positive and negative evidence. We believe there is no need for a valuation allowance of the federal net operating losses. We will continue to evaluate our position throughout the year. We maintain a valuation allowance for certain state net operating losses which totaled \$1.3 million at July 31, 2018.

8. Contingencies

Remediation and Environmental Compliance Costs

Under applicable state and federal laws, we may be responsible for, among other things, all or part of the costs required to remove or remediate wastes or hazardous substances at locations we, or our predecessors, have owned or operated. From time to time, we also have been alleged to be liable for all or part of the costs incurred to clean up third-party sites where there might have been an alleged improper disposal of hazardous substances. At present, we are not involved in any such matters.

From time to time, we incur routine expenses and capital expenditures associated with compliance with existing environmental regulations, including control of air emissions and water discharges, and plant decommissioning costs. We have not incurred any material expenses or capital expenditures related to environmental matters during the past three fiscal years, and do not expect to incur a material amount of such costs in fiscal 2018. While we will continue to have future expenditures related to environmental matters, any such amounts are impossible to reasonably estimate at this time. Based upon our experience to date, we do not believe that our compliance with environmental requirements will have a material adverse effect on our operations, financial condition or cash flows.

Litigation

From time to time, we, along with our subsidiaries, are involved in various litigation matters arising in the ordinary course of our business, including those arising from or related to contractual matters, commercial disputes, intellectual property, personal injury, environmental matters, product performance or warranties, product liability, insurance coverage and personnel and employment disputes.

We regularly review with legal counsel the status of all ongoing proceedings, and we maintain insurance against these risks to the extent deemed prudent by our management and to the extent such insurance is available. However, there is no assurance that we will prevail in these matters or that our insurers will accept full coverage of these matters, and we could, in the future, incur judgments, enter into settlements of claims, or revise our expectations regarding the outcome or insurability of matters we face, which could materially impact our results of operations.

We have been and are currently party to multiple claims, some of which are in litigation, relating to alleged defects in a commercial sealant product that was manufactured and sold during the 2000's. During the nine months ended July 31, 2018 and 2017, our insurance carrier reimbursed fees and expenses originally incurred as part of our defense of these various commercial sealant claims totaling \$0.5 million and \$2.0 million, respectively. While we believe that

our product was not defective and that we would prevail in these commercial sealant product claims if taken to trial, the timing, ultimate resolution and potential impact of these claims is not currently determinable. Nevertheless, after taking into account all currently available information, including our defenses, the advice of our counsel, and the extent and currently-expected availability of our existing insurance coverage, we believe that the eventual outcome of these commercial sealant claims will not have a material adverse effect on our overall financial condition, results of operations or cash flows, and we have not recorded any accrual with regard to these claims.

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 9. Derivative Instruments

Our derivative activities are subject to the management, direction, and control of the Chief Financial Officer and Chief Executive Officer. Certain transactions in excess of specified levels require further approval from the Board of Directors.

The nature of our business activities requires the management of various financial and market risks, including those related to changes in foreign currency exchange rates. We have historically used foreign currency forwards and options to mitigate or eliminate certain of those risks at our subsidiaries. We use foreign currency contracts to offset fluctuations in the value of accounts receivable and accounts payable balances that are denominated in currencies other than the United States dollar, including the Euro, British Pound and Canadian Dollar. Currently, we do not enter into derivative transactions for speculative or trading purposes. We are exposed to credit loss in the event of nonperformance by the counterparties to our derivative transactions. We attempt to mitigate this risk by monitoring the creditworthiness of our counterparties and limiting our exposure to individual counterparties. In addition, we have established master netting agreements in certain cases to facilitate the settlement of gains and losses on specific derivative contracts.

We have not designated any of our derivative contracts as hedges for accounting purposes in accordance with the provisions under the Accounting Standards Codification Topic 815 "Derivatives and Hedging" (ASC 815). Therefore, changes in the fair value of these contracts and the realized gains and losses are recorded in the unaudited condensed consolidated statements of income (loss) for the three and six months ended July 31, 2018 and 2017 as follows (in thousands):

	Three Months Ended July 31, 2018	2017	Nine Months Ended July 31, 2018	2017
Location of gains (losses):				
Other, net	Foreign currency derivatives	\$11 \$(323)	\$(18)	\$(213)

We have chosen not to offset any of our derivative instruments in accordance with the provisions of ASC 815.

Therefore, the assets and liabilities are presented on a gross basis on the accompanying condensed consolidated balance sheets. Less than \$0.1 million of fair value related to foreign currency derivatives was included in prepaid and other current assets as of October 31, 2017. Less than \$0.1 million of fair value related to foreign currency derivatives was included in accrued liabilities as of July 31, 2018 and October 31, 2017.

The following table summarizes the notional amounts and fair value of outstanding derivative contracts at July 31, 2018 and October 31, 2017 (in thousands):

	Notional as indicated		Fair Value in \$	
	July 31, 2018	October 31, 2017	July 31, 2018	October 31, 2017
Foreign currency derivatives:				
Sell EUR, buy USD	EUR \$138	\$ 1,271	\$—	\$ 24
Sell CAD, buy USD	CAD314	320	(1)	1
Sell GBP, buy USD	GBP 123	75	—	—
Buy EUR, sell GBP	EUR 48	30	—	(1)
Buy USD, sell EUR	USD 17	—	—	—



For the classification in the fair value hierarchy, see Note 10, "Fair Value Measurement of Assets and Liabilities", included herewith.

#### 10. Fair Value Measurement of Assets and Liabilities

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market data developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to Level 1 and the lowest priority to Level 3. The three levels of the fair value hierarchy are described below:

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QUANEX BUILDING PRODUCTS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2 - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly or indirectly including quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates) and inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 - Inputs that are both significant to the fair value measurement and unobservable.

As of July 31, 2018 and October 31, 2017, foreign currency derivatives were the only instruments being measured on a recurring basis. Less than \$0.1 million of foreign currency derivatives were included in total liabilities as of July 31, 2018 and less than \$0.1 million of foreign currency derivatives were included in total assets and total liabilities as of October 31, 2017. All of our derivative contracts are valued using quoted market prices from brokers or exchanges and are classified within Level 2 of the fair value hierarchy.

We have recorded land totaling approximately \$2.4 million at fair value on a non-recurring basis which is classified as a Level 3 measurement as of July 31, 2018 and October 31, 2017. The fair value was based on broker opinions received during the fourth fiscal quarter of the year ended October 31, 2017.

Carrying amounts reported on the balance sheet for cash, cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term maturity of these instruments. Our outstanding debt is variable rate debt that re-prices frequently, thereby limiting our exposure to significant change in interest rate risk. As a result, the fair value of our debt instruments approximates carrying value at July 31, 2018, and October 31, 2017 (Level 3 measurement).

#### 11. Stock-Based Compensation

We have established and maintain an Omnibus Incentive Plan (2008 Plan) that provides for the granting of restricted stock awards, stock options, restricted stock units, performance share awards, performance restricted stock units, and other stock-based and cash-based awards. The 2008 Plan is administered by the Compensation and Management Development Committee of the Board of Directors.

The aggregate number of shares of common stock authorized for grant under the 2008 Plan is 7,650,000 as approved by shareholders. Any officer, key employee and/or non-employee director is eligible for awards under the 2008 Plan. We grant restricted stock units to non-employee directors on the first business day of each fiscal year. As approved by the Compensation & Management Development Committee of our Board of Directors annually, we grant a mix of stock options, restricted stock awards, performance shares and/or performance restricted stock units to officers, management and key employees. Occasionally, we may make additional grants to key employees at other times during the year.

#### Restricted Stock Awards

Restricted stock awards are granted to key employees and officers annually, and typically cliff vest over a three year period with service and continued employment as the only vesting criteria. The recipient of the restricted stock award is entitled to all of the rights of a shareholder, except that the award is nontransferable during the vesting period. The fair value of the restricted stock award is established on the grant date and then expensed over the vesting period resulting in an increase in additional paid-in-capital. Shares are generally issued from treasury stock at the time of grant.



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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

A summary of non-vested restricted stock awards activity during the nine months ended July 31, 2018 is presented below:

	Restricted Stock Awards	Weighted Average Grant Date Fair Value per Share
Non-vested at October 31, 2017	284,300	\$ 19.66
Granted	73,400	20.70
Cancelled	(28,700 )	19.66
Vested	(111,800)	20.16
Non-vested at July 31, 2018	217,200	\$ 19.76

The total weighted average grant-date fair value of restricted stock awards that vested during each of the nine month periods ended July 31, 2018 and 2017 was \$2.3 million and \$1.3 million, respectively. As of July 31, 2018, total unrecognized compensation cost related to unamortized restricted stock awards was \$1.9 million. We expect to recognize this expense over the remaining weighted average vesting period of 1.8 years.

**Stock Options**

Historically, stock options have been awarded to key employees, officers and non-employee directors. Effective May 2015, the director compensation structure was revised to eliminate the annual grant of stock options to non-employee directors. Employee stock options typically vest ratably over a three-year period with service and continued employment as the vesting conditions. Our stock options may be exercised up to a maximum of ten years from the date of grant. The fair value of the stock options is determined on the grant date and expensed over the vesting period resulting in an increase in additional paid-in-capital. For employees who are nearing retirement-eligibility, we recognize stock option expense ratably over the shorter of the vesting period or the period from the grant-date to the retirement-eligibility date. During December 2017, the Compensation & Management Committee of the Board of Directors approved a change to the long-term incentive award program eliminating the grant of stock options and replacing this award with a grant of performance restricted stock units as further described below.

We use a Black-Scholes pricing model to estimate the fair value of stock options. A description of the methodology for the valuation assumptions was disclosed in our Annual Report on Form 10-K for the fiscal year ended October 31, 2017.

The following table provides a summary of assumptions used to estimate the fair value of our stock options issued during the nine months ended July 31, 2017.

	Nine Months Ended April 30, 2017
Weighted-average expected volatility	34.7%
Weighted-average expected term (in years)	5.7
Risk-free interest rate	2.0%
Expected dividend yield over expected term	1.0%
Weighted average grant date fair value	\$6.25

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table summarizes our stock option activity for the nine months ended July 31, 2018:

	Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (000s)
Outstanding at October 31, 2017	2,152,758	\$ 17.44		
Granted	—	—		
Exercised	(277,899 )	19.50		
Forfeited/Expired	(67,084 )	18.69		
Outstanding at July 31, 2018	1,807,775	\$ 18.00	4.9	\$ 1,760
Vested or expected to vest at July 31, 2018	1,807,775	\$ 18.00	4.9	\$ 1,760
Exercisable at July 31, 2018	1,543,965	\$ 17.76	4.4	\$ 1,759

Intrinsic value is the amount by which the market price of the common stock on the date of exercise exceeds the exercise price of the stock option. The total intrinsic value of stock options exercised during the nine months ended July 31, 2018 and 2017 was \$2.0 million and \$2.5 million. The weighted-average grant date fair value of stock options that vested during the nine months ended July 31, 2018 and 2017 was \$1.5 million and \$1.8 million, respectively. As of July 31, 2018, total unrecognized compensation cost related to stock options was \$0.4 million. We expect to recognize this expense over the remaining weighted average vesting period of 1.1 years.

**Restricted Stock Units**

Restricted stock units may be awarded to key employees and officers from time to time, and annually to non-employee directors. The non-employee director restricted stock units vest immediately but are payable only upon the director's cessation of service unless an election is made by the non-employee director to settle and pay the award on an earlier specified date. Restricted stock units awarded to employees and officers typically cliff vest after a three-year period with service and continued employment as the vesting conditions. Restricted stock units are not considered outstanding shares and do not have voting rights, although the holder does receive a cash payment equivalent to the dividend paid, on a one-for-one basis, on our outstanding common shares. Once the criteria is met, each restricted stock unit is payable to the holder in cash based on the market value of one share of our common stock. Accordingly, we record a liability for the restricted stock units on our balance sheet and recognize any changes in the market value during each reporting period as compensation expense.

As of July 31, 2018, there were no non-vested restricted stock units. During the nine month periods ended July 31, 2018 and 2017, non-employee directors received 18,050 and 24,560 restricted stock units, respectively, at a grant date fair value of \$21.85 per share and \$15.65 per share, respectively, which vested immediately. During the nine month periods ended July 31, 2018 and 2017, there were no payments to settle restricted stock units.

**Performance Share Awards**

We have awarded annual grants of performance shares to key employees and officers. These awards cliff vest after a three-year period with service and performance measures (relative total shareholder return (R-TSR) and earnings per share (EPS) growth), as vesting conditions. However, the number of shares earned is variable depending on the metrics achieved, and the settlement method is 50% in cash and 50% in our common stock.

To account for these awards, we have bifurcated the portion subject to a market condition (relative total shareholder return) and the portion subject to an internal performance measure (earnings per share growth). We have further bifurcated these awards based on the settlement method, as the portion expected to settle in stock (equity component) and the portion expected to settle in cash (liability component).

To value the shares subject to the market condition, we utilized a Monte Carlo simulation model to arrive at a grant-date fair value. This amount will be expensed over the three-year term of the award with a credit to additional paid-in-capital. To value the shares subject to the internal performance measure, we used the value of our common stock on the date of grant as the grant-date fair value per share. This amount is being expensed over the three-year term of the award, with a credit to additional paid-in-capital, and could fluctuate depending on the number of shares ultimately expected to vest based on our assessment of the probability that the performance conditions will be achieved. For both performance conditions, the portion of the award expected to settle in cash is recorded as a liability and is being marked to market over the three-year term of the award, and can fluctuate

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

depending on the number of shares ultimately expected to vest. Depending on the achievement of the performance conditions, 0% to 200% of the awarded performance shares may ultimately vest.

The following table summarizes our performance share grants and the grant date fair value for the EPS and R-TSR performance metrics:

Grant Date	Grant Date Fair Value			Shares Forfeited
	Shares Awarded	EPS	R-TSR	
December 2, 2015	158,100	\$19.31	\$23.72	18,936
January 25, 2016	4,300	17.46	26.65	—
November 30, 2016	186,500	19.45	26.61	17,940
December 7, 2017	146,500	\$20.70	\$21.81	10,848

On December 3, 2017, 123,600 shares vested pursuant to the December 2014 grant, resulting in the issuance of 25,340 shares of common stock and a cash payment of \$0.6 million. The November 2016 and December 2017 grants include a return on invested capital (ROIC) metric which, if achieved, could enhance the number of shares that are ultimately issued but cannot exceed the maximum (200%). Due to the uncertainty with regard to achieving this metric, no value has been assigned. In the event and at such time the metric is deemed achievable, compensation expense will begin to be recognized through the remaining vesting period. During the three months ended July 31, 2018, we recorded compensation expense of \$0.4 million related to the current portion of outstanding performance share grants which will vest in future years. During the nine months ended July 31, 2018, we recorded a decrease in compensation expense of \$1.2 million, which reflects a decrease in the number of shares expected to vest in December 2018 associated with the December 2, 2015 performance share grant. During the three and nine months ended July 31, 2017, we recorded compensation expense of \$1.0 million and \$2.7 million related to our performance share awards. Performance share awards are not considered outstanding shares and do not have voting rights, although dividends are accrued over the performance period and will be payable in cash based upon the number of performance shares ultimately earned.

The performance shares are excluded from the diluted weighted-average shares used to calculate earnings per share until the performance criteria is probable to result in the issuance of contingent shares. As of July 31, 2018, we have deemed no shares related to the December 2015 and January 2016 grants of performance shares as probable to vest.

**Performance Restricted Stock Units**

We awarded performance restricted share units to key employees and officers in December 2017. These awards cliff vest upon a three-year service period with the absolute total shareholder return of our common stock over this three-year term as the vesting criteria. The number of shares earned is variable depending on the metric achieved, and the settlement method is 100% in our common stock, with accrued dividends paid in cash at the time of vesting, assuming the shares had been outstanding throughout the performance period.

To value the shares, we utilized a Monte Carlo simulation model to arrive at a grant-date fair value. This amount will be adjusted for forfeitures and expensed over the three-year term of the award with a credit to additional paid-in-capital. Depending on the achievement of the performance conditions, a minimum of 0% and a maximum of 150% of the awarded performance restricted stock units may vest. Specifically, the awards vest on a continuum with the following Absolute Total Shareholder Return (A-TSR) milestones:

Vesting Level	Vesting Criteria	Percentage of Award Vested
Level 1	A-TSR greater than or equal to 50%	150%
Level 2	A-TSR less than 50% and greater than or equal to 20%	100%

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Level 3 A-TSR less than 20% and greater than or equal to -20% 50%

Level 4 A-TSR less than -20% —%

On December 7, 2017, we awarded 78,200 performance restricted share units with a grant date fair value of \$17.76 per share. During the nine months ended July 31, 2018, 5,789 of the performance restricted share units were forfeited. During the three and

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

nine months ended July 31, 2018, we recorded compensation expense of approximately \$0.1 million and \$0.2 million, respectively, related to our performance share restricted units.

Similar to performance shares, the performance restricted stock units are not considered outstanding shares, do not have voting rights, and are excluded from diluted weighted-average shares used to calculate earnings per share until the performance criteria is probable to result in the issuance of contingent shares.

Treasury Shares

We record treasury stock purchases under the cost method whereby the entire cost of the acquired stock is recorded as treasury stock. Shares are generally issued from treasury stock at the time of grant of restricted stock awards, and upon the exercise of stock options and upon the vesting of performance shares and performance restricted stock units. On the subsequent issuance of treasury shares, we record proceeds in excess of cost as an increase in additional paid in capital. A deficiency of such proceeds relative to costs would be applied to reduce paid-in-capital associated with prior issuances to the extent available, with the remainder recorded as a charge to retained earnings. We recorded a charge to retained earnings of \$1.3 million during the nine months ended July 31, 2018.

The following table summarizes the treasury stock activity during the nine months ended July 31, 2018:

	Nine Months Ended July 31, 2018
Beginning balance as of November 1, 2017	2,670,743
Restricted stock awards granted	(73,400 )
Performance share awards vested	(25,340 )
Stock options exercised	(277,899 )
Balance at July 31, 2018	2,294,104

12. Other (Expense) Income

Other (expense) income, included under the caption "Other, net" on the accompanying condensed consolidated statements of income, consisted of the following for the three and nine months ended July 31, 2018 and 2017:

	Three Months Ended July 31, 2018		Nine Months Ended July 31, 2017	
	2018	2017	2018	2017
	(In thousands)			
Foreign currency transaction (losses) gains	\$(90)	\$362	\$106	\$727
Foreign currency derivative gains (losses)	11	(323 )	(18 )	(213 )
Interest income	14	22	54	68
Other	3	(15 )	8	(10 )
Other, net	\$(62)	\$46	\$150	\$572

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QUANEX BUILDING PRODUCTS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

13. Segment Information

We present three reportable business segments in accordance with Topic 280-10-50, "Segment Reporting" (ASC 280): (1) North American Engineered Components segment ("NA Engineered Components"), comprising four operating segments primarily focused on the fenestration market in North America including vinyl profiles, insulating glass (IG) spacers, screens & other fenestration components; (2) European Engineered Components segment ("EU Engineered Components"), comprising our United Kingdom-based vinyl extrusion business, manufacturing vinyl profiles & conservatories, and the European insulating glass business manufacturing IG spacers; and (3) North American Cabinet Components segment ("NA Cabinet Components"), comprising solely the North American cabinet door and components business acquired in November 2015. We maintain an Unallocated Corporate & Other grouping which includes LIFO inventory adjustments, corporate office charges, and inter-segment eliminations, less an allocation of a portion of the general and administrative costs associated with the corporate office which have been allocated to the reportable business segments, based upon a relative measure of profitability, in order to more accurately reflect each reportable business segment's administrative cost. Certain costs are not allocated to the reportable operating segments, but remain in Unallocated Corporate & Other, including transaction expenses, stock-based compensation, long-term incentive awards based on the performance of our common stock and other factors, certain severance and legal costs not deemed to be allocable to all segments, depreciation of corporate assets, interest expense, other, net, income taxes and inter-segment eliminations. The accounting policies of our operating segments are the same as those used to prepare the accompanying condensed consolidated financial statements. Corporate general and administrative expense allocated during the three and nine month periods ended July 31, 2018 were \$5.3 million and \$15.3 million, respectively, and \$4.6 million and \$13.2 million, respectively, for the prior year comparable periods.

ASC 280 permits aggregation of operating segments based on factors including, but not limited to: (1) similar nature of products serving the building products industry, primarily the fenestration business; (2) similar production processes, although there are some differences in the amount of automation amongst operating plants; (3) similar types or classes of customers, namely the primary OEMs; (4) similar distribution methods for product delivery, although the extent of the use of third-party distributors will vary amongst the businesses; (5) similar regulatory environment; and (6) converging long-term economic similarities.

Segment information for the three and nine months ended July 31, 2018 and 2017, and total assets as of July 31, 2018 and October 31, 2017 are summarized in the following table (in thousands):

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

	NA Eng. Comp.	EU Eng. Comp.	NA Cabinet Comp.	Unallocated Corp. & Other	Total
Three Months Ended July 31, 2018					
Net sales	\$133,397	\$42,661	\$65,114	\$ (1,351 )	\$239,821
Depreciation and amortization	6,741	2,352	3,432	166	12,691
Operating income (loss)	12,270	3,934	3,340	(2,457 )	17,087
Capital expenditures	3,391	698	1,792	4	5,885
Three Months Ended July 31, 2017					
Net sales	\$126,446	\$40,359	\$63,839	\$ (1,277 )	\$229,367
Depreciation and amortization	7,899	2,391	3,491	134	13,915
Operating income (loss)	11,822	3,804	1,705	21	17,352
Capital expenditures	5,068	1,770	2,476	234	9,548
Nine Months Ended July 31, 2018					
Net sales	\$350,280	\$115,481	\$183,705	\$ (3,767 )	\$645,699
Depreciation and amortization	20,561	7,328	10,957	428	39,274
Operating income (loss)	19,442	7,674	665	(3,047 )	24,734
Capital expenditures	10,855	4,562	5,563	118	21,098
Nine Months Ended July 31, 2017					
Net sales	\$343,694	\$106,133	\$188,359	\$ (3,780 )	\$634,406
Depreciation and amortization	26,377	6,753	10,160	411	43,701
Operating income (loss)	15,861	8,944	2,880	(9,549 )	18,136
Capital expenditures	14,468	6,721	5,473	436	27,098
As of July 31, 2018					
Total assets	\$248,678	\$216,132	\$279,872	\$ 6,841	\$751,523
As of October 31, 2017					
Total assets	\$258,315	\$219,622	\$285,457	\$ 10,485	\$773,879

The following table summarizes the change in the carrying amount of goodwill by segment for the nine months ended July 31, 2018 (in thousands):

	NA Eng. Comp.	EU Eng. Comp.	NA Cabinet Comp.	Unallocated Corp. & Other	Total
Balance as of October 31, 2017	\$38,712	\$69,735	\$113,747	\$	—\$222,194
Foreign currency translation adjustment	—	(607 )	—	—	(607 )
Balance as of July 31, 2018	\$38,712	\$69,128	\$113,747	\$	—\$221,587

For further details of Goodwill, see Note 4, "Goodwill & Intangible Assets", located herewith.

We did not allocate non-operating loss or income tax benefit to the reportable segments. The following table reconciles operating loss as reported above to net income for the three and nine months ended July 31, 2018 and 2017:

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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

	Three Months Ended July 31, 2018		Nine Months Ended July 31, 2017	
	2018	2017	2018	2017
	(In thousands)			
Operating income	\$17,087	\$17,352	\$24,734	\$18,136
Interest expense	(2,641 )	(2,575 )	(7,584 )	(7,126 )
Other, net	(62 )	46	150	572
Income tax (expense) benefit	(3,631 )	(4,608 )	2,536	(3,631 )
Net income	\$10,753	\$10,215	\$19,836	\$7,951

## Product Sales

We produce a wide variety of products that are used in the fenestration industry, including window and door systems; accessory trim profiles with real wood veneers and wood grain laminate finishes; window spacer systems; extruded vinyl products; metal fabrication; and astragals, thresholds and screens. In addition, we produce certain non-fenestration products, including kitchen and bath cabinet doors and components, trim moldings, solar edge tape, plastic decking, fencing, water retention barriers, conservatory roof components, and other products.

The following table summarizes our product sales for the three and nine months ended July 31, 2018 and 2017 into general groupings by segment to provide additional information to our shareholders.

	Three months ended July 31, 2018		Nine Months Ended July 31, 2017	
	2018	2017	2018	2017
	(In thousands)			
NA Engineered Components:				
United States - fenestration	\$112,914	\$107,193	\$297,700	\$289,231
International - fenestration	11,851	9,959	27,758	24,945
United States - non-fenestration	4,675	7,060	13,518	19,590
International - non-fenestration	3,957	2,234	11,304	9,928
	\$133,397	\$126,446	\$350,280	\$343,694
EU Engineered Components:				
United States - fenestration	\$—	\$190	\$—	\$304
International - fenestration	34,881	35,087	97,597	94,528
International - non-fenestration	7,780	5,082	17,884	11,301
	\$42,661	\$40,359	\$115,481	\$106,133
NA Cabinet Components:				
United States - fenestration	\$3,650	\$4,322	\$10,500	\$12,316
United States - non-fenestration	60,843	59,237	171,547	174,404
International - non-fenestration	621	280	1,658	1,639
	\$65,114	\$63,839	\$183,705	\$188,359
Unallocated Corporate & Other				
Eliminations	\$(1,351 )	\$(1,277 )	\$(3,767 )	\$(3,780 )
	\$(1,351 )	\$(1,277 )	\$(3,767 )	\$(3,780 )
Net sales	\$239,821	\$229,367	\$645,699	\$634,406



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## QUANEX BUILDING PRODUCTS CORPORATION

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 14. Earnings Per Share

We compute basic earnings (loss) per share by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted earnings per common and potential common shares include the weighted average of additional shares associated with the incremental effect of dilutive employee stock options, non-vested restricted stock as determined using the treasury stock method prescribed by U.S. GAAP and contingent shares associated with performance share awards, if dilutive.

Basic and diluted earnings per share for the each of the three and nine months ended July 31, 2018 and 2017 were calculated as follows (in thousands, except per share data):

	Three Months Ended July 31, 2018		
	Net Income	Weighted Average Shares	Per Share
Basic earnings per common share	\$10,753	34,840	\$0.31
Effect of dilutive securities:			
Stock options		171	
Restricted stock awards		109	
Diluted earnings per common share	\$10,753	35,120	\$0.31
	Three Months Ended July 31, 2017		
	Net Income	Weighted Average Shares	Per Share
Basic earnings per common share	\$10,215	34,224	\$0.30
Effect of dilutive securities:			
Stock options		495	
Restricted stock awards		143	
Performance shares		62	
Diluted earnings per common share	\$10,215	34,924	\$0.29
	Nine Months Ended July 31, 2018		
	Net Income	Weighted Average Shares	Per Share
Basic earnings per common share	\$19,836	34,766	\$0.57
Effect of dilutive securities:			
Stock options		226	
Restricted stock awards		133	
Diluted earnings per common share	\$19,836	35,125	\$0.56
	Nine Months Ended July 31, 2017		

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	Net	Weighted	Per
	Income	Average	Share
		Shares	
Basic earnings per common share	\$7,951	34,141	\$0.23
Effect of dilutive securities:			
Stock options		440	
Restricted stock awards		128	
Performance shares		62	
Diluted earnings per common share	\$7,951	34,771	\$0.23

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QUANEX BUILDING PRODUCTS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

We had common stock equivalents that were potentially dilutive in future earnings per share calculations of 1,015,946 and 972,606 for the three and nine months ended July 31, 2018, respectively, and 411,450 and 839,150, respectively, for the prior year comparable periods. Such dilution will be dependent on the excess of the market price of our stock over the exercise price and other components of the treasury stock method.

15. New Accounting Guidance

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-02, Leases (Topic 842): Amendments to the Accounting Standards Codification. These amendments replace current guidance and require the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous U.S. GAAP. The amendments apply to any entity that enters into leasing arrangements. This guidance becomes effective for fiscal years beginning after December 15, 2018, and, therefore, we will adopt this pronouncement in fiscal 2020. We are currently evaluating the impact of this pronouncement on our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. This guidance prescribes a methodology to determine when revenue is recognizable and constitutes a principles-based approach to revenue recognition based on the consideration to which the entity expects to be entitled in exchange for goods or services. In addition, this guidance requires additional disclosure in the notes to the financial statements with regard to the methodology applied. This pronouncement will essentially supersede and replace existing revenue recognition rules in U.S. GAAP, including industry-specific guidance. We will adopt this guidance using the modified retrospective approach in the first quarter of 2019 with a cumulative adjustment to retained earnings.

As of July 31, 2018, we have completed the evaluation of our revenue streams and have reviewed a sample of customer contracts that we believe fairly represent contract traits that could be accounted for differently under amended guidance. We have begun evaluating the potential impact of the new revenue standard on each of the selected contracts including: (i) estimating the contract consideration under the new standard, (ii) identifying the performance obligations within the customer contracts, (iii) calculating the anticipated allocation of contract consideration to each performance obligation, (iv) determining the timing of revenue recognition for each performance obligation, and (v) determining the classification of the contract revenue for disclosure purposes. Based on the contract reviews and evaluations performed to date, we do not currently anticipate any material impacts from implementing the amended guidance.

In July 2015, the FASB issued ASU No. 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. This amendment simplifies the subsequent measurement of inventories by replacing the lower of cost or market revaluation method with the lower of cost and net realizable value test. This guidance is applicable to all inventories measured using methods other than last-in first-out method and the retail inventory method. We adopted the provisions of ASU 2016-09 effective November 1, 2017, with no material impact on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This guidance prescribes the presentation of excess tax benefits or deficiencies derived from book and tax timing differences associated with stock-based compensation arrangements and certain related statement of cash flow implications. We adopted the provisions of ASU 2016-09 effective November 1, 2017, as noted below with no significant impact on our consolidated financial statements.

Excess tax benefits or deficiencies for share-based payments are to be recorded in the income tax provision, rather than as an adjustment to additional paid-in-capital. We made this change on a prospective basis;

•



Cash flows related to excess tax benefits or deficiencies are included in net cash provided by operating activities rather than as a financing activity. We adopted this change retrospectively, which resulted in an increase to net cash provided by operating activities and a corresponding decrease to net cash provided by financing activities of less than \$0.2 million for the nine months ended July 31, 2017;

Cash paid to taxing authorities when withholding shares from an employee's vesting or exercise of equity-based compensation awards for tax-withholding purposes is to be classified as net cash used in financing activities rather than as an operating activity. We adopted this change retrospectively, which resulted in an increase to net cash provided by operating activities and a corresponding decrease to net cash provided by financing activities of \$1.0 million for the nine months ended July 31, 2017;

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QUANEX BUILDING PRODUCTS CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

• We elected to continue to withhold shares associated with stock-based compensation vesting or exercises to satisfy the minimum statutory tax withholding requirements, rather than electing to withhold at a higher rate; and

• We elected to continue to estimate forfeitures rather than account for forfeitures as they occur.

In February 2018, the FASB issued ASU 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. This amendment requires disclosure of the accounting policy for releasing income tax effects from accumulated other comprehensive income. It also provides an option for entities to reclassify the income tax effects of the Tax Cuts and Jobs Act from accumulated other comprehensive income to retained earnings. We elected to early adopt this ASU effective November 1, 2017. We record income tax effects related to our unrecognized pension obligations in accumulated other comprehensive income as discussed in our Annual Report on Form 10-K for the year ended October 31, 2017. We have not elected to reclassify the income tax effects of the Tax Cuts and Jobs Act from accumulated other comprehensive income to retained earnings.

16. Subsequent Events

On August 30, 2018, our Board of Directors approved a stock repurchase program that authorized the repurchase of up to \$60.0 million worth of shares of our common stock. Repurchases under the new program will be made in open market transactions or privately negotiated transactions, subject to market conditions, applicable legal requirements and other relevant factors. The program does not have an expiration date or a limit on the number of shares that may be purchased.

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Unless the context indicates otherwise, references to "Quanex", the "Company", "we", "us" and "our" refer to the consolidated business operations of Quanex Building Products Corporation and its subsidiaries.

### Cautionary Note Regarding Forward-Looking Statements

Certain of the statements contained in this document and in documents incorporated by reference herein, including those made under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" are "forward-looking" statements as defined under the Private Securities Litigation Reform Act of 1995. Generally, the words "expect," "believe," "intend," "estimate," "anticipate," "project," "will" and similar expressions identify forward-looking statements, which generally are not historical in nature. Forward looking statements are (1) all statements which address future operating performance, (2) events or developments that we expect or anticipate will occur in the future, including statements relating to volume, sales, operating income and earnings per share, and (3) statements expressing general outlook about future operating results. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our historical experience and our current projections or expectations. As and when made, we believe that these forward-looking statements are reasonable. However, caution should be taken not to place undue reliance on any such forward-looking statements since such statements speak only as of the date when made and there can be no assurance that such forward-looking statements will occur. We are not obligated to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Factors that could cause actual results to differ materially from those expressed or implied by the forward-looking statements include, but are not limited to the following:

- changes in market conditions, particularly in the new home construction, and residential remodeling and replacement (R&R) activity markets in the United States, United Kingdom and Germany;
- changes in non-pass-through raw material costs;
- changes in domestic and international economic conditions;
- changes in purchases by our principal customers;
- fluctuations in foreign currency exchange rates;
- our ability to maintain an effective system of internal controls;
- our ability to successfully implement our internal operating plans and acquisition strategies;
- our ability to successfully implement our plans with respect to information technology (IT) systems and processes;
- our ability to control costs and increase profitability;
- changes in environmental laws and regulations;
- changes in warranty obligations;
- changes in energy costs;
- changes in tax laws, and interpretations thereof;
- changes in interest rates;
- our ability to service our debt facilities and remain in good standing with our lenders;
- changes in the availability or applicability of our insurance coverage;
- our ability to maintain a good relationship with our suppliers, subcontractors, and key customers; and
- the resolution of litigation and other legal proceedings.

For information on additional factors that could cause actual results to differ materially, please refer to the section entitled "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended October 31, 2017.

### About Third-Party Information

In this report, we rely on and refer to information regarding industry data obtained from market research, publicly available information, industry publications, United States government sources and other third parties. Although we believe this information is reliable, we cannot guarantee the accuracy or completeness of the information and have not independently verified it.



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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 the accompanying unaudited condensed consolidated financial statements and related notes as of July 31, 2018, and for the three and nine months ended July 31, 2018 and 2017, included elsewhere herein. For additional information pertaining to our business, including risk factors which should be considered before investing in our common stock, refer to our Annual Report on Form 10-K for the fiscal year ended October 31, 2017.

Our Business

We manufacture components for original equipment manufacturers (OEMs) in the building products industry. These components can be categorized as window and door (fenestration) components and kitchen and bath cabinet components. Examples of fenestration components include (1) energy-efficient flexible insulating glass spacers, (2) extruded vinyl profiles, (3) window and door screens, and (4) precision-formed metal and wood products. We also manufacture cabinet doors and other components for OEMs in the kitchen and bathroom cabinet industry. In addition, we provide certain other non-fenestration components and products, which include solar panel sealants, trim moldings, vinyl decking, fencing, water retention barriers, and conservatory roof components. We use low-cost, short lead-time production processes and engineering expertise to provide our customers with specialized products for their specific window, door, and cabinet applications. We believe these capabilities provide us with unique competitive advantages. We serve a primary customer base in North America and the United Kingdom, and also serve customers in international markets through our operating plants in the United Kingdom and Germany, as well as through sales and marketing efforts in other countries.

We currently have three reportable business segments: (1) North American Engineered Components segment ("NA Engineered Components"), comprising four operating segments primarily focused on the fenestration market in North America manufacturing vinyl profiles, IG spacers, screens & other fenestration components; (2) European Engineered Components segment ("EU Engineered Components"), comprising our United Kingdom-based vinyl extrusion business, manufacturing vinyl profiles and conservatories, and the European insulating glass business manufacturing IG spacers; and (3) North American Cabinet Components segment ("NA Cabinet Components"), comprising our cabinet door and components operations. We maintain a grouping called Unallocated Corporate & Other, which includes transaction expenses, stock-based compensation, long-term incentive awards based on performance of our common stock and other factors, certain severance and legal costs not allocable to our operating segments, depreciation of corporate assets, interest expense, other, net, income taxes and inter-segment eliminations. Other corporate general and administrative costs have been allocated to the reportable business segments, based upon a relative measure of profitability in order to more accurately reflect each reportable business segment's administrative costs. The accounting policies of our operating segments are the same as those used to prepare our accompanying condensed consolidated financial statements.

In an effort to focus on protecting margins and improving cash flows, we implemented a strategy to reduce our sales volume with certain low-margin customers. During 2017, we rationalized capacity and closed two United States vinyl plants and two cabinet door plants, relocating assets to improve overall operational efficiency. Pursuant to these restructuring efforts, we expensed \$0.2 million and \$0.9 million during the three and nine months ended July 31, 2018 respectively, and \$0.9 million and \$3.1 million, respectively, for the comparable prior year periods. We recognized \$1.3 million and \$5.5 million of accelerated depreciation and amortization associated with related assets during the three and nine months ended July 31, 2017.

We continue to invest in organic growth initiatives and intend to continue to pursue business acquisitions that allow us to expand our existing fenestration and cabinet component footprint, enhance our product offerings, provide new complementary technology, enhance our leadership position within the markets we serve, and expand into new markets or service lines. We have disposed of non-core businesses in the past, and continue to evaluate our business portfolio to ensure that we are investing in markets where we believe there is potential future growth.

Recent Transactions and Events

On December 22, 2017, President Trump signed into law a sweeping tax reform bill which includes the following provisions which impact United States corporations: (1) reduction of the statutory federal corporate tax rate from 35% to 21%; (2) shifting to a territorial tax system in which foreign earnings could be repatriated through a 100%

dividends received deduction; (3) imposing a one-time tax on un-repatriated earnings of 15.5% on cash and 8% on other assets; (4) doubling bonus depreciation to 100% for five years and allowing used property to qualify; (5) limiting net interest expense deductions to 30% of adjusted taxable income; (6) limiting NOL deductions to 80% of taxable income; and (7) repealing the corporate alternative minimum tax. We have made an initial assessment of this new tax law and recorded a discrete benefit of \$6.5 million during the nine months ended July 31, 2018. We expect the effective tax rate for fiscal 2018 to be approximately 7%, or 24% excluding these discrete items.

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## Market Overview and Outlook

We believe the primary drivers of our operating results continue to be North American new home construction and residential remodeling and replacement (R&R) activity. We believe that housing starts and window shipments are indicators of activity levels in the homebuilding and window industries, and we use this data, as published by or derived from third-party sources, to evaluate the market. We have historically evaluated the market using data from the National Association of Homebuilders (NAHB) with regard to housing starts, and published reports by Ducker Worldwide, LLC (Ducker), a consulting and research firm, with regard to window shipments in the United States. To assess the housing market in the United Kingdom, we use published reports by D&G Consulting, a consulting and research firm. We obtain market data from Freedomia Group and Catalina Research and KCMA, each a consulting and research firm, for insight into the United States residential wood cabinet demand.

Reports and forecasts from these sources indicate continued growth in the markets we serve. The NAHB has forecasted calendar-year housing starts (excluding manufactured units) to increase slightly through 2020. Ducker indicated that window shipments in the R&R market are expected to increase approximately 3% annually through 2020. Derived from reports published by Ducker, the overall growth in window shipments for the trailing twelve months ended March 31, 2018 was 3.8%. During this period, growth in new construction increased 5.5%, while growth in R&R activity increased 2.4%. Growth in new construction continues to outpace the growth in R&R. D&G Consulting forecasts an increase in housing in the United Kingdom through 2020. Catalina Research estimates residential semi-custom cabinet demand in the U.S. to grow between 4% to 6% annually through 2020.

We utilize several commodities in our business for which pricing can fluctuate, including polyvinyl resin (PVC), titanium dioxide (TiO<sub>2</sub>), petroleum products, aluminum and wood. For the majority of our customers and critical suppliers, we have price adjusters in place which effectively share the base pass-through price changes for our primary commodities with our customers commensurate with the market at large. Our long-term exposure to these price fluctuations is somewhat mitigated due to the contractual component of the adjuster program. However, these adjusters are not in place with all customers and for all commodities, and there is a level of exposure to such volatility due to the lag associated with the timing of price updates in accordance with our customer agreements, particularly with regard to hardwoods. In addition, some of these commodities, such as silicone, are in high demand, particularly in Europe, which can affect the cost of the raw materials, a portion of which we may not be able to fully recover. Our business continues to be impacted by fluctuations in foreign exchange rates as the United States dollar has strengthened recently compared to other currencies where we have operations, including the United Kingdom.

## Results of Operations

Three Months Ended July 31, 2018 Compared to Three Months Ended July 31, 2017

	Three Months Ended July 31,				
	2018	2017	Change %		
			\$	Variance	
	(Dollars in millions)				
Net sales	\$239.8	\$229.4	\$10.4	5	%
Cost of sales (excluding depreciation and amortization)	185.6	176.7	8.9	(5)	%
Selling, general and administrative	24.2	20.5	3.7	(18)	%
Restructuring charges	0.2	0.9	(0.7)	78	%
Depreciation and amortization	12.7	13.9	(1.2)	9	%
Operating income	\$17.1	\$17.4	\$(0.3)	(2)	%
Interest expense	(2.6)	(2.6)	—	—	%
Other, net	(0.1)	—	(0.1)	(100)	%
Income tax expense	(3.6)	(4.6)	1.0	22	%
Net income	\$10.8	\$10.2	\$0.6	6	%

Our period-over-period results by reportable segment follow.

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## Changes Related to Operating Income by Reportable Segment:

## NA Engineered Components

	Three Months Ended July 31,			
	2018	2017	\$ Change	% Variance
	(Dollars in millions)			
Net sales	\$133.3	\$126.5	\$ 6.8	5%
Cost of sales (excluding depreciation and amortization)	101.0	94.2	6.8	(7)%
Selling, general and administrative	13.1	11.7	1.4	(12)%
Restructuring charges	0.2	0.8	(0.6 )	75%
Depreciation and amortization	6.7	7.9	(1.2 )	15%
Operating income	\$12.3	\$11.9	\$ 0.4	3%
Operating income margin	9	% 9	%	

Net Sales. Net sales increased \$6.8 million, or 5%, for the three months ended July 31, 2018 compared to the same period in 2017. We experienced \$8.9 million of revenue growth driven both by market growth and new volume for our insulating spacer and window components businesses and an increase of \$2.8 million related to price and surcharges for commodities, primarily oil used in our insulating spacer business. These increases were partially offset by a \$4.7 million volume decrease primarily driven by our strategy to shed lower margin business at our United States vinyl business resulting in the loss of a major customer during 2017, as well as the sale of our wood flooring business on October 31, 2017.

Cost of Sales. The cost of sales increased \$6.8 million, or 7%, when comparing the three months ended July 31, 2018 to the same period in 2017. Cost of sales increased due to the corresponding increase in volume coupled with inflationary cost increases. A portion of the raw material increases are recovered through surcharges.

Selling, General and Administrative. Selling, general and administrative expenses increased \$1.4 million when comparing the three months ended July 31, 2018 to the same period in 2017. This increase was due primarily to increases in higher incentive accruals and an increase in medical expense during the period.

Restructuring Charges. Restructuring charges of \$0.2 million primarily relate to facility lease expenses related to two vinyl extrusion plants which were closed in November 2016 and January 2017 in the United States that have not been sublet or otherwise exited as of July 31, 2018.

Depreciation and Amortization. Depreciation and amortization expense decreased \$1.2 million, or 15% when comparing the three months ended July 31, 2018 and 2017. The decrease reflects the impact of restructuring efforts in 2017 which included incremental depreciation of \$1.0 million associated with an October 2016 change in estimate of the remaining service lives of assets displaced or abandoned, and accelerated amortization of \$0.3 million related to a change in estimate for certain related intangible assets. The incremental depreciation expense associated with property, plant and equipment placed into service during the trailing twelve months ended July 31, 2018, was offset by the run-off of depreciation expense associated with existing assets and disposals during this period.

## EU Engineered Components

	Three Months Ended July 31,			
	2018	2017	\$ Change	Variance %
	(Dollars in millions)			
Net sales	\$42.7	\$40.4	\$ 2.3	6%
Cost of sales (excluding depreciation and amortization)	30.8	29.0	1.8	(6)%
Selling, general and administrative	5.6	5.2	0.4	(8)%
Depreciation and amortization	2.4	2.4	—	—%
Operating income	\$3.9	\$3.8	\$ 0.1	3%
Operating income margin	9	% 9	%	

Net Sales. Net sales increased \$2.3 million when comparing the three months ended July 31, 2018 to the same period in 2017. This increase reflects \$2.3 million of volume increases, a \$1.1 million favorable impact associated with



changes in foreign

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exchange rates, and \$0.7 million of base price increases, partially offset by \$1.8 million due to the intentional shedding of some lower margin vinyl customers.

Cost of Sales. The cost of sales increased \$1.8 million, or 6%, for the three months ended July 31, 2018 compared to the same period in 2017. Foreign currency contributed \$0.8 million of the increase. The remaining increase was driven by increased volume, higher vinyl resin costs and notable silicone cost increases.

Selling, General and Administrative. Selling, general and administrative expense increased \$0.4 million for the three months ended July 31, 2018 compared to the same period in 2017. The increase was primarily attributable to foreign currency exchange rate changes, and increased staffing costs at our U.K. vinyl business.

Depreciation and Amortization. Depreciation and amortization expense for the three months ended July 31, 2018 remained constant when compared to the same period in 2017. The run-off of depreciation and amortization expense associated with property, plant and equipment placed into service during the trailing twelve months ended July 31, 2018 were offset by the effect of changes in exchange rates.

## NA Cabinet Components

	Three Months Ended July 31,			
	2018	2017	\$ Change	Variance %
	(Dollars in millions)			
Net sales	\$65.1	\$63.8	\$ 1.3	2%
Cost of sales (excluding depreciation and amortization)	54.8	54.5	0.3	(1)%
Selling, general and administrative	3.6	4.0	(0.4 )	10%
Restructuring charges	—	0.1	(0.1 )	100%
Depreciation and amortization	3.4	3.5	(0.1 )	3%
Operating income	\$3.3	\$1.7	\$ 1.6	94%
Operating income margin	5	% 3	%	

Net Sales. Net sales increased \$1.3 million, or 2%, for the three months ended July 31, 2018 compared to the same period in 2017. On a year-over-year basis, we experienced an increase of \$4.0 million in price increases and raw material surcharges, partially offset by \$2.4 million of market declines in existing business and a \$0.2 million decrease in sales volume related to the closure of two facilities last year.

Cost of Sales. Cost of sales increased \$0.3 million, or 1%, for the three months ended July 31, 2018 compared with the same period in 2017 due to higher raw material costs partially offset by lower volumes. Margins were favorably impacted by the price increases noted above offsetting the higher wood and material costs.

Selling, General and Administrative. Selling, general and administrative expense decreased \$0.4 million for the three months ended July 31, 2018 compared to the same period in 2017, primarily due to decreases in incentive compensation expense.

Restructuring Charges. Restructuring charges of \$0.1 million in the three months ended July 31, 2017 represent equipment moving and other related costs associated with the Mexican plant closure effected in October 2016.

Depreciation and Amortization. Depreciation and amortization expense decreased \$0.1 million for the three months ended July 31, 2018 compared with the same period in 2017, reflecting the run-off of depreciation expense related to existing assets and disposals during the period.

## Unallocated Corporate &amp; Other

	Three Months Ended July 31,			
	2018	2017	\$ Change	Variance %
	(Dollars in millions)			
Net sales	\$(1.3)	\$(1.3)	\$ —	—%
Cost of sales (excluding depreciation and amortization)	(1.0 )	(1.0 )	—	—%
Selling, general and administrative	1.9	(0.4 )	2.3	(575)%
Depreciation and amortization	0.2	0.1	0.1	(100)%
Operating loss	\$(2.4)	\$—	\$ (2.4 )	(100)%



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Net Sales. Net sales for Unallocated Corporate & Other represents the elimination of inter-segment sales for the three months ended July 31, 2018 and 2017.

Cost of Sales. Cost of sales for Unallocated Corporate & Other consists of the elimination of inter-segment sales, profit in inventory, LIFO reserve adjustments and other costs.

Selling, General and Administrative. Selling, general and administrative expenses increased \$2.3 million for the three months ended July 31, 2018 compared to the same period in 2017. Increases in professional and advisory fees during the period were offset by decreases in stock based compensation. The increase in professional fees relate to the absence of a \$2.0 million reimbursement, which occurred during the three months ended July 31, 2017, from our insurance carrier for legal costs incurred to defend against claims of an alleged defect in a commercial sealant product, as described in Note 8, "Contingencies," to the accompanying unaudited condensed consolidated financial statements contained elsewhere herein.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.1 million for the three months ended July 31, 2018 compared to the same period in 2017. Relatively few new assets were placed in service at corporate during the trailing twelve months ended July 31, 2018.

Changes related to Non-Operating Items:

Interest Expense. Interest expense remained flat for the three months ended July 31, 2018 compared to the same period in 2017. Higher interest rates on our revolving credit facilities were offset by a lower average outstanding debt balance.

Other, net. The decrease in other, net of \$0.1 million at July 31, 2018 compared to the same period in 2017 relates primarily to changes in net foreign exchange transaction losses.

Income Taxes. We recorded income tax expense of \$3.6 million for the three months ended July 31, 2018, an effective rate of 25.2%, and income tax expense of \$4.6 million for the three months ended July 31, 2017, an effective rate of 31.1%. The difference in the effective rates between these periods relates to the Tax Cuts and Jobs Act (the Act) which was signed into law on December 22, 2017. The act reduced our federal tax rate from 35% to 23.3% for the fiscal year ending October 31, 2018. The effective rate for the three months ended July 31, 2018 was further impacted by a discrete charge of \$0.1 million related to the exercise of equity-based compensation awards, and the effective rate for the corresponding prior year period reflects a decrease in permanent items.

Nine Months Ended July 31, 2018 Compared to Nine Months Ended July 31, 2017

	Nine Months Ended July 31,				
	2018	2017	Change	% Variance	
	(\$ in millions)				
Net sales	\$645.7	\$634.4	\$ 11.3	2	%
Cost of sales (excluding depreciation and amortization)	508.8	494.6	14.2	(3)	)%
Selling, general and administrative	72.1	74.8	(2.7)	) 4	%
Restructuring charges	0.9	3.1	(2.2)	) 71	%
Depreciation and amortization	39.2	43.8	(4.6)	) 11	%
Operating income	\$24.7	\$18.1	\$ 6.6	36	%
Interest expense	(7.6)	(7.1)	(0.5)	(7)	)%
Other, net	0.2	0.6	(0.4)	) 67	%
Income tax benefit (expense)	2.5	(3.6)	6.1	169	%
Net income	\$19.8	\$8.0	\$ 11.8	148	%

Our period-over-period results by reportable segment follow.

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## Changes Related to Operating Income by Reportable Segment:

## NA Engineered Components

	Nine Months Ended July 31,			
	2018	2017	\$ Change	% Variance
	(Dollars in millions)			
Net sales	\$350.3	\$343.7	\$ 6.6	2%
Cost of sales (excluding depreciation and amortization)	269.2	260.5	8.7	(3)%
Selling, general and administrative	40.4	38.7	1.7	(4)%
Restructuring charges	0.8	2.2	(1.4 )	64%
Depreciation and amortization	20.6	26.4	(5.8 )	22%
Operating income	\$19.3	\$15.9	\$ 3.4	21%
Operating income margin	6	% 5	%	

Net Sales. Net sales increased \$6.6 million for the nine months ended July 31, 2018 compared to the same period in 2017. We experienced market growth of \$20.8 million year-over-year across the core product sales and an increase in revenue of \$4.8 million related to price and resin and oil based surcharges. This was offset by a \$19.1 million decrease related to the US vinyl volume we shed and the divestiture of the wood flooring business.

Cost of Sales. The cost of sales increased \$8.7 million, or 3%, when comparing the nine months ended July 31, 2018 to the same period in 2017. The largest drivers of the increase are inflationary increases from raw material, freight and labor costs.

Selling, General and Administrative. Selling, general and administrative expenses increased \$1.7 million, or 4% when comparing the nine months ended July 31, 2018 to the same period in 2017. This increase was due primarily to increases in higher incentive accruals and an increase in medical expenses during the period.

Restructuring Charges. Restructuring charges of \$0.8 million for the nine months ended July 31, 2018 primarily relate to facility lease expenses related to two U.S. vinyl extrusion plants which were closed in November 2016 and January 2017 and have not been sublet or otherwise exited as of July 31, 2018.

Depreciation and Amortization. Depreciation and amortization expense decreased \$5.8 million, or 22% when comparing the three-month periods ended July 31, 2018 and 2017. The decrease reflects the impact of restructuring efforts in 2017 which included accelerated depreciation of \$3.9 million and amortization of \$1.6 million associated with an October 2016 change in estimate of the remaining service lives of select fixed and intangible assets. The incremental depreciation expense associated with property, plant and equipment placed into service during the trailing twelve months ended July 31, 2018, was more than offset by the run-off of depreciation expense associated with existing assets and disposals during this period.

## EU Engineered Components

	Nine Months Ended July 31,			
	2018	2017	\$ Change	Variance %
	(Dollars in millions)			
Net sales	\$115.5	\$106.1	\$ 9.4	9%
Cost of sales (excluding depreciation and amortization)	83.2	75.3	7.9	(10)%
Selling, general and administrative	17.3	15.1	2.2	(15)%
Depreciation and amortization	7.3	6.8	0.5	(7)%
Operating income	\$7.7	\$8.9	\$ (1.2 )	(13)%
Operating income margin	7	% 8	%	

Net Sales. Net sales increased \$9.4 million when comparing the nine months ended July 31, 2018 to the same period in 2017. This increase reflects a \$7.9 million favorable foreign exchange impact, volume increases of \$4.9 million, and \$3.0 million base price increases, partially offset by \$6.5 million of lower margin U.K. vinyl business that was shed during 2017.

Cost of Sales. The cost of sales increased \$7.9 million for the nine months ended July 31, 2018 compared to the same period in 2017. The primary drivers of the increase were the continued U.K. vinyl material cost inflation and the change in foreign exchange rates.

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Selling, General and Administrative. Selling, general and administrative expense increased \$2.2 million, for the nine months ended July 31, 2018 compared to the same period in 2017. The increase was primarily attributable to foreign currency exchange rate changes and increased staffing costs at our U.K. vinyl business.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.5 million for the nine months ended July 31, 2018 compared to the same period in 2017. The increase was primarily attributable to foreign currency exchange rate changes and depreciation expense associated with property, plant and equipment placed into service during the trailing twelve months.

## NA Cabinet Components

	Nine Months Ended July 31,			
	2018	2017	\$ Change	Variance %
	(Dollars in millions)			
Net sales	\$183.7	\$188.3	\$ (4.6 )	(2)%
Cost of sales (excluding depreciation and amortization)	159.1	161.7	(2.6 )	2%
Selling, general and administrative	12.9	12.7	0.2	(2)%
Restructuring charges	0.1	0.9	(0.8 )	89%
Depreciation and amortization	10.9	10.2	0.7	(7)%
Operating income	\$0.7	\$2.8	\$ (2.1 )	(75)%
Operating income margin	—	% 1	%	

Net Sales. Net sales decreased \$4.6 million, or 2%, for the nine months ended July 31, 2018 compared to the same period in 2017. On a year-over-year basis, we experienced a \$3.9 million decrease in sales volume related to the closure of two facilities last year and additional lower margin business we shed and \$8.7 million of market declines in existing business, partially offset by an increase of \$8.1 million in price and raw material surcharges.

Cost of Sales. The cost of sales decreased \$2.6 million, or 2%, for the nine months ended July 31, 2018 compared with the same period in 2017, primarily related to the lower sales volume. Margins were unfavorably impacted by higher wood and material costs which began being recovered in the third quarter through surcharges and price increases, along with an overall unfavorable product mix.

Selling, General and Administrative. Selling, general and administrative expense increased \$0.2 million for the nine months ended July 31, 2018 compared to the same period in 2017, primarily related to some additional administrative headcount, normal wage inflation, and higher medical insurance and employee benefit costs, as well as higher corporate allocations year-over-year of \$0.5 million, which were offset by a decrease in incentive based compensation accruals.

Restructuring Charges. Restructuring charges of \$0.1 million for the nine months ended July 31, 2018 primarily represent costs associated with a Kansas plant closure effected in September 2017. Restructuring charges of \$0.9 million in the nine months ended July 31, 2017 represent equipment moving and other related costs associated with the Mexican plant closure effected in October 2016.

Depreciation and Amortization. Depreciation and amortization expense increased \$0.7 million for the nine months ended July 31, 2018 compared with the same period in 2017. This increase primarily reflects accelerated depreciation expense associated with a change in estimate for useful lives of certain assets associated with a plant re-layout. The incremental depreciation expense associated with assets placed in service during the trailing twelve months ended July 31, 2017 was largely offset by the run-off of depreciation expense associated with existing assets and disposals during this period.

## Unallocated Corporate &amp; Other

	Nine Months Ended July 31,			
	2018	2017	\$ Change	Variance %
	(Dollars in millions)			
Net sales	\$(3.8)	\$(3.7)	\$ (0.1 )	(3)%
Cost of sales (excluding depreciation and amortization)	(2.7 )	(2.9 )	0.2	(7)%

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Selling, general and administrative	1.5	8.3	(6.8 )	82%
Depreciation and amortization	0.4	0.4	—	—%
Operating loss	\$(3.0)	\$(9.5)	\$ 6.5	68%

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**Net Sales.** Net sales for Unallocated Corporate & Other represents the elimination of inter-segment sales for the nine months ended July 31, 2018 and 2017. The change between periods reflects the change in the amount of inter-segment sales.

**Cost of Sales.** Cost of sales for Unallocated Corporate & Other consists of the elimination of inter-segment sales, profit in inventory, LIFO reserve adjustments and other costs. For the nine months ended July 31, 2018 and 2017, the change of \$0.2 million was primarily related to the elimination of inter-segment sales.

**Selling, General and Administrative.** Selling, general and administrative expenses decreased \$6.8 million for the nine months ended July 31, 2018 compared to the same period in 2017. Stock based compensation decreased \$6.7 million based on revised lower estimates of performance shares expected to vest in December 2018, the impact of the lower stock price on other long-term liabilities that are marked-to-market, and the impact of issuing performance restricted stock units in December 2017 instead of stock options. The results for the nine months ended July 31, 2017 include a reimbursement of \$2.0 million of legal costs incurred to defend against claims of an alleged defect in a commercial sealant product, as described in Note 8, "Contingencies," to the accompanying unaudited condensed consolidated financial statements contained elsewhere herein.

**Depreciation and Amortization.** Depreciation and amortization expense remained flat when comparing the nine months ended July 31, 2018 to the same period in 2017. The incremental depreciation expense associated with property, plant and equipment placed into service during the trailing twelve months ended July 31, 2017 was offset by the run-off of depreciation expense associated with existing assets and disposals during this period.

**Changes related to Non-Operating Items:**

**Interest Expense.** Interest expense increased \$0.5 million for the nine months ended July 31, 2018 compared to the same period in 2017. This increase is primarily attributable to higher interest rates on our revolving credit facilities and the addition of the warehouse facility lease at HLP during the second quarter of 2017, offset somewhat by a lower average outstanding debt balance.

**Other, net.** The decrease in other, net of \$0.4 million at July 31, 2018 compared to the same period in 2017 relates primarily to changes in net foreign exchange transaction gains.

**Income Taxes.** Our estimated annual effective tax rates for the nine months ended July 31, 2018 and 2017 were 14.7% and 31.4%, respectively. The change in the annual rate was due to the Tax Cuts and Jobs Act (the Act) which was signed into law on December 22, 2017. The Act reduced our federal income tax rate from 35% to 23.3% for the fiscal year ending October 31, 2018. Discrete items impacting the income tax benefit for the nine months ended July 31, 2018 were a benefit of \$7.7 million for the re-measurement of our deferred income tax assets and liabilities due to the decrease in the federal corporate income tax rate, a charge of \$0.1 million for the excess tax benefits related to the vesting or exercise of equity-based compensation awards, and a benefit of \$0.2 million for the true up of our accruals and related deferred taxes from prior year filings and settled tax audits, partially offset by a tax expense of \$1.2 million for the one-time mandatory transition tax on deemed repatriation of previously tax-deferred and unremitted foreign earnings.

## Liquidity and Capital Resources

### Overview

Historically, our principal sources of funds have been cash on hand, cash flow from operations, and borrowings under our credit facilities.

We maintain a \$450.0 million credit agreement comprising a \$150.0 million Term Loan A and a \$300.0 million revolving credit facility (collectively, the Credit Agreement). The Credit Agreement matures in 2021 (5-year term) and requires interest payments calculated, at our election and depending upon our Consolidated Leverage Ratio, at either a Base Rate plus an applicable margin (0.50% to 1.25%) or the LIBOR Rate plus an applicable margin (1.50% to 2.25%). The applicable rate during the nine months ended July 31, 2018 was LIBOR + 2.00%. In addition to the Consolidated Leverage Ratio covenant, we are required to meet a Consolidated Fixed Charge Coverage Ratio covenant, and there are limitations on certain transactions including our ability to incur indebtedness, incur liens, dispose of material assets, acquire businesses, make restricted payments and pay dividends (limited to \$10.0 million per year). We are amortizing deferred financing fees of \$1.7 million straight-line over the remaining term of the facility.

As of July 31, 2018, we had \$12.4 million of cash and equivalents, \$193.5 million outstanding under the Credit Agreement, \$5.3 million of outstanding letters of credit and \$17.9 million outstanding under capital leases. We had \$228.6 million available for use under the Credit Agreement at July 31, 2018.

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We repatriated \$2.8 million of foreign cash in the first half of fiscal 2018. We expect to repatriate excess cash moving forward and utilize the funds to retire debt or meet current working capital needs.

## Analysis of Cash Flow

The following table summarizes our cash flow results for the nine months ended July 31, 2018 and 2017:

	Nine Months Ended July 31, 2018 2017	
	(In millions)	
Cash provided by operating activities	\$48.5	\$46.5
Cash used for investing activities	\$(20.8)	\$(34.4)
Cash used for financing activities	\$(32.0)	\$(21.6)

**Operating Activities.** Cash provided by operating activities for the nine months ended July 31, 2018 increased by approximately \$2.0 million compared to the nine months ended July 31, 2017. Cash receipts were impacted favorably by higher net income and a reduction of inventory in 2018 versus a build in 2017.

**Investing Activities.** Cash used for investing activities decreased \$13.6 million when comparing the nine months ended July 31, 2018 to the same period in 2017. In 2017, we paid \$8.5 million related to the HLP acquisition earn-out, with no corresponding cash payment in 2018. Our investment in capital expenditures declined by \$6.0 million for the nine months ended July 31, 2018 compared to the same period in 2017, which was partially offset by a decline in proceeds from the sale of capital assets during these periods.

**Financing Activities.** Cash used for financing activities was \$32.0 million for the nine months ended July 31, 2018, primarily attributable to \$30.6 million of net repayments of debt, dividends paid to our shareholders of \$4.2 million, and \$1.0 million of cash paid for payroll taxes related to stock based compensation, partially offset by \$3.8 million of proceeds received from stock option exercises. For the nine months ended July 31, 2017, cash used for financing activities was \$21.6 million, primarily attributable to \$22.9 million of net repayments of debt, dividends paid to our shareholders of \$4.1 million, and for payroll taxes related to stock based compensation of \$1.0 million, partially offset by \$6.4 million of proceeds received from stock option exercises.

## Liquidity Requirements

Our strategy for deploying cash is to invest in organic growth opportunities, develop our infrastructure, make strategic acquisitions. Other uses of cash include paying cash dividends to our shareholders and repurchasing our common stock. We have historically invested cash and cash equivalents in commercial paper with terms of three months or less. To the extent we have excess cash which has not been applied to reduce our outstanding borrowings under our credit facilities, we intend to remain in commercial paper, highly-rated money market funds, financial institutions and treasuries following a prudent investment philosophy. From time to time, to prepare for potential disruption in the money markets, we may temporarily move funds into operating bank accounts of highly-rated financial institutions to meet on-going operational liquidity requirements. We did not have any investments during the nine months ended July 31, 2018 and 2017. We maintain cash balances in foreign countries which total \$9.4 million as of July 31, 2018. During the nine months ended July 31, 2018, we repatriated \$2.8 million of foreign earnings from our insulating spacer division in the United Kingdom. We utilize cash flow from HLP to fund the operation in the United Kingdom, and to repay a note arrangement implemented as part of the capitalization of the acquisition.

## Critical Accounting Policies and Estimates

The preparation of our financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) requires us to make estimates and assumptions that affect the reported amount of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. Estimates and assumptions about future events and their effects cannot be perceived with certainty. Estimates may change as new events occur, as more experience is acquired, as additional information becomes available and as our operating environment changes. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, and that we believe provide a basis for making judgments about the carrying value of assets and liabilities that are not readily available through open market quotes. We must use our

judgment with regard to uncertainties in order to make these estimates. Actual results could differ from these estimates.

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For a description of our critical accounting policies and estimates, see our Annual Report on Form 10-K for the fiscal year ended October 31, 2017. Our critical accounting policies and estimates have not changed materially during the nine months ended July 31, 2018.

**New Accounting Pronouncements**

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board (FASB) or other standards setting bodies that we adopt as of the specified effective date. Unless otherwise discussed, we believe the impact of any recently issued standards that are not yet effective are either not applicable to us at this time or will not have a material impact on our consolidated financial statements upon adoption.

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers. This guidance prescribes a methodology to determine when revenue is recognizable and constitutes a principles-based approach to revenue recognition based on the consideration to which the entity expects to be entitled in exchange for goods or services. In addition, this guidance requires additional disclosure in the notes to the financial statements with regard to the methodology applied. This pronouncement will essentially supersede and replace existing revenue recognition rules in U.S. GAAP, including industry-specific guidance. We will adopt this guidance using the modified retrospective approach in the first quarter of 2019 with a cumulative adjustment to retained earnings.

As of July 31, 2018, we have completed the evaluation of our revenue streams and have reviewed a sample of customer contracts that we believe fairly represent contract traits that could be accounted for differently under amended guidance. We have begun evaluating the potential impact of the new revenue standard on each of the selected contracts including: (i) estimating the contract consideration under the new standard, (ii) identifying the performance obligations within the customer contracts, (iii) calculating the anticipated allocation of contract consideration to each performance obligation, (iv) determining the timing of revenue recognition for each performance obligation, and (v) determining the classification of the contract revenue for disclosure purposes. Based on the contract reviews and evaluations performed to date, we do not currently anticipate any material impacts from implementing the amended guidance.

Refer to our Annual Report on Form 10-K for the year ended October 31, 2017 for additional standards we are currently evaluating.

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## Item 3. Quantitative and Qualitative Disclosures About Market Risk

The following discussion of our exposure to various market risks contains “forward looking statements” regarding our estimates, assumptions and beliefs concerning our exposure. Although we believe these estimates and assumptions are reasonable in light of information currently available to us, we cannot provide assurance that these estimates will not materially differ from actual results due to the inherent unpredictability of interest rates, foreign currency rates and commodity prices as well as other factors. We do not use derivative financial instruments for speculative or trading purposes.

**Interest Rate Risk**

Our outstanding debt bears interest at variable rates and accordingly is sensitive to changes in interest rates. Based upon the balances of the variable rate debt at July 31, 2018, a hypothetical 1.0% increase or decrease in interest rates could result in approximately \$1.9 million of additional pretax charges or credit to our operating results per year. This sensitivity is impacted by the amount of borrowings under our credit facilities, and amounts outstanding under finance leases at HLP.

**Foreign Currency Rate Risk**

Our international operations have exposure to foreign currency rate risks, primarily due to fluctuations in the Euro, the British Pound Sterling and the Canadian Dollar. From time to time, we enter into foreign exchange contracts associated with our operations to manage a portion of the foreign currency rate risk.

The notional and fair market values of these positions at July 31, 2018 and October 31, 2017, were as follows (in thousands):

	Notional as indicated		Fair Value in \$	
	July 31, 2018	October 31, 2017	July 31, 2018	October 31, 2017
Foreign currency derivatives:				
Sell EUR, buy USD	EUR \$138	\$ 1,271	\$—	\$ 24
Sell CAD, buy USD	CAD314	320	(1)	1
Sell GBP, buy USD	GBP 123	75	—	—
Buy EUR, sell GBP	EUR 48	30	—	(1)
Buy USD, sell EUR	USD 17	—	—	—

At July 31, 2018 and October 31, 2017, we held foreign currency derivative contracts hedging cross-border intercompany and commercial activity for our insulating glass spacer business. Although these derivatives hedge our exposure to fluctuations in foreign currency rates, we do not apply hedge accounting and therefore, the change in the fair value of these foreign currency derivatives is recorded directly to other income and expense in the accompanying condensed consolidated statements of income (loss). To the extent the gain or loss on the derivative instrument offsets the gain or loss from the re-measurement of the underlying foreign currency balance, changes in exchange rates should have no effect. See Note 9, "Derivative Instruments," to the accompanying unaudited condensed consolidated financial statements contained elsewhere herein.

We currently have an unhedged foreign currency position associated with the debt borrowed to facilitate the HLP acquisition. We are evaluating our options with regard to hedging our exposure. For the three and nine months ended July 31, 2018, we recorded unrealized losses of \$0.2 million and unrealized gains of less than \$0.1 million, respectively, and an unrealized loss of less than \$0.1 million and an unrealized gain of \$0.6 million, respectively, for the comparable prior year periods associated with this foreign currency exposure.

**Commodity Price Risk**

We purchase polyvinyl resin (PVC) as the significant raw material consumed in the manufacture of vinyl extrusions. We have a monthly resin adjuster in place with a majority of our customers and our resin supplier that is adjusted based upon published industry indices for resin prices for the prior month. This adjuster effectively shares the base pass-through price changes of PVC with our customers commensurate with the market at large. Our long-term exposure to changes in PVC prices is somewhat mitigated due to the contractual component of the resin adjuster program. In addition, there is a level of exposure to short-term volatility due to the one month lag.



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We also charge certain customers a surcharge related to petroleum-based raw materials. The surcharge is intended to offset the rising cost of products which are highly correlated to the price of oil including butyl and other oil-based raw materials. The surcharge is in place with the majority of our customers who purchase these products and is adjusted monthly based upon the 90-day average published price for Brent crude. The oil-based raw materials that we purchase are subject to similar pricing schemes. As such, our long-term exposure to changes in oil-based raw material prices is significantly reduced under this surcharge program.

Similarly, our NA Cabinet Components business includes a surcharge provision in the majority of its customer contracts to insulate against significant fluctuations in the price for various hardwood products used as the primary raw material for kitchen and bathroom cabinet doors and components. We are exposed to short-term volatility in wood prices due to a lag in the timing of price updates which generally are updated quarterly, though contractual mechanics could delay changes from taking effect beyond three months.

While we maintain surcharges and other adjusters to manage our exposure to changes in the prices of our critical raw materials, we utilize several commodities in our business that are not covered by contractual surcharges or adjusters for which pricing can fluctuate, including titanium dioxide (TiO<sub>2</sub>), aluminum, silicone and other inputs. Further discussion of our industry risks is included within our Annual Report on Form 10-K for the year ended October 31, 2017.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (1934 Act) as of July 31, 2018. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of July 31, 2018, the disclosure controls and procedures are effective.

Changes in Internal Control over Financial Reporting

There have been no changes in internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the 1934 Act) during the most recent fiscal quarter that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.



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## PART II. OTHER INFORMATION

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

## Issuer Purchases of Equity Securities

During the three months ended July 31, 2018, we repurchased common stock as follows:

Period	(a) Total Number of Shares Purchased <sup>(1)</sup>	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum US Dollars Remaining that May Yet Be Used to Purchase Shares Under the Plans or Programs
May 1, 2018 through May 31, 2018	14,942	\$17.00	—	—
June 1, 2018 through June 30, 2018	—	—	—	—
July 1, 2018 through July 31, 2018	—	—	—	—
Total	14,942	\$17.00	—	—

<sup>(1)</sup> Shares cancelled in connection with tax withholding related to the vesting of restricted share awards. Shares so cancelled are cancelled pursuant to the terms of our 2008 Omnibus Incentive Plan, as amended, and are not part of any publicly announced share repurchase authorizations.

## Item 6. Exhibits

The exhibits required to be furnished pursuant to Item 6 are listed in the Exhibit Index filed herewith, which Exhibit Index is incorporated herein by reference.

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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.

QUANEX BUILDING PRODUCTS CORPORATION

Date: September 7, 2018 /s/ Brent L. Korb

Brent L. Korb

Senior Vice President – Finance and Chief Financial Officer

(Principal Financial Officer)

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EXHIBIT INDEX

Exhibit Number	Description of Exhibits
<u>3.1</u>	<u>Restated Certificate of Incorporation of the Registrant dated as of March 4, 2016, filed as Exhibit 3.1 of the Registrant's Current Report on Form 8-K (Reg. No. 001-33913) as filed with the Securities and Exchange Commission on March 7, 2016, and incorporated herein by reference.</u>
<u>3.2</u>	<u>Third Amended and Restated Bylaws of the Registrant as of March 4, 2016, filed as Exhibit 3.2 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-33913) for the quarter ended July 31, 2016, and incorporated herein by reference.</u>
<u>4.1</u>	<u>Form of Registrant's Common Stock certificate, filed as Exhibit 4.1 of Amendment No. 1 to the Registrant's Registration Statement on Form 10 (Reg. No. 001-33913) as filed with the Securities and Exchange Commission on February 14, 2008, and incorporated herein by reference.</u>
<u>4.2</u>	<u>Credit Agreement dated as of July 29, 2016, among the Company; certain of its subsidiaries as guarantors; Wells Fargo Bank, National Association, as administrative agent; Bank of America, N.A., as syndication agent; Wells Fargo Securities LLC and Merrill Lynch, Pierce, Fenner &amp; Smith Incorporated as joint lead arrangers; and the lenders party thereto, filed as Exhibit 10.1 of the Registrant's Current Report on Form 8-K (Reg. No. 001-33913) as filed with the Securities and Exchange Commission on August 1, 2016, and incorporated herein by reference.</u>
<u>*31.1</u>	<u>Certification by chief executive officer pursuant to Rule 13a-14(a)/15d-14(a).</u>
<u>*31.2</u>	<u>Certification by chief financial officer pursuant to Rule 13a-14(a)/15d-14(a).</u>
<u>*32.1</u>	<u>Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
*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 Linkbase Document
*101.LAB	XBRL Taxonomy Extension Label Linkbase Document
*101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

\* Filed herewith

As permitted by Item 601(b)(4)(iii)(A) of Regulation S-K, the Registrant has not filed with this Quarterly Report on Form 10-Q certain instruments defining the rights of holders of long-term debt of the Registrant and its subsidiaries because the total amount of securities authorized under any of such instruments does not exceed 10% of the total assets of the Registrant and its subsidiaries on a consolidated basis. The Registrant agrees to furnish a copy of any such agreements to the Securities and Exchange Commission upon request.