

GRAFTECH INTERNATIONAL LTD

Form 10-Q

October 29, 2012

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

FORM 10-Q

(Mark One)

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

for the quarterly period ended September 30, 2012

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: 1-13888

GRAFTECH INTERNATIONAL LTD.  
(Exact name of registrant as specified in its charter)

Delaware 27-2496053  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification Number)

12900 Snow Road 44130  
Parma, OH (Zip code)

(Address of principal executive offices)  
Registrant's telephone number, including area code: (216) 676-2000

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 (§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. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  Smaller Reporting Company

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

As of October 15, 2012, 134,180,806 shares of common stock, par value \$.01 per share, were outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## GRAFTECH INTERNATIONAL LTD. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share data)

(Unaudited)

	As of December 31, 2011	As of September 30, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 12,429	\$ 16,193
Accounts and notes receivable, net of allowance for doubtful accounts of \$4,153 at December 31, 2011 and \$5,227 at September 30, 2012	253,151	230,096
Inventories	444,062	545,779
Prepaid expenses and other current assets	22,308	28,168
Total current assets	731,950	820,236
Property, plant and equipment	1,431,432	1,502,826
Less: accumulated depreciation	654,548	689,273
Net property, plant and equipment	776,884	813,553
Deferred income taxes	7,931	6,629
Goodwill	498,681	498,471
Other assets	152,920	137,209
Total assets	\$2,168,366	\$2,276,098
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 74,280	\$ 56,643
Short-term debt	14,168	170
Accrued income and other taxes	44,330	35,062
Supply chain financing liability	29,930	26,210
Other accrued liabilities	114,545	93,310
Total current liabilities	277,253	211,395
Long-term debt	387,624	593,453
Other long-term obligations	131,300	120,070
Deferred income taxes	32,245	33,529
Contingencies – Note 13		
Stockholders' equity:		
Preferred stock, par value \$.01, 10,000,000 shares authorized, none issued	—	—
Common stock, par value \$.01, 225,000,000 shares authorized, 149,861,081 shares issued at December 31, 2011 and 150,623,174 shares issued at September 30, 2012	1,499	1,506
Additional paid-in capital	1,798,161	1,810,600
Accumulated other comprehensive loss	(261,937	) (282,658
(Accumulated deficit) Retained earnings	(50,757	) 38,245
Less: cost of common stock held in treasury, 6,265,114 shares at December 31, 2011 and 16,375,460 shares at September 30, 2012	(146,041	) (249,095
Less: common stock held in employee benefit and compensation trusts, 75,807 shares at December 31, 2011 and 73,598 shares at September 30, 2012	(981	) (947

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Total stockholders' equity	1,339,944	1,317,651
Total liabilities and stockholders' equity	\$2,168,366	\$2,276,098
See accompanying Notes to Consolidated Financial Statements		

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CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(Dollars in thousands, except per share amounts)

(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2012	2011	2012
<b>CONSOLIDATED STATEMENTS OF INCOME</b>				
Net sales	\$345,832	\$320,716	\$972,200	\$877,265
Cost of sales	253,088	240,730	731,362	645,971
Gross profit	92,744	79,986	240,838	231,294
Research and development	2,852	2,778	8,856	9,919
Selling and administrative expenses	32,401	33,645	97,276	107,228
Operating income	57,491	43,563	134,706	114,147
Other expense (income), net	5,321	1,653	5,134	(1,376 )
Interest expense	4,792	5,839	13,780	15,733
Interest income	(119 )	(33 )	(363 )	(178 )
Income before provision for income taxes	47,497	36,104	116,155	99,968
Provision for income taxes	7,200	6,478	20,026	10,966
Net income	\$40,297	\$29,626	\$96,129	\$89,002
Basic income per common share:				
Net income per share	\$0.28	\$0.22	\$0.66	\$0.64
Weighted average common shares outstanding	145,413	134,347	145,293	139,939
Diluted income per common share:				
Net income per share	\$0.28	\$0.22	\$0.66	\$0.63
Weighted average common shares outstanding	146,181	135,001	146,113	140,565
<b>STATEMENTS OF COMPREHENSIVE INCOME</b>				
Net income	\$40,297	\$29,626	\$96,129	\$89,002
Other comprehensive income:				
Foreign currency translation adjustments	(41,667 )	712	(25,472 )	(11,963 )
Commodities and foreign currency derivatives, net of tax of \$1,176, \$249, \$5,083 and (\$144), respectively	(894 )	(3,952 )	6,590	(8,758 )
Other comprehensive loss, net of tax:	(42,561 )	(3,240 )	(18,882 )	(20,721 )
Comprehensive (loss) income	\$(2,264 )	\$26,386	\$77,247	\$68,281

See accompanying Notes to Consolidated Financial Statements

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	For the Nine Months Ended September 30,	
	2011	2012
Cash flow from operating activities:		
Net income	\$96,129	\$89,002
Adjustments to reconcile net income to cash provided by operations:		
Depreciation and amortization	60,682	58,232
Deferred income tax provision	4,820	1,906
Post-retirement and pension plan changes	3,122	3,637
Currency gains	(886	) (3,351
Stock-based compensation	6,054	8,096
Interest expense	8,659	9,221
Insurance recoveries	—	4,007
Other charges, net	(6,921	) (13,393
Increase in working capital*	(139,819	) (128,361
Increase in long-term assets and liabilities	(2,544	) (15,390
Net cash provided by operating activities	29,296	13,606
Cash flow from investing activities:		
Capital expenditures	(102,018	) (92,827
Proceeds from derivative instruments	7,772	6,807
Cash paid for acquisition	(6,500	) —
Other	428	121
Net cash used in investing activities	(100,318	) (85,899
Cash flow from financing activities:		
Short-term debt borrowings (reductions), net	18,030	(13,989
Revolving Facility borrowings	177,000	343,000
Revolving Facility reductions	(124,000	) (145,000
Principal payments on long-term debt	(178	) (182
Supply chain financing	(2,957	) (3,719
Proceeds from exercise of stock options	1,917	92
Purchase of treasury shares	(683	) (103,056
Excess tax benefit from stock-based compensation	1,105	531
Other	(436	) (1,073
Net cash provided by financing activities	69,798	76,604
Net (decrease) increase in cash and cash equivalents	(1,224	) 4,311
Effect of exchange rate changes on cash and cash equivalents	(532	) (547
Cash and cash equivalents at beginning of period	13,096	12,429
Cash and cash equivalents at end of period	\$11,340	\$16,193
* Net change in working capital due to the following components:		
Change in current assets:		
Accounts and notes receivable, net	\$(54,914	) \$25,614
Inventories	(76,207	) (96,309
Prepaid expenses and other current assets	(5,350	) (3,215
Decrease in accounts payable and accruals	(3,259	) (54,373

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Decrease in interest payable	(89	)	(78	)
Increase in working capital	\$(139,819	)	\$(128,361	)

See accompanying Notes to Consolidated Financial Statements

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PART I (CONT'D)  
GRAFTECH INTERNATIONAL LTD. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

(1) Organization and Summary of Significant Accounting Policies

A. Organization

GrafTech International Ltd. is one of the world's largest manufacturers and providers of high quality synthetic and natural graphite and carbon based products. References herein to "GTI," "we," "our," or "us" refer collectively to GrafTech International Ltd. and its subsidiaries. We have five major product categories: graphite electrodes, refractory products, needle coke products, advanced graphite materials and natural graphite, which are reported in the following segments: Industrial Materials includes graphite electrodes, refractory products, and needle coke products, and primarily serves the steel industry.

Engineered Solutions includes advanced graphite and carbon materials and natural graphite products, and provides primary and specialty products to the advanced electronics, industrial, energy, transportation and defense industries.

B. Basis of Presentation

The interim Consolidated Financial Statements are unaudited; however, in the opinion of management, they have been prepared in accordance with Rule 10-01 of Regulation S-X and in accordance with accounting principles generally accepted in the United States of America ("GAAP"). December 31, 2011 final position data included herein was derived from the audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2011 (the "Annual Report") but does not include all disclosures required by GAAP. These interim Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements, including the accompanying Notes, contained in the Annual Report.

The unaudited consolidated financial statements reflect all adjustments (all of which are of a normal, recurring nature) which management considers necessary for a fair statement of financial position, results of operations, comprehensive income and cash flows for the interim period presented. The results for the interim periods are not necessarily indicative of results which may be expected for any other interim period or for the full year.

During the three and nine months ended September 30, 2012, the Company recorded additional cost of \$2.8 million and \$0.3 million, respectively, related to prior periods. These costs were recorded primarily to defer to inventory or release to cost of sales certain inventoriable costs/variances. Net of taxes, these adjustments were \$1.8 million and \$0.2 million, for the three and nine months ended September 30, 2012, respectively, and were not material to the current or any previously issued financial statements.

C. New Accounting Standards

As of January 1, 2012, we adopted new guidance on the testing of goodwill impairment that allows the option to assess qualitative factors to determine whether performing the two step goodwill impairment assessment is necessary. Under the option, the calculation of the reporting unit's fair value is not required to be performed unless, as a result of the qualitative assessment, it is more likely than not that the fair value of the reporting unit is less than the unit's carrying amount. The adoption of this guidance impacts testing steps only. We test goodwill annually as of December 31, and when triggering events occur. No triggering events occurred in the nine months ended September 30, 2012.

As of January 1, 2012, we adopted new guidance on the presentation of comprehensive income. The guidance allows an entity to present components of net income and other comprehensive income in one continuous statement, referred to as the statement of comprehensive income, or in two separate but consecutive statements. The guidance eliminates the option to report other comprehensive income and its components in the statement of changes in equity. While the guidance changes the presentation of comprehensive income, there are no changes to the components that are recognized in net income or other comprehensive income under current accounting guidance. We elected to adopt the two separate but consecutive statements presentation, and the adoption did not have a material impact on our consolidated financial statements.

As of January 1, 2012, we adopted new guidance regarding disclosures about fair value measurements. The guidance requires new disclosures related to activity in Level 3 fair value measurements. This guidance requires purchases, sales, issuances, and settlements to be presented separately in the rollforward of activity in Level 3 fair

PART I (CONT'D)  
 GRAFTECH INTERNATIONAL LTD. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

value measurements. The adoption of this guidance did not have a significant impact on our disclosures.

(2) Acquisitions

Fiber Materials, Inc.

On October 31, 2011, we purchased substantially all of the assets and assumed certain trade liabilities of Fiber Materials, Inc. ("FMI") for \$14.0 million of cash. FMI is a manufacturer of highly engineered advanced carbon composite materials serving the aerospace and defense industries and high temperature insulation for use in industrial applications. FMI has been assigned to our Engineered Solutions ("ES") business segment. The substance of the transaction was the acquisition of a business and we accounted for the transaction following the guidance in FASB ASC 805, Business Combinations. Tangible assets acquired and liabilities assumed were recorded at their estimated fair values of \$13.3 million and \$1.4 million, respectively. The estimated fair value of finite-lived intangible assets acquired of \$2.5 million relating to customer relationships is being amortized over its estimated useful life of 5 years. These values have been prepared based on the preliminary allocation of purchase price using estimates of the fair values and useful lives of assets acquired and liabilities assumed based on best available information determined with the assistance of independent valuations, quoted market prices and management estimates. The purchase price allocations are subject to further adjustment until all pertinent information regarding the assets acquired and liabilities assumed are fully evaluated by us.

(3) Stock-Based Compensation

For the three months ended September 30, 2011 and 2012, we recognized stock-based compensation expense totaling \$2.2 million and \$1.7 million, respectively. A majority of the expense, \$1.9 million and \$1.6 million, respectively, was recorded as selling and administrative expenses in the Consolidated Statements of Income, with the remaining expenses recorded as cost of sales and research and development.

For the nine months ended September 30, 2011 and 2012, we recognized \$6.1 million and \$8.1 million, respectively, in stock-based compensation expense. A majority of the expense, \$5.4 million and \$7.3 million, respectively, was recorded as selling and administrative expenses in the Consolidated Statements of Income, with the remaining expenses recorded as cost of sales and research and development.

As of September 30, 2012, the total compensation cost related to non-vested restricted stock, performance shares and stock options not yet recognized was \$15.9 million, which will be recognized over the weighted average life of 1.2 years.

Restricted Stock and Performance Shares

Restricted stock and performance share awards activity under the plans for the nine months ended September 30, 2012 was:

	Number of Shares	Weighted- Average Grant Date Fair Value
Outstanding unvested as of January 1, 2012	1,725,158	\$15.82
Granted	114,706	14.27
Vested	(380,396)	) 13.15
Forfeited/canceled/expired	(105,079)	) 16.04
Outstanding unvested as of September 30, 2012	1,354,389	16.42

Stock Options

Stock option activity under the plans for the nine months ended September 30, 2012 was:



PART I (CONT'D)  
 GRAFTECH INTERNATIONAL LTD. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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	Number of Shares	Weighted- Average Exercise Price
Outstanding as of January 1, 2012	1,327,087	\$13.15
Granted	26,300	14.76
Forfeited/canceled/expired	(8,671)	) 10.60
Exercised	(21,401)	) 15.74
Outstanding as of September 30, 2012	1,323,315	13.16

## (4) Earnings per Share

The following table shows the information used in the calculation of our share counts for basic and diluted earnings per share:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2012	2011	2012
Weighted average common shares outstanding for basic calculation	145,412,661	134,347,199	145,293,165	139,938,771
Add: Effect of stock options and restricted stock	768,292	653,466	819,884	625,907
Weighted average common shares outstanding for diluted calculation	146,180,953	135,000,665	146,113,049	140,564,678

Basic earnings per common share are calculated by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per share are calculated by dividing net income by the sum of the weighted average number of common shares outstanding plus the additional common shares that would have been outstanding if potentially dilutive securities had been issued.

The weighted average common shares outstanding for the diluted earnings per share calculation excludes consideration of stock options covering 210,897 and 229,497 shares in the three and nine months ended September 30, 2011 as the exercise prices were greater than the weighted average market price of our common stock for that period.

The weighted average common shares outstanding for the diluted earnings per share calculation excludes consideration of stock options covering 862,977 shares in the three and nine months ended September 30, 2012 as the exercise prices were greater than the weighted average market price of our common stock for that period.

During the three months ended September 30, 2012, we repurchased, in the open market, the remaining 1.2 million common shares under a previously announced ten million share repurchase program authorized by the Board of Directors. Ten million shares authorized under this program were repurchased during the nine months ended September 30, 2012. These share repurchases represented a financing cash outflow of \$101.7 million for the nine months ended September 30, 2012. These share repurchases decreased the weighted average shares outstanding by 9.9 million shares for the three months ended September 30, 2012 and 4.1 million shares for the nine months ended September 30, 2012.

## (5) Segment Reporting

Our businesses are reported in the following reportable segments:

**Industrial Materials.** Our Industrial Materials segment manufactures and delivers high quality graphite electrodes, refractory products and needle coke products. Electrodes are key components of the conductive power systems used to produce steel and other non-ferrous metals. Refractory products are used in blast furnaces and submerged arc furnaces due to their high thermal conductivity and the ease with which they can be machined to large or complex shapes.

Needle coke, a crystalline form of carbon derived from decant oil, is the key ingredient in, and is used primarily in, the

production of graphite electrodes.

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PART I (CONT'D)  
 GRAFTECH INTERNATIONAL LTD. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

Engineered Solutions. Engineered Solutions include advanced graphite materials products for industrial, energy, transportation, and defense markets, as well as natural graphite products enabling thermal management solutions for the advanced electronics industry and energy storage solutions for the transportation and power generation industries. We continue to evaluate the performance of our segments based on segment operating income. Inter-segment sales and transfers are not material and the accounting policies of the reportable segments are the same as those for our Consolidated Financial Statements as a whole. Corporate expenses are allocated to segments based on each segment's percentage of consolidated net sales.

The following tables summarize financial information concerning our reportable segments:

	For the Three Months Ended September 30, 2011		For the Nine Months Ended September 30, 2011	
	2012	2012	2011	2012
	(Dollars in thousands)		(Dollars in thousands)	
Net sales to external customers:				
Industrial Materials	\$302,355	\$260,180	\$835,591	\$715,461
Engineered Solutions	43,477	60,536	136,609	161,804
Total net sales	\$345,832	\$320,716	\$972,200	\$877,265
Segment operating income:				
Industrial Materials	54,130	37,301	120,465	104,103
Engineered Solutions	3,361	6,262	14,241	10,044
Total segment operating income	\$57,491	\$43,563	\$134,706	\$114,147
Reconciliation of segment operating income to income before provision for income taxes				
Other expense (income), net	5,321	1,653	5,134	(1,376)
Interest expense	4,792	5,839	13,780	15,733
Interest income	(119)	(33)	(363)	(178)
Income before provision for income taxes	\$47,497	\$36,104	\$116,155	\$99,968

(6) Other Expense (Income), Net

Other income for the nine months ended September 30, 2012, includes \$4.0 million of insurance reimbursements for claims made related to flood damages incurred at our Clarksburg, West Virginia facility during 2011.

(7) Benefit Plans

The components of our consolidated net pension costs are set forth in the following table:

	For the Three Months Ended September 30, 2011		For the Nine Months Ended September 30, 2011	
	2012	2012	2011	2012
	(Dollars in thousands)		(Dollars in thousands)	
Service cost	\$164	\$426	\$492	\$1,278
Interest cost	2,446	2,150	7,338	6,450
Expected return on plan assets	(2,138)	(2,195)	(6,414)	(6,585)
Amortization of prior service cost	13	6	39	18
Net cost	\$485	\$387	\$1,455	\$1,161



PART I (CONT'D)  
 GRAFTECH INTERNATIONAL LTD. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

The components of our consolidated net postretirement costs are set forth in the following table:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2012	2011	2012
	(Dollars in thousands)		(Dollars in thousands)	
Service cost	\$41	\$46	\$123	\$138
Interest cost	440	381	1,320	1,143
Amortization of prior service benefit	(48	) (49	) (144	) (147