
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended October 31, 2002

or

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

Commission file number 1-5725

QUANEX CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or
organization)

38-1872178

(I.R.S. Employer Identification No.)

1900 West Loop South, Suite 1500, Houston, Texas
(Address of principal executive offices)

77027
(zip code)

(713) 961-4600

(Registrant's telephone number, including area code)

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

| <u>Title of each class</u> | <u>Name of each exchange on which registered</u> |
|---|--|
| Common Stock, \$.50 par value | New York Stock Exchange, Inc. |
| Rights to Purchase Series A Junior Participating Preferred Stock | New York Stock Exchange, Inc. |

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

NONE

Indicate by check mark 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

The aggregate market value of the registrant's voting stock held by non-affiliates as of November 30, 2002, computed by reference to the closing price for the Common Stock on the New York Stock Exchange, Inc. on that date, was \$498,490,477. Such calculation assumes only the registrant's officers and directors were affiliates of the registrant.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☒ No ☐

The aggregate market value of the voting common equity held by non-affiliates as of April 30, 2002, computed by reference to the closing price for the Common Stock on the New York Stock Exchange, Inc. on that date, was \$506,334,420. Such calculation assumes only the registrant's officers and directors were affiliates of the registrant.

At December 13, 2002, there were outstanding 16,443,519 shares of the registrant's Common Stock, \$.50 par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement, to be filed with the Commission within 120 days of October 31, 2002, for its Annual Meeting of Stockholders to be held on February 26, 2003, are incorporated herein by reference in Items 10, 11, 12, and 13 of Part III of this Annual Report.

TABLE OF CONTENTS

| | <u>Page</u> |
|---|-------------|
| PART I | |
| Item 1. Business | 1 |
| General | 1 |
| Business Developments in Fiscal 2002 | 1 |
| Manufacturing Processes, Markets and Product Sales by Business Segment | 2 |
| Raw Materials and Supplies | 4 |
| Backlog | 5 |
| Competition | 5 |
| Sales and Distribution | 5 |
| Seasonal Nature of Business | 6 |
| Service Marks, Trademarks, Trade Names and Patents | 6 |
| Research and Development | 6 |
| Environmental Matters | 6 |
| Employees | 7 |
| Financial Information About Foreign and Domestic Operations | 7 |
| Website | 7 |
| Item 2. Properties | 8 |
| Item 3. Legal Proceedings | 8 |
| Item 4. Submission of Matters to a Vote of Security Holders | 8 |
| PART II | |
| Item 5. Market for Registrant’s Common Equity and Related Security Holder Matters | 9 |
| Item 6. Selected Financial Data | 10 |
| Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations . | 13 |
| Item 7A. Quantitative\Qualitative Disclosure | 26 |
| Item 8. Financial Statements and Supplementary Data | 28 |
| Item 9. Disagreements on Accounting and Financial Disclosure | 67 |
| PART III | |
| Item 10. Directors and Executive Officers of the Registrant | 67 |
| Item 11. Executive Compensation | 67 |
| Item 12. Security Ownership of Certain Beneficial Owners and Management | 67 |
| Item 13. Certain Relationships and Related Transactions | 67 |
| Item 14. Controls and Procedures | 67 |
| PART IV | |
| Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K | 68 |

PART I

Item 1. Business

General

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

The Company's businesses are managed on a decentralized basis. Each operating division has administrative, operating and marketing functions. The Company measures each division's return on investment, and seeks to reward superior performance with incentive compensation, which is a significant portion of total compensation for salaried employees. Intercompany sales are conducted on an arms-length basis. Operational activities and policies are managed by corporate officers and key division executives. Also, a small corporate staff provides corporate accounting, financial and treasury management, tax, and human resource services to the operating divisions.

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

Business Developments in Fiscal 2002

In February 2002, Quanex completed the purchase of Colonial Craft, Inc. ("COLONIAL CRAFT"), a leading manufacturer of value-added, wood and door (fenestration) related wood products, located in Roseville, Minnesota (relocated to Mounds View, Minnesota in December 2002). COLONIAL CRAFT manufactures custom wood window accessories and their two primary product lines are hardwood architectural mouldings and wood window grilles used by wood window manufacturers. The company compliments Quanex's other Engineered Products businesses by serving a similar customer base.

In the Company's MACSTEEL operations, rotary centrifugal continuous casters are used with an in-line manufacturing process to produce bearing grade quality, seam-free, engineered carbon and alloy steel bars that enable Quanex to participate in higher margin markets within its vehicular products market. Since 1990, the Company has invested approximately \$285 million to enhance its steel bar manufacturing and refining processes, to improve rolling and finishing capability, and to expand shipping capacity at its MACSTEEL operations to approximately 720,000 tons per year. Phases I through VI of the MACSTEEL expansions have been completed. Phase V, completed in December 2000, included projects at MACSTEEL Heat Treating, based in Huntington, Indiana, where a third processing line was built, and at Pleasant Prairie, Wisconsin-based MACSTEEL NitroSteel, where efficiency enhancing equipment has been installed. In Phase VI, finished in December 2002, the Company installed additional equipment at each of the MACSTEEL plants in Jackson, Michigan, and Ft. Smith, Arkansas to increase their bar cutting capability and value-added turning capacity. This project increased MACPLUS engineered steel bar shipping capacity by approximately 13% to 270,000 tons annually with the installation of two additional bar turning and polishing lines, one at the plant in Jackson, which was completed in December of 2001 and the other at the Ft. Smith plant, which was completed in December 2002. MACSTEEL now has a total of six value-added MACPLUS lines.

Manufacturing Processes, Markets, and Product Sales by Business Segment

Quanex operates 18 manufacturing facilities in ten states in the United States. These facilities feature efficient plant design and flexible manufacturing processes, enabling the Company to produce a wide variety of custom engineered products and materials for the Company's vehicular products and building products markets. The Company is generally able to maintain minimal levels of finished goods inventories at most locations because it typically manufactures products to customer specifications upon order.

During the latter portion of the fiscal year ended October 31, 2001, the Company completed a strategic review of its business, which resulted in a shift of strategy away from primarily a manufacturing "process" oriented enterprise to a more "market-focused" enterprise. As expected, the review underscored a high concentration of sales in two market segments—vehicular products and building products. Beginning in fiscal 2002, the Company realigned its management, strategy and tactics to support this new focus and now reports operations in those two market-focused segments.

The majority of the company's products are sold into the vehicular products and building products markets with minimal sales to the industrial machinery and capital equipment markets.

For financial information regarding each of Quanex's business segments, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" herein and Note 14 to the Consolidated Financial Statements. For net sales of the Company by major product lines see Note 14 to the Consolidated Financial Statements. For the years ended October 31, 2002, 2001 and 2000, no one customer accounted for 10% or more of the Company's sales.

Vehicular Products Segment

The vehicular products segment is comprised of MACSTEEL, Piper Impact and Temroc Metals. The segment includes engineered steel bar operations, impact-extrusion operations, steel bar and tube heat-treating services, steel bar and tube corrosion and wear resistant finishing services, and aluminum extrusion and fabricated metal products.

MACSTEEL

The Company's engineered steel bar operations, which represent the majority of the segment's sales and operating income, are conducted through its MACSTEEL division. MACSTEEL includes two plants, one located in Ft. Smith, Arkansas, and the other in Jackson, Michigan, which in the aggregate are capable of shipping up to 720,000 tons annually of hot finished, precision engineered, carbon and alloy steel bars. The Company believes that MACSTEEL has the only two plants in North America using scrap-fed continuous rotary centrifugal casting technology. This casting process produces seam-free bars, without surface defects or inclusions, thereby reducing the need for subsequent surface conditioning. The continuous casting and automated in-line manufacturing operations at the MACSTEEL plants substantially reduce labor and energy costs by eliminating the intermittent steps that characterize manufacturing operations at most larger, and particularly integrated steel mills. The Company typically sells only complete heat lots, or batches, which are made to specific customer requirements.

MACSTEEL produces various grades of customized, engineered steel bars by melting steel scrap and casting it in a rotary centrifugal continuous caster. MACSTEEL's molten steel is further processed through secondary refining processes that include argon stirring, ladle injection, and vacuum arc degassing prior to casting. These processes enable MACSTEEL to produce higher quality, "cleaner" steel.

As a result of its state-of-the-art continuous manufacturing technology, which reduces labor and energy costs and process yield loss, the Company believes that MACSTEEL is one of the lowest cost producers of engineered carbon and alloy steel bars in North America. The Company believes that energy costs at MACSTEEL are significantly lower than those of its competitors because its bars are moved directly from the caster to the rolling mill before cooling, eliminating the need for costly reheating. MACSTEEL's low unit labor costs are achieved with its highly automated manufacturing process, enabling it to produce finished steel bars using less than two

man-hours of labor per ton compared with an estimated average of four to five man-hours per ton for U.S. integrated steel producers.

MACSTEEL products are custom manufactured primarily for the vehicular product markets serving the passenger car, light truck, sport utility vehicle, heavy truck, anti-friction bearing, off-road and farm equipment, and seamless tubular industries. These industries use engineered steel bars in critical applications such as camshafts, crankshafts, transmission gears, wheel spindles and hubs, bearing components, steering components, hydraulic mechanisms and seamless tube production. Also, MACSTEEL engineered steel bars are used for the manufacture of components for safety critical steel air bag inflators at the Company's Piper Impact plant in New Albany, Mississippi.

Also included in the MACSTEEL division is a heat treating plant in Huntington, Indiana ("Heat Treat") and a plant in Pleasant Prairie, Wisconsin that improves the wear and corrosion resistance properties of steel bars and tubes ("NitroSteel").

The Heat Treat facility uses custom designed, in-line equipment to provide tube and bar heat-treating and related services, such as quench and temper, stress relieving, normalizing, "cut-to-length", and metallurgical testing. This plant primarily serves customers in the vehicular products and energy markets.

The NitroSteel plant processes steel bars and tubes using the patented Nitrotec treatment to improve corrosion and wear resistance while providing an environmentally friendly, non-toxic alternative to chrome plating. NitroSteel's products are made for specific customer applications and are used for fluid power applications in primarily the vehicular products markets.

Piper Impact

Piper Impact includes two impact-extrusion facilities in New Albany, Mississippi, dedicated to aluminum and steel impact-extruded products.

Piper Impact is a manufacturer of custom designed, impact extruded aluminum and steel parts primarily for vehicular and defense applications. Piper Impact's operations use impact extrusion technology to produce highly engineered near-net shaped components from aluminum and steel slugs. The pressure resulting from the impact of the extrusion presses causes metal to flow into the desired shape. This cost efficient cold forming of the metal results in a high quality, work hardened product with a superior finish. Products may be further processed with heat-treating and precision machining. The parts are then delivered to customers' assembly lines, requiring little or no additional processing. Though down from prior years, one customer remains a majority of Piper's sales for use in the automotive air bag systems.

Temroc Metals

Temroc Metals is located in Hamel, Minnesota. Temroc Metals is an aluminum extruder and fabricator of metal products. The single facility manufactures engineered products that primarily serve the outdoor recreational vehicular products market.

Building Products Segment

The building products segment is comprised of the Engineered Products and Nichols Aluminum divisions. The segment includes four fabricated metal components operations, two wood fenestration product operations, two aluminum sheet casting and three stand alone finishing operations.

Engineered Products

The Engineered Products division, which includes AMSCO in Rice Lake, Wisconsin, HOMESHIELD, with two plants in Chatsworth, Illinois, IMPERIAL PRODUCTS in Richmond, Indiana, and COLONIAL CRAFT in Roseville and Maplewood, Minnesota (relocated to Mounds View, Minnesota in December 2002) and Luck, Wisconsin, produces various engineered products for the building products markets. These products include

aluminum window and patio door screens, window frames, residential exterior door products, custom wood window grilles and accessories, and a broad line of custom designed, roll-formed aluminum products and stamped aluminum shapes for manufacturers of premium wood windows and vinyl windows for the home improvement, residential, and commercial construction markets. AMSCO combines strong product design and development expertise with reliable, just-in-time delivery. HOMESHIELD also coats and/or paints aluminum sheet in many colors, sizes, and finishes, and fabricates aluminum coil into rain carrying systems, soffit, exterior housing trim and roofing products. IMPERIAL PRODUCTS produces sophisticated residential exterior door thresholds, astragals, patio door systems and other miscellaneous door components. COLONIAL CRAFT produces custom hardwood architectural moulding and window and door accessories for premium wood window manufacturers.

Nichols Aluminum

Nichols Aluminum manufactures mill finished and coated aluminum sheet for the building products market and the food packaging market. The division comprises five plants: a thin-slab casting and hot rolling mill (“NAC”) located in Davenport, Iowa, three cold rolling and finishing plants located in Davenport, Iowa (“NAD”), Lincolnshire, Illinois (“NAL”), and Decatur, Alabama (“NAA”), and Nichols Aluminum–Golden (“NAG”), an aluminum production facility located in Fort Lupton, Colorado.

NAC’s mini-mill uses an in-line casting process that can produce 400 million pounds of reroll (hot-rolled aluminum sheet) annually. The mini-mill converts aluminum scrap to sheet through melting, continuous casting, and in-line hot rolling processes. NAC has shredding and blending capabilities, including two rotary barrel furnaces and dross recovery system that broaden its sources of raw material, allow it to melt cheaper grades of scrap, and improve raw material yields. Delacquering equipment improves the quality of the raw material before it reaches the melting furnaces by burning off combustibles in the scrap. Scrap is blended using computerized processes to most economically achieve the desired molten aluminum alloy composition.

The Company believes the combination of base capacity increases and technological enhancements directed at producing higher quality reroll results in a significant manufacturing advantage with savings derived from reduced raw material costs, optimized scrap utilization, reduced unit energy cost, reduced cold rolling requirements and lower labor costs.

Further processing of the reroll occurs at NAD, NAL or NAA, where customers’ specific product requirements can be met through cold rolling to various gauges, annealing for additional mechanical and formability properties, tension leveling to improve the flatness of the sheet, and slitting to specific widths. Products at the NAD and NAA plants can also be custom painted, an important value-added feature for the applications of certain customers in the building products market.

Operations at NAG include melting and casting aluminum into sheet, cold rolling to specific gauge, annealing, leveling, custom coating and slitting to width. NAG manufactures high quality aluminum sheet from scrap, then finishes the sheet for specialized applications primarily for food packaging markets.

Raw Materials and Supplies

The Company’s MACSTEEL plants purchase their principal raw material, steel scrap or substitutes such as pig iron, beach iron and hot briquetted iron on the open market. Collection and transportation of these raw materials to the Company’s plants can be adversely affected by extreme weather conditions. Prices for scrap also vary in relation to the general business cycle, typically declining in periods of slow economic activity.

Temroc Metal’s raw material consists primarily of aluminum billet, which it purchases from several suppliers on the open market.

Piper Impact’s raw material consists of aluminum bars and slugs that it purchases on the open market, and steel bars that it purchases from MACSTEEL.

AMSCO and HOMESHIELD’s primary raw material is coated and uncoated aluminum sheet purchased primarily from Nichols Aluminum. Raw materials utilized at IMPERIAL PRODUCTS include aluminum, wood

and vinyl that are available from a number of suppliers. Prices for aluminum are typically set on a monthly basis based upon market rates. In addition, IMPERIAL PRODUCTS purchases two types of wood materials—hardwood and softwood, which it purchases at market prices.

COLONIAL CRAFT's primary raw material is kiln-dried hardwood and softwood lumber. This is purchased from sawmills and lumber concentration yards throughout North America at market prices.

Nichols Aluminum's principal raw material is aluminum scrap purchased on the open market, which can also be adversely affected by extreme weather conditions. Nichols purchases and sells aluminum ingot futures contracts on the London Metal Exchange to hedge against fluctuations in the price of aluminum scrap required to manufacture products for fixed-price sales contracts.

Backlog

At October 31, 2002, Quanex's backlog of orders to be shipped in the next twelve months was approximately \$240 million. This compares to approximately \$165 million at October 31, 2001. Because many of the markets in which Quanex operates have short lead times, the Company does not believe that backlog figures are reliable indicators of annual sales volume or operating results.

Competition

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

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

Piper Impact competes with several other impact extrusion companies, and companies that offer other technologies that can provide similar products, on the basis of design, quality, price and service. Temroc Metals competes largely with other small aluminum extrusion and machining facilities.

Engineered Products competes with many small and midsize metal and wood fabricators and wood moulding facilities, primarily on the basis of custom engineering, product development, quality, service, and price. The division also competes against in-house operations of vertically integrated fenestration original equipment manufacturers ("OEM"s).

Nichols Aluminum competes with many small and large aluminum sheet manufacturers. Some of these competitors are divisions or subsidiaries of major corporations with substantially greater resources than the Company. The Company also competes with major aluminum producers in coil-coated and mill finished products, primarily on the basis of the breadth of product lines, the quality and responsiveness of its services, and price.

Sales and Distribution

The Company has sales organizations with sales representatives in many parts of the U.S. MACSTEEL sells engineered steel bars primarily to tier-one or tier-two suppliers through its sales organization and manufacturers' representatives. Piper Impact and Temroc Metals sell directly to OEMs. The Engineered Products division's products are sold primarily to OEMs, except for some residential building products, which are also sold through distributors. Nichols Aluminum products are sold directly to OEMs and through metal service centers.

Seasonal Nature of Business

Sales for Engineered Products and Nichols Aluminum are seasonal. The primary markets of these divisions are in the Northeast and Midwest regions of the United States, where winter weather typically reduces homebuilding and home improvement activity. These divisions typically experience their lowest sales during the Company's first fiscal quarter. Profits tend to be lower in quarters with lower sales because a high percentage of their manufacturing overhead and operating expense is due to labor and other costs that are generally semi-variable throughout the year.

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

Service Marks, Trademarks, Trade Names, and Patents

The Company's Quanex, Quanex design, Seam-Free design, NitroSteel, MACGOLD, MACSTEEL, MACSTEEL design, MAC+, Ultra-Bar, Homeshield, Homeshield design, and "The Best Alloy & Specialty Bars" marks are registered trademarks or service marks. The Company's Piper Impact name is used as a service mark, but is not yet registered in the United States. The trade name Nichols-Homeshield and the Homeshield design trademarks are used in connection with the sale of the Company's aluminum mill sheet products and residential building products. The Homeshield, Piper Impact, Colonial Craft, MACSTEEL and Quanex word and design marks and associated trade names are considered valuable in the conduct of the Company's business. The businesses conducted by the Company generally do not depend upon patent protection. Although the Company holds numerous patents, in many cases, the proprietary technology that the Company has developed for using the patents is more important than the patents themselves.

Research and Development

Expenditures for research and development of new products or services during the last three years were not significant. Although not technically defined as research and development, a significant amount of time, effort and expense is devoted to custom engineering and qualifying the Company's products for specific customer applications.

Environmental Matters

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

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

From time to time, Quanex also has been alleged to be liable for all or part of the costs incurred to clean up third-party sites where it is alleged to have arranged for disposal of hazardous substances. The Company's allocable share of liability at those sites, taking into account the likelihood that other parties will pay their shares, has not been material to its operations or financial condition.

Total remediation reserves, at October 31, 2002, for Quanex's current plants, former operating locations, and disposal facilities were approximately \$17 million. Of that, approximately 80% is allocated to the cleanup of

historical soil and groundwater contamination and other corrective measures at the Piper Impact division in New Albany, Mississippi. Depending upon such factors as the nature and extent of contamination, the cleanup technologies employed, and regulatory concurrences, final remediation costs may be more or less than amounts accrued; however, management believes it has established adequate reserves for all probable and reasonably estimable remediation liabilities.

Environmental agencies continue to develop regulations implementing the Federal Clean Air Act. Depending on the nature of the regulations adopted, Quanex may be required to incur additional capital and other expenditures sometime in the next several years for air pollution control equipment, to maintain or obtain operating permits and approvals, and to address other air emission-related issues. In fiscal 2003, the Company plans to have capital expenditures for equipment upgrades in order to comply with secondary aluminum production emissions standards at two of its Nichols Aluminum facilities. Based upon its analysis and experience to date, Quanex does not believe that its compliance with Clean Air Act requirements will have a material effect on its operations or financial condition.

Quanex incurred approximately \$4 million and \$3 million during fiscal 2002 and 2001, respectively, in expenses in order to comply with existing environmental regulations. For 2003, the Company estimates expenses at various of its facilities will be approximately \$3 million for continuing environmental compliance. Capital expenditures for compliance with existing or proposed environmental regulations were approximately \$1.5 million during fiscal 2002 and were immaterial in 2001. For fiscal 2003, the Company estimates that capital expenditures for environmental compliance will be approximately \$6 million, which includes amounts for upgrades related to secondary aluminum production emissions standards at two of its Nichols Aluminum facilities. Future expenditures relating to environmental matters will necessarily depend upon the application to Quanex and its facilities of future regulations and government decisions. Quanex will continue to have expenditures in connection with environmental matters beyond 2003, but it is not possible at this time to reasonably estimate the amount of those expenditures.

Employees

At October 31, 2002, the Company employed 3,476 persons. Of the total employed, 31% were covered by collective bargaining agreements. A five-year collective bargaining agreement for Temroc Metals was ratified by the United Automobile Workers International Union of Americas in February, 2002. A five year collective bargaining agreement for Nichols Aluminum Casting and Nichols Aluminum Davenport was ratified by the International Brotherhood of Teamsters in November 2002. MACSTEEL Arkansas' collective bargaining agreement expires January 31, 2003 and negotiations for the renewal of that agreement will begin in January.

Financial Information About Foreign and Domestic Operations

For financial information on the Company's foreign and domestic operations, see Note 14 of the Financial Statements contained in this Annual Report on Form 10-K.

Website

The Company's required Securities and Exchange Act filings such as Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q are accessible free of charge on its website at www.Quanex.com.

Item 2. *Properties*

The following table lists Quanex's principal plants together with their locations, general character and the industry segment which uses the facility. (See Item 1, "Business", for some discussion of capacity of various facilities.)

| <u>Location</u> | <u>Plant</u> | <u>Square footage</u> |
|---|----------------------------------|---------------------------|
| <i>Owned:</i> | <i>Vehicular Products</i> | |
| Fort Smith, Arkansas | MACSTEEL | 614,000 |
| Jackson, Michigan | MACSTEEL | 386,000 |
| Huntington, Indiana | Heat Treating | 99,821 |
| Pleasant Prairie, Wisconsin | NitroSteel | 35,000 |
| New Albany, Mississippi | Piper Impact (two plants) | 683,000 |
| Hamel, Minnesota | Temroc Metals | 240,000 |
| <i>Owned:</i> | <i>Building Products</i> | |
| Lincolnshire, Illinois | Nichols Aluminum | 142,000 |
| Davenport, Iowa | Nichols Aluminum | 236,000 |
| Davenport, Iowa | Nichols Aluminum Casting | 300,000 |
| Fort Lupton, Colorado | Nichols Aluminum Golden | 240,400 |
| Rice Lake, Wisconsin | AMSCO | 336,000 |
| Chatsworth, Illinois | HOMESHIELD (two plants) | 218,000 |
| Richmond, Indiana | IMPERIAL PRODUCTS | 92,000 |
| Luck, Wisconsin | COLONIAL CRAFT | 105,000 |
| <i>Leased (3 leases expiring 2003, 2003 and 2008, respectively):</i> | | |
| Maplewood, Minnesota ⁽¹⁾ | COLONIAL CRAFT | 35,000 |
| Roseville, Minnesota ⁽¹⁾ | COLONIAL CRAFT | 48,000 |
| Mounds View, Minnesota | COLONIAL CRAFT | 125,000 |
| <i>Leased (4 leases expiring 2003, 2004, 2005 and 2018):</i> | | |
| Decatur, Alabama | Nichols Aluminum Alabama | 410,000 |
| <i>Leased (expires 2010):</i> | <i>Executive Offices</i> | |
| Houston, Texas | Quanex Corporation | 21,000 |

(1) These leases expire during fiscal 2003. COLONIAL CRAFT consolidated these facilities into the Mounds View, Minnesota facility in December 2002.

Item 3. *Legal Proceedings*

Other than the proceedings described under Item 1, "Environmental Matters", there are no material legal proceedings to which Quanex, its subsidiaries, or their property is subject.

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

None.

PART II

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

Quanex's common stock, \$.50 par value, is traded on the New York Stock Exchange, under the ticker symbol: NX. Quarterly stock price information and annual dividend information for the common stock is as follows:

Quarterly Common Stock Dividends

| <u>Quarter Ended</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>1999</u> | <u>1998</u> |
|----------------------|-------------|-------------|-------------|-------------|-------------|
| January | .16 | .16 | .16 | .16 | .16 |
| April | .16 | .16 | .16 | .16 | .16 |
| July | .16 | .16 | .16 | .16 | .16 |
| October | .16 | .16 | .16 | .16 | .16 |
| Total | <u>.64</u> | <u>.64</u> | <u>.64</u> | <u>.64</u> | <u>.64</u> |

Quarterly Common Stock Sales Price (High & Low)

| <u>Quarter Ended</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>1999</u> | <u>1998</u> |
|----------------------|----------------|----------------|--------------------|-------------------|--------------------|
| January | 29.64 25.71 | 21 16.375 | 26.5625 19.0625 | 23.875 16.8125 | 30.4375 27.0625 |
| April | 38.35 28.63 | 21.15 17.35 | 23.6875 16.125 | 26.25 15.375 | 33.8125 28.50 |
| July | 44.19 31.01 | 27.55 20.70 | 18.625 14.375 | 29 25.125 | 32.1875 27.25 |
| October | 40.55 33.18 | 27.48 20.75 | 20.6875 17.0625 | 27.375 20.125 | 27.875 15.625 |

The terms of Quanex's new revolving credit agreement, which was entered into in November 2002, does not specifically limit the total amount of dividends and other distribution on its stock. However, the covenant to maintain a certain fixed charge coverage ratio indirectly impacts the Company's ability to pay dividends. As of October 31, 2002, the aggregate amount available for dividends under the new credit facility was approximately \$33 million.

There were 5,006 holders of Quanex common stock (excluding individual participants in securities positions listings) on record as of November 30, 2002.

The following table summarizes as of October 31, 2002, certain information regarding equity compensation to our employees, officers, directors and other persons under our equity compensation plans.

Equity Compensation Plan Information

| Plan Category | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|---|---|---|---|
| | (a) | (b) | (c) |
| Equity compensation plans approved by security holders | 777,137 | \$23 | 593,143 |
| Equity compensation plans not approved by security holders ⁽¹⁾ | 163,465 | 23 | 130,454 |
| Total | <u>940,602</u> | <u>\$23</u> | <u>723,597</u> |

(1) The Quanex Corporation 1997 Key Employee Stock Plan was approved by the Company's Board of Directors in October 1997. This plan provides for the granting of stock options to eligible persons employed by the Company who are not executive officers of the Company. Under the plan, the total number of stock options which may be granted is 400,000 shares. Stock options may be granted at not less than the fair market value (as defined in the plan) on the date the options are granted and generally become exercisable after one year in 33½ percent annual increments. The options expire ten years after the date of grant. The Board of Directors may amend, terminate or suspend the plan at any time.

Item 6. Selected Financial Data

Glossary of Terms

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

Capital expenditures: Additions to property, plant and equipment.

Book value per common share: Stockholders' equity less the stated value of preferred stock divided by the number of common shares outstanding.

Asset turnover: Net sales divided by average total assets.

Current ratio: Current assets divided by current liabilities.

EBITDA: Earnings before interest, taxes, depreciation and amortization, excluding unusual items.

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

Return on common stockholders' equity: Net income attributable to common stockholders divided by average common stockholders' equity.

Financial Summary 1997–2002

| Fiscal years ended October 31, | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 |
|--|---------------------------------------|---------|-----------------------|---------|-----------------------|--------------------|
| | (\$ thousands, except per share data) | | | | | |
| Revenues and Earnings | | | | | | |
| Net sales ^{(1),(8)} | 994,387 | 924,353 | 964,518 | 834,902 | 821,507 | 768,743 |
| Cost of sales including operating depreciation and amortization | 855,177 | 809,027 | 841,047 | 706,607 | 707,971 | 666,691 |
| Gross profit | 139,210 | 115,326 | 123,471 | 128,295 | 113,536 | 102,052 |
| Piper Impact Asset Impairment Charge | — | — | 56,300 ⁽²⁾ | — | 58,500 ⁽²⁾ | — |
| Loss on sale of Piper Impact Europe | — | — | 14,280 ⁽³⁾ | — | — | — |
| Other depreciation and amortization | 1,502 | 3,808 | 3,308 | 3,434 | 5,059 | 3,669 |
| Selling, general and administrative expenses . . . | 54,408 | 54,202 | 53,545 | 53,104 | 47,713 | 43,375 |
| Operating income (loss) | 83,300 | 57,316 | (3,962) | 71,757 | 2,264 | 55,008 |
| Percent of net sales ⁽⁸⁾ | 8.4 | 6.2 | (0.4) | 8.6 | 0.3 | 7.2 |
| Retired executive life insurance benefit (See Note 5 to financial statements) | 9,020 | | | | | |
| Other income—net | 2,227 | 3,195 | 2,420 | 2,021 | 2,278 | 1,637 |
| Interest expense—net | 12,933 | 14,889 | 13,314 | 12,791 | 10,506 | 14,002 |
| Income (loss) before income taxes and income from discontinued operations | 81,614 | 45,622 | (14,856) | 60,987 | (5,964) | 42,643 |
| Income taxes (credit) | 26,132 | 16,428 | (5,191) | 21,271 | (2,087) | 14,925 |
| Income (loss) from continuing operations | 55,482 | 29,194 | (9,665) | 39,716 | (3,877) | 27,718 |
| Income from discontinued operations | 0 | — | — | — | — | 5,176 |
| Gain on sale of discontinued operations | 0 | — | — | — | 13,046 | 36,290 |
| Net income (loss) | 55,482 | 29,194 | (9,665) | 39,716 | 9,169 | 69,184 |
| Percent of net sales ⁽⁸⁾ | 5.6 | 3.2 | (1.0) ⁽⁷⁾ | 4.8 | 1.1 ⁽⁶⁾ | 9.0 ⁽⁵⁾ |
| Per Share Data | | | | | | |
| Basic Earnings per share: | | | | | | |
| Income (loss) from continuing operations . . . | 3.74 | 2.18 | (0.70) | 2.79 | (0.27) | 2.01 |
| Income from discontinued operations | — | — | — | — | — | 0.37 |
| Gain on sale of discontinued operations | — | — | — | — | 0.92 | 2.63 |
| Net earnings (loss) | 3.74 | 2.18 | (0.70) ⁽⁷⁾ | 2.79 | 0.65 ⁽⁶⁾ | 5.01 |
| Cash dividends declared | 0.64 | 0.64 | 0.64 | 0.64 | 0.64 | 0.61 |
| Book value | 25.67 | 20.88 | 19.90 | 21.24 | 19.19 | 19.13 |
| Average shares outstanding (000) | 14,823 | 13,399 | 13,727 | 14,234 | 14,149 | 13,807 |
| Market closing price range: | | | | | | |
| High | 44.15 | 27.38 | 26.56 | 28.94 | 33.50 | 36.50 |
| Low | 25.89 | 17.00 | 14.38 | 15.50 | 16 | 23.38 |

| Fiscal years ended October 31, | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 |
|--|---------------------------------------|----------|----------------------|----------|--------------------|---------------------|
| | (\$ thousands, except per share data) | | | | | |
| Financial Position—Year End | | | | | | |
| Working capital | 100,997 | 102,288 | 104,944 | 76,247 | 62,979 | 52,818 |
| Property, plant and equipment—net | 353,132 | 357,635 | 338,248 | 406,841 | 395,054 | 379,071 |
| Other assets | 100,207 | 103,118 | 71,665 | 71,218 | 69,422 | 119,738 |
| Total assets | 689,140 | 697,631 | 645,859 | 690,446 | 674,288 | 685,705 |
| Noncurrent deferred income taxes | 29,210 | 29,282 | 27,620 | 43,910 | 33,412 | 48,111 |
| Long-term debt | 75,131 | 219,608 | 191,657 | 179,121 | 188,302 | 201,858 |
| Stockholders' equity | 421,395 | 279,977 | 266,497 | 301,061 | 272,044 | 268,823 |
| Total capitalization | 496,526 | 499,585 | 458,154 | 480,182 | 460,346 | 470,681 |
| Long-term debt percent of capitalization | 15.2 | 44.0 | 41.8 | 37.3 | 40.9 | 42.9 |
| Other Data | | | | | | |
| Asset turnover ⁽⁸⁾ | 1.4 | 1.4 | 1.4 | 1.2 | 1.2 | 1.2 |
| Current ratio | 1.7 to 1 | 1.8 to 1 | 1.8 to 1 | 1.6 to 1 | 1.4 to 1 | 1.4 to 1 |
| Return on average investment—percent | 12.8 | 8.1 | (0.2) ⁽⁷⁾ | 10.0 | 3.4 ⁽⁶⁾ | 16.7 ⁽⁵⁾ |
| Return on average common equity—percent | 15.8 | 10.7 | (3.4) ⁽⁷⁾ | 13.9 | 3.4 ⁽⁶⁾ | 29.7 ⁽⁵⁾ |
| EBITDA ⁽⁴⁾ | 129,092 | 104,567 | 116,061 | 118,217 | 102,439 | 92,541 |
| Depreciation and amortization | 43,987 | 43,910 | 48,445 | 45,883 | 42,400 | 37,865 |
| Capital expenditures | 34,513 | 55,640 | 42,355 | 60,934 | 60,936 | 69,146 |
| Backlog for shipment in next 12 months | 325,000 | 185,000 | 157,830 | 164,128 | 183,847 | 225,498 |
| Number of stockholders | 5,030 | 5,313 | 5,697 | 5,113 | 5,720 | 5,488 |
| Average number of employees | 3,378 | 3,340 | 3,361 | 3,393 | 3,261 | 2,994 |
| Sales per employee ⁽⁸⁾ | 294 | 277 | 287 | 246 | 252 | 257 |

Note: Several acquisitions and divestitures have been made in past years. See Notes 2 and 3 to the financial statements for a description of these transactions.

- (1) Excludes sales from discontinued operations for the fiscal year 1997 of \$187,123.
- (2) During fiscal 2000 and 1998, Piper Impact recorded a \$56.3 million and \$58.5 million, respectively, asset impairment charge as described by Statement of Financial Accounting Standards No. 121. See Footnote 4 to the financial statements for further information.
- (3) See Note 3 to the financial statements for further information regarding the loss on the sale of Piper Impact Europe.
- (4) EBITDA is defined as earnings before interest, taxes, depreciation and amortization, excluding unusual items such as the Retired executive life insurance benefit, Piper Impact asset impairment charges and the Loss on the sale of Piper Impact Europe.
- (5) Includes gain on sale of discontinued operations.
- (6) Includes effect of Piper Impact's asset impairment charge (\$58.5 million in fiscal 1998) and gain on sale of discontinued operations (\$13 million in fiscal 1998).
- (7) Includes effect of Piper Impact's asset impairment charge (\$56.3 million in fiscal 2000) and the loss on sale of Piper Impact Europe (\$14.3 million in fiscal 2000).
- (8) Beginning in fiscal 2001, freight costs are no longer netted against sales, they are included in cost of sales. Prior year's net sales and sales ratios have been restated to conform to this presentation.

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

General

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

Private Securities Litigation Reform Act

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

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

Results of Operations

Overview

Summary Information as % of Sales

| | Fiscal Year Ended October 31, | | | | | |
|--|-------------------------------|------------|----------------|------------|-----------------|-------------|
| | 2002 | | 2001 | | 2000 | |
| | Dollar Amount | % of Sales | Dollar Amount | % of Sales | Dollar Amount | % of Sales |
| | (Dollars in millions) | | | | | |
| Net Sales | \$994.4 | 100% | \$924.3 | 100% | \$964.5 | 100% |
| Cost of Sales | 813.0 | 82 | 769.3 | 83 | 796.4 | 83 |
| Selling, general and admin. | 54.4 | 6 | 54.2 | 6 | 53.5 | 5 |
| Depreciation and amortization | 43.7 | 4 | 43.5 | 5 | 47.9 | 5 |
| Piper Impact Impairment Charge | — | — | — | — | 56.3 | 6 |
| Loss on sale of Piper Impact Europe | — | — | — | — | 14.3 | 1 |
| Operating Income (Loss) | 83.3 | 8% | 57.3 | 6% | (3.9) | 0% |
| Interest Expense | (14.8) | (1) | (16.6) | (1) | (15.3) | (2) |
| Capitalized Interest | 1.9 | 0 | 1.7 | 0 | 1.9 | 0 |
| Retired executive life insurance benefit | 9.0 | 1 | — | 0 | — | 0 |
| Other, net | 2.2 | 0 | 3.2 | 0 | 2.4 | 0 |
| Income tax benefit (expense) | (26.1) | (2) | (16.4) | (2) | 5.2 | 1 |
| Net income (loss) | <u>\$ 55.5</u> | <u>6%</u> | <u>\$ 29.2</u> | <u>3%</u> | <u>\$ (9.7)</u> | <u>(1)%</u> |

The Company achieved record level net sales and operating income in fiscal 2002 and demonstrated its ability to generate healthy results notwithstanding the somewhat weak broad-based economic climate. The Company also ended the year with a strong balance sheet as the total debt to capitalization ratio decreased from 44% as of October 31, 2001 to 15.2% at October 31, 2002.

Acquisitions/Divestitures Since October 31, 1999

In January 2000, the Company purchased from Alcoa, Inc. the Golden Aluminum production facility based in Fort Lupton, Colorado. Quanex acquired the assets of the facility for \$9 million plus working capital valued at approximately \$13 million. The newly acquired facility became part of Quanex's flat-rolled aluminum sheet division—Nichols Aluminum in the building products segment. It was renamed Nichols Aluminum–Golden, Inc., (“Nichols Aluminum–Golden”), a wholly owned subsidiary of Quanex.

Operations at Nichols Aluminum–Golden include melting and casting aluminum into sheet made from a blend of primary P1020 ingot and selected grades of scrap metal, cold rolling it to specific gauge, annealing, leveling, custom coating and slitting to width. Nichols Aluminum–Golden can produce up to 60 million pounds annually of high quality metal for engineered applications in niche markets, such as end and tab stock for food and beverage packaging, metal components for computer disks, and home accessory products.

In April 2000, the Company acquired the stock of Imperial Products, Inc., a leading manufacturer of value-added exterior door components based in Richmond, Indiana, for approximately \$15 million. Imperial Products, Inc., (“IMPERIAL PRODUCTS”), operates as a wholly owned subsidiary of Quanex. This acquisition expands the specialized design and manufacturing operations of Quanex's Engineered Products division in the building products segment.

In July 2000, the Company sold Piper Impact Europe, an impact-extrusion facility based in The Netherlands, to the plant's existing management group for a nominal amount. The transaction was structured as a sale of stock. As a result of this transaction, the Company recorded a pretax charge of \$14.3 million for the fiscal third quarter ending July 31, 2000. In connection with the sale, the Company's range forward foreign currency agreement with a

notional amount of 30 million Guilders was closed. This agreement was entered into to protect the Company's investment in Piper Impact Europe from foreign currency fluctuations. The settlement of this agreement resulted in a gain, which was offset against the charge on the sale of Piper Impact Europe.

On November 30, 2000, the Company completed the purchase of all of the capital stock of Temroc Metals, Inc. ("Temroc"), a Minnesota corporation for approximately \$22 million in cash. Temroc, as a surviving corporation, became a wholly owned subsidiary of the Company. Temroc has production facilities in Hamel, Minnesota, where it manufactures customized aluminum extrusions and fabricated metal products for recreational vehicles, architectural products, electronics and other markets. Temroc has become part of the Company's vehicular products segment and will continue to operate as a manufacturer of aluminum extrusions and fabricated metal products.

On February 12, 2002, Quanex completed the purchase of certain assets and assumption of certain liabilities of Ekamar, Inc., formerly known as Colonial Craft, Inc., a Minnesota corporation, through its wholly owned subsidiary, Quanex Windows, Inc., for approximately \$17.3 million in cash, \$1.5 million of which has been set aside in an escrow fund for environmental and certain other issues that may arise. The business operates as a wholly owned subsidiary of the Company and has been renamed Colonial Craft, Inc. ("COLONIAL CRAFT"). COLONIAL CRAFT is a leading manufacturer of value-added, fenestration related wood products based in Roseville, Minnesota (relocated to Mounds View, Minnesota in December 2002). COLONIAL CRAFT manufactures custom wood window accessories with two primary product lines: wood window grilles and hardwood architectural mouldings. COLONIAL CRAFT has become part of the Engineered Products division within the building products business segment. COLONIAL CRAFT provides direct synergy with one of the Company's two core businesses, sharing a similar customer base with Engineered Products.

Business Segments

Business segments are reported in accordance with Statement of Financial Accounting Standards ("SFAS") No. 131. SFAS No. 131 requires that the Company disclose certain information about its operating segments where operating segments are defined as "components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance". Generally, financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments.

The Company completed a strategic review of its business during fiscal 2001, which resulted in a shift of strategy away from primarily a manufacturing "process" oriented enterprise to a more "market focused" enterprise. The chief executive officer believes the focus on customers will provide a more effective corporate strategy to drive growth and shareholder value. As expected, the review underscored a high concentration of sales in two market segments—vehicular products and building products. The Company has made organizational and reporting changes aligned to this new strategy. The chief executive officer evaluates performance and allocates the Company's resources under this segment structure.

The vehicular products segment is comprised of MACSTEEL, Piper Impact (US operations only) and Temroc. That segment's main driver is North American light vehicle builds. MACSTEEL's sales and operating income for fiscal 2002 represented approximately 80% and 95%, respectively of the segment's results. The building products segment is comprised of Engineered Products and Nichols Aluminum. The main drivers of this segment are residential housing starts and remodeling expenditures. For fiscal 2002, Engineered Products' sales and operating income represented about 30% and 65% of the segment's results.

The following table sets forth selected operating data for the Company's two business segments:

| | Years Ended October 31, | | |
|--|-------------------------|-----------|-----------|
| | 2002 | 2001 | 2000 |
| | (In thousands) | | |
| Vehicular Products: ⁽²⁾⁽³⁾ | | | |
| Net sales | \$459,531 | \$439,307 | \$444,124 |
| Operating income | 57,606 | 47,466 | (8,052) |
| Depreciation and amortization | 27,849 | 25,905 | 28,769 |
| Identifiable assets | \$363,559 | \$362,442 | \$321,204 |
| Building Products: ⁽¹⁾⁽⁴⁾ | | | |
| Net sales | \$534,856 | \$485,046 | \$502,562 |
| Operating income | 37,985 | 23,662 | 35,830 |
| Depreciation and amortization | 15,492 | 17,061 | 16,408 |
| Identifiable assets | \$283,475 | \$269,387 | \$291,164 |

- (1) Fiscal 2000 results include Nichols Aluminum–Golden operations acquired January 25, 2000 and IMPERIAL PRODUCTS operations, acquired April 2000. See Note 2 to the consolidated financial statements.
- (2) Fiscal 2001 results include Temroc operations, acquired November 2000. See Note 2 to the consolidated financial statements.
- (3) Fiscal 2000 results include the \$56.3 million asset impairment charge relating to Piper Impact facilities in New Albany, Mississippi. See Note 4 to the consolidated financial statements.
- (4) Fiscal 2002 results include Colonial Craft operations, acquired February 2002. See Note 2 to the consolidated financial statements.

Within the vehicular products segment, strong North American light vehicle builds continued to drive demand for MACSTEEL's engineered steel bar products. This year's light vehicle builds, which had been estimated to be about 15.2 million builds at the beginning of fiscal 2002, will finish the calendar year closer to 16.6 million, exceeding 2001 builds by approximately 8%. On top of these build rates, MACSTEEL remains the supplier of choice and continues to capture new business. Ongoing lean manufacturing initiatives also contribute to MACSTEEL's success. The other businesses within the vehicular products segment also earned positive operating income for fiscal year 2002. However, Piper Impact experienced approximately a \$1 million loss in the fiscal fourth quarter as aluminum airbag sales continued to decline and new business was slower than expected. New business prospects look promising, but meaningful sales volumes are slow to materialize.

Within the building products segment, strong residential housing starts and remodeling expenditures during fiscal 2002 resulted in strong demands and operating results for both Engineered Products and Nichols Aluminum. For Engineered Products, this strong level of demand, combined with improved productivity through lean manufacturing efforts, resulted in record net sales and operating income even without the results of the COLONIAL CRAFT acquisition.

Outlook

For 2003, Quanex believes it is in a position to outperform the markets it serves. The Company expects its primary drivers to be down slightly for fiscal 2003 when compared to 2002 levels. However, it expects to offset nominal market weakness with more value-added products at both MACSTEEL and Nichols Aluminum, price relief at MACSTEEL and new programs at Engineered Products. Market share gains at several business units should also bolster revenues. On the cost side, lean manufacturing initiatives are expected to contribute to margin improvement.

Quanex will continue to explore both internal and external growth opportunities in fiscal 2003. The Company has purposely built a tough set of prerequisites for any acquisition candidate recognizing the fact that acquisitions have inherent risks. Generally, acquisition candidates must support one of the two core businesses: MACSTEEL or Engineered Products. An acquisition candidate should have projections to earn in excess of its cost of capital by at least the third year. Quanex will continue to look for opportunities for internal growth. Currently the Company is looking at ways to further increase both base load and value-added capabilities of MACSTEEL and ways to add more painted production at Nichols Aluminum with small investments.

The Company's fiscal first quarter (November, December and January) is historically its least profitable as there are fewer production days due to the holidays, customers manage year-end inventories tightly and the winter months reduce building product sales. Because this year's strong inventory replenishment activity during the first quarter is not expected to repeat in fiscal 2003, the diluted earnings per share for the fiscal first quarter 2003 may be near the results of this year's first quarter. Assuming a slowly recovering economy, the Company would expect to report sequentially better operating results for the other quarters of fiscal 2003 compared to 2002.

2002 Compared to 2001

Net Sales—Consolidated net sales for fiscal 2002 were \$994.4 million representing an increase of \$70.0 million, or 8%, when compared to consolidated net sales for fiscal 2001. Both the vehicular and building products segments experienced increased net sales.

Net sales from the Company's vehicular products segment for fiscal 2002 were \$459.5 million representing an increase of \$20.2 million, or 5%, when compared to the prior year due to increases at MACSTEEL, offset somewhat by lower net sales at both Piper and Temroc. MACSTEEL's net sales increase was due largely to a 13% increase in volume, which more than offset lower selling prices compared to the fiscal 2001. Over half of MACSTEEL's business is based on fixed contracts, so their ability to change pricing was limited on a near term basis. Piper experienced lower net sales as aluminum airbag component sales declined from its prior year levels. This decline was only partially offset by sales of new products, as meaningful sales volumes of these products have been slower to materialize than expected.

Net sales from the Company's building products segment for fiscal 2002 were \$534.9 million, representing an increase of \$49.8 million, or 10%, when compared to fiscal 2001. Engineered Products' net sales increases were due largely to the acquisition of COLONIAL CRAFT in February. Nichols Aluminum's net sales also increased from the prior year due to increased volume resulting from continuing strength in the building construction markets, despite lower selling prices.

Operating income—Consolidated operating income for fiscal 2002 was \$83.3 million, representing an increase of \$26.0 million, or 45%, when compared to last year. Both the vehicular and building products segments experienced increased operating income.

Operating income from the Company's vehicular products segment for fiscal 2002 was \$57.6 million, representing an increase of \$10.1 million, or 21%, when compared to last year. This increase was due to higher operating income at MACSTEEL compared to the prior year's results, partially offset by lower operating income at Piper and Temroc. The higher net sales volume combined with productivity gains and lower conversion costs at MACSTEEL more than offset the impact of lower spreads between selling prices and scrap prices. Piper and Temroc had lower operating income for the periods due largely to lower net sales and volume. Depreciation expense for the vehicular products segment was higher with the completion of MACSTEEL capital projects.

Also contributing to the improvement in the vehicular products segment is the elimination of goodwill amortization in accordance with the adoption of Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets" effective the beginning of the current fiscal year. The vehicular products segment had goodwill amortization of approximately \$500 thousand in the prior year ended October 31, 2001.

Operating income from the Company's building products segment for fiscal year 2002 was \$38.0 million, representing an increase of \$14.3 million, or 61%, when compared to the prior year. This increase was a result of record operating income at Engineered Products, as well as improved results at Nichols Aluminum. Engineered Products benefited from the acquisition of COLONIAL CRAFT in February 2002, however it achieved record operating income levels without COLONIAL CRAFT's contribution due largely to strong demand for its products, productivity improvements and new product development and cost reduction efforts. Nichols Aluminum also had increased operating income. This increase was largely a result of increased volume and cost reduction initiatives, as well as a \$1.6 million business interruption insurance recovery collected during the year (See Note 20 to the financial statements). Although spreads between selling price and raw material costs improved

during the second half of the year, as compared to the same prior year period, for the year ended October 31, 2002, spreads were lower as scrap prices rose more quickly than Nichol's ability to raise selling prices.

Also contributing to the improvement in the building products segment is the elimination of goodwill amortization in accordance with the adoption of Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets" effective the beginning of the current fiscal year. The building products segment had goodwill amortization of approximately \$1.8 million in the prior year ending October 31, 2001.

In addition to the two operating segments mentioned above, corporate level operating expenses for fiscal 2002 decreased by approximately \$1.5 million. Included in corporate and other are the consolidated inventory LIFO adjustments, corporate office expenses and inter-segment eliminations. (See Note 8 to the financial statements regarding LIFO valuation method of inventory accounting.)

Selling, general and administrative expense was \$54.4 million for fiscal 2002, representing an increase of \$206 thousand, less than 1%, when compared to last year. This increase results primarily from the acquisition of COLONIAL in February 2002.

Depreciation and amortization—Depreciation and amortization expense (excluding goodwill amortization) increased \$2.5 million in fiscal 2002 as compared to the prior year. Most of the increase came from the vehicular products segment due largely to recently completed capital projects at MACSTEEL.

Effective November 1, 2001, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets". Under SFAS No. 142, goodwill is no longer amortized. Goodwill amortization, on a consolidated basis, for the year ended October 31, 2001, was \$2.3 million. (See Note 6 to the financial statements for further information.)

Interest expense for fiscal 2002 was \$14.8 million compared to \$16.6 million last year. The decrease in interest expense is due largely to the Company's outstanding debt balance substantially decreasing year over year as 1) the 6.88% convertible subordinated debentures were converted to Company stock or redeemed in June of 2002 and 2) the Company paid down its bank revolver and other interest bearing debt and notes. See Note 12 to the financial statements for further information.

Another factor affecting interest expense was the discontinuance of hedge accounting under SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" for the interest swap agreements. Based on future cash flow projections that were prepared during the second fiscal quarter ended April 30, 2002, it was determined there was a high likelihood the Company would pay down its variable rate debt under the Bank Agreement Revolver to approximately \$65 million by the end of this fiscal year. Based on these projections, a portion of the future projected cash flow being hedged (interest payments) would not occur. Therefore, during the period ended April 30, 2002, the Company discontinued hedge accounting under SFAS 133 for \$35 million of the interest swap agreement and reclassified the related portion of other comprehensive income, a loss of \$1.3 million, to interest expense. Additionally, during the fourth fiscal quarter ended October 31, 2002, the timing of the finalization of the new bank agreement was determined. Since the swaps were designated as hedges of the Bank Agreement Revolver, which was expected to terminate upon completion of the new bank agreement, the swap no longer qualified as a hedge, as those specific forecasted transactions would not occur (future interest payments). As a result, the Company discontinued hedge accounting under SFAS No. 133 on the swaps based on the projected new bank agreement date and reclassified the related portion of other comprehensive income, a loss of \$2.1 million, to interest expense. The Company however has not terminated or closed any of the \$100 million swap agreement and therefore the entire swap agreement's fair market value is reflected on the balance sheet. (See Note 18 to the financial statements for further explanation.)

Capitalized interest increased \$213 thousand for fiscal 2002 compared to 2001. The entire amount of capitalized interest is due to the long-term capital expansion programs that were underway at MACSTEEL. These capital projects have been completed and the capitalization of interest ceased after the third fiscal quarter of 2002.

Other, net decreased \$968 thousand from fiscal 2001. During fiscal 2002, as a result of the redemption of the subordinated debentures, a loss of \$922 thousand was recognized due to the early extinguishment of debt. This

loss resulted from the write-off of the remaining debt issuance costs associated with the subordinated debentures, as well as the .688% premium paid on the \$1.3 million of debentures which were redeemed. Fiscal 2001 included a \$573 thousand gain on the early extinguishment of debt. In accordance with SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections", which was adopted by the Company in the period ended July 31, 2002, these early extinguishment of debt items were classified as ordinary instead of extraordinary items, net of tax. Also included in other, net is investment income and the amortization of debt issuance costs.

Net income was \$55.5 million for fiscal 2002 compared to \$29.2 million for fiscal 2001. In addition to the items mentioned above, fiscal 2002 included a non-taxable \$9.0 million retired executive life insurance benefit. (See Note 5 to the financial statements.)

2001 Compared to 2000

Net sales—Consolidated net sales for fiscal 2001 were \$924.4 million, representing a decrease of \$40.2 million, or 4%, when compared to fiscal 2000. Both operating segments experienced decreased net sales.

Net sales from the Company's vehicular products segment for fiscal 2001 were \$439.3 million, representing a decrease of \$4.8 million, or 1%, when compared to fiscal 2000. MACSTEEL experienced lower volume resulting from weaker markets in the transportation and capital goods industries as well as lower sales prices. The business continued to experience pricing pressures; however, due to the increased proportion of MACPLUS volume, a value added product, the impact on overall average sales price was lessened. Piper (US operations) net sales decreased 3% over the same prior year period. These results were impacted by declining aluminum air bag product sales and competitive pricing pressures. Comparable net sales of Piper's operations, excluded Piper Europe. Also included in the vehicular products was the net sales of Temroc which was acquired in November 2000.

Net sales for fiscal 2001 from the Company's building products segment decreased by \$17.5 million, or 3%, to \$485.0 million when compared to fiscal 2000. Nichols Aluminum's results for fiscal 2001 included a full year of Nichols Aluminum Golden, which was acquired January 25, 2000. The decrease in net sales at Nichols Aluminum was due to lower volume as well as lower sales prices. Volume was affected by more severe winter weather during the first fiscal quarter than was experienced in the prior year, as well as a general economic slowdown. These factors negatively affected the building and construction and truck-trailer markets that Nichols Aluminum serves. Sales prices were also negatively impacted by the extremely competitive pricing environment, and the fact that other mills were aggressively seeking available business during the economic slowdown. The lower net sales at Nichols Aluminum was offset however by increased net sales from Engineered Products. The increase was largely due to the acquisition of IMPERIAL PRODUCTS in April of 2000. Engineered Products' net sales also benefited from the capital expansion project at AMSCO, which was completed in November 2000, and new product development initiatives.

Corporate and Other for the period ending October 31, 2000 included net sales from Piper Impact Europe which was sold in July of 2000.

Operating income—Consolidated operating income for fiscal 2001 was \$57.3 million, compared to \$66.6 million in 2000, excluding the \$14.3 million loss on the sale of Piper Impact Europe and the \$56.3 million asset impairment charge. This represents a decrease of \$9.3 million, or 14% as both the vehicular products and building products segments had lower operating income compared to fiscal 2000.

Operating income from the Company's vehicular products segment was \$47.5 million for fiscal 2001, representing a decrease of \$782 thousand, or 2%, excluding the \$56.3 million asset impairment charge, when compared to fiscal 2000. At MACSTEEL, the decrease was due largely to lower net sales resulting from the sluggish demand in the transportation and capital goods markets as well as competitive pricing pressures. Lower material scrap prices helped offset some of the impact of reduced volume and lower selling price. The MACSTEEL division experienced increased utility costs as energy prices rose and recognized higher depreciation expense with the completion of capital projects. Comparative operating income for Piper Impact US, excluding

the fiscal 2000 \$56.3 million asset impairment charge improved \$12.7 million from the prior year's results, despite a decline in net sales. This improvement is a result of lower costs realized from cellular manufacturing and cost cutting efforts as well as a \$6.3 million reduction of depreciation expense. Depreciation expense decreased due to the asset impairment charge recorded in the fourth quarter of fiscal 2000. Also included in vehicular products were the operational results of Temroc which was acquired in November 2000.

Operating income for fiscal 2001 from the Company's building products segment was \$23.7 million, representing a decrease of \$12.2 million, or 34%, from last year. Nichols Aluminum experienced a decrease largely due to significantly lower net sales, lower spreads and higher energy costs. On the other hand, Engineered Products experienced a 40% increase in operating income from fiscal 2000. The increase at Engineered Products was due in part to the acquisition of IMPERIAL PRODUCTS, acquired in April of 2000. Additionally, operating income increased at the other facilities as a result of new product development initiatives, higher net sales and improved productivity.

In addition to the two operating segments mentioned above, operating expenses for corporate and other for fiscal 2001 were \$13.8 million, representing a decrease of \$17.9 million from the \$31.7 million recorded in fiscal 2000. Included in corporate and other are the corporate office expenses, impact of inventory accounting using LIFO method and inter-segment eliminations. Also included in corporate and other are the results of Piper Europe, which was sold in July 2000 for a loss of \$14.3 million dollars. See Note 8 to the financial statements regarding LIFO valuation method of inventory accounting.

Selling, general and administrative expenses—Selling, general and administrative expenses increased by \$657 thousand, or 1%, in fiscal 2001 as compared to last year. This increase largely resulted from the following items: 1) acquisitions of IMPERIAL PRODUCTS in April 2000 and Temroc in November 2000 2) write-down of assets held for disposition to estimated realizable value in the corporate and other segment and 3) severance costs. These increases were partially offset, however, by 1) reduced expenses due to the sale of Piper Europe in July 2000, and 2) cost cutting initiatives throughout the Company.

Depreciation and amortization—Depreciation and amortization decreased by \$4.4 million, or 9%, in fiscal 2001 as compared to last year. MACSTEEL, Nichols Aluminum and Engineered Products all experienced increased depreciation expense compared to last year due to the completion of capital projects as well as recent acquisitions. Piper Impact's depreciation and amortization decreased substantially from the prior year due to the sale of Piper Europe in July of 2000, as well as the reduced asset base, which resulted from the asset impairment charge recorded in the fourth quarter of fiscal 2000.

Interest expense—Interest expense increased by \$1.3 million, or 9%, in fiscal 2001 as compared to the prior year. The increase was primarily due to 1) higher outstanding debt balances during fiscal 2001 (resulting largely from the Temroc acquisition) and 2) the ineffective portion of the loss on certain interest rate swap derivatives recognized during that period. (See Note 12 and 18 to the financial statements.)

Capitalized interest—Capitalized interest decreased by \$275 thousand in fiscal 2001 as compared to fiscal 2000 primarily due to the completion of the Phase V capital project at MACSTEEL in December of 2000.

Other, net—"Other, net" increased by \$775 thousand in fiscal 2001 as compared to last year primarily as a result of increased investment income. Additionally, fiscal 2001 included a \$573 thousand gain on the early extinguishment of debt, compared to a \$551 thousand gain in fiscal 2000.

Net income/loss—Fiscal 2001 net income was \$29.2 million, compared to a net loss of \$9.7 million for fiscal 2000. In addition to the items mentioned above, fiscal 2000 included a \$9.3 million after-tax loss on the sale of Piper Impact Europe and a \$36.6 million after-tax impairment charge associated with Piper Impact.

Liquidity and Capital Resources

Total capitalization at October 31, 2002 was \$497.0 million, consisting of \$75.6 million of debt and \$421.4 million of equity. The debt-to-capitalization ratio at the end of fiscal 2002 was 15.2% compared with 44.0% and 41.9% at the end of fiscal years 2001 and 2000, respectively. The lower debt-to-capitalization ratio in fiscal

2002 resulted from 1) the conversion of \$57.4 million aggregate principal amount of the subordinated debentures to 1.8 million shares of Company stock combined with redemption of the remaining balance in fiscal year 2002 and 2) paying down approximately \$85 million of other debt instruments during fiscal year 2002. Quanex was able to reduce the debt level as a result of cash provided from operations, cash received from the exercise of stock options and cash received from a retired executive life insurance policy.

At October 31, 2002, the Company had commitments of \$5 million for the purchase or construction of capital assets. The Company plans to fund these capital expenditures through cash flow from operations and, if necessary, additional borrowings.

The Company's principal sources of funds are cash on hand, cash flow from operations, and borrowings under the new secured \$200 million Revolving Credit Agreement described below. The Company believes that it has sufficient funds and adequate financial sources available to meet its anticipated liquidity needs. The Company also believes that cash flow from operations, cash balances and available borrowings will be sufficient for the foreseeable future to finance anticipated working capital requirements, capital expenditures, debt service requirements, environmental expenditures and dividends and the stock purchase program.

Moody's Investor Services announced on May 10, 2002, that it upgraded its ratings for Quanex. The following ratings were upgraded: \$250 million unsecured revolving credit facility to Ba1 from Ba2, the \$58.7 million of 6.88% convertible subordinated debentures due 2007 to Ba3 from B1 (these debentures have subsequently been converted/redeemed), its senior implied rating to Ba1 from Ba2, and senior unsecured issuer rating to Ba1 from Ba2. In support of the upgrade, Moody's cited the Company's strong performance in a difficult industry and its prospects for further improved financial performance.

Debt Structure and Activity

Old Bank Agreement "Revolver"—In July 1996, the Company entered into an unsecured \$250 million Revolving Credit and Term Loan Agreement ("Bank Agreement"). This Bank Agreement consisted of a revolving line of credit ("Revolver"). In July 1997, the term loan provisions of the Bank Agreement expired. The Bank Agreement had an expiration date of July 23, 2003, and provided for up to \$25 million for standby letters of credit, limited to the undrawn amount available under the Revolver. All borrowings under the Revolver bore interest, at the option of the Company, at either (a) the prime rate or the federal funds rate plus one percent, whichever is higher, or (b) a Eurodollar based rate. At October 31, 2002 and 2001, the Company had \$65 and \$140 million, respectively, outstanding under the Revolver. This Bank Agreement was replaced with a new Bank Agreement which is described below. The intent and ability to refinance the outstanding balance on this bank agreement on a long-term basis was evidenced by the signing of the new bank agreement in November 2002. Therefore, the outstanding balance under the old bank agreement revolver was classified as non-current as of October 31, 2002.

New Bank Agreement "Revolver"—In November 2002, the Company entered into a secured \$200 million Revolving Credit Agreement ("new Bank Agreement"). The new Bank Agreement is secured by all Company assets, excluding land and buildings. The new Bank Agreement expires November 2005 and provides for up to \$25 million for standby letters of credit, limited to the undrawn amount available under the new Bank Agreement. All borrowings under the new bank agreement bear interest, at the option of the Company, at either (a) the prime rate or federal funds rate plus one percent, whichever is higher, or (b) a Eurodollar based rate. The Bank Agreement requires facility fees, which are not significant, maintenance of certain financial ratios and maintenance of a minimum consolidated tangible net worth. As of October 31, 2002, the Company was in compliance with all new Bank Agreement covenants.

Convertible Subordinated Debentures—The Company accepted unsolicited block offers to buy back \$4.6 and \$10.4 million principal amount of the 6.88% Convertible Subordinated Debentures for \$3.9 and \$9.6 million in cash during the years ended October 31, 2001 and 2000, respectively.

On May 9, 2002, the Company announced that it would redeem the remaining \$58.7 million principal amount of its 6.88% Convertible subordinated debentures. The Company set a redemption date of June 12, 2002 for all

debentures outstanding. Notice of the redemption was mailed on May 10, 2002 to the current holders. The redemption price was 100.688% of the principal amount plus accrued interest to the redemption date. Holders of the debentures had the right, as an alternative to redemption, to convert the debentures into shares of common stock of Quanex Corporation at a conversion price of \$31.50 per share of common stock. The right to convert the debentures expired at the close of business on June 5, 2002. As of June 5, 2002, \$57.4 million aggregate principal amount of the subordinated debentures were converted to 1.8 million shares of Company stock and \$1.3 million aggregate principal amount of the subordinated debentures was redeemed on June 12, 2002.

Other Debt—During the year ended October 31, 2002, the Company made an early payment in the amount of \$7.0 million on a contingent note payable as well as an early retirement in the amount of \$1.6 million for one of the industrial revenue and economic development bonds.

See Note 12 to the financial statements for further details of all of the Company's debt instruments, outstanding balances and aggregate maturities over each of the next five years and beyond.

Stock Purchase Program

On December 9, 1999, the Company announced that its Board of Directors approved a program to repurchase shares of the Company's common stock. Under terms of the program, the Company would periodically purchase up to a total of 2 million shares of its common stock in the open market or in privately negotiated transactions. Funds for the program would be provided from the Company's available working capital and bank credit line. During the fiscal year ended October 31, 2001, the Company repurchased 119,000 shares for \$2.2 million. During the fiscal year ended October 31, 2000, the Company repurchased 834,300 shares for \$17.2 million. No shares were purchased during fiscal 2002 and the stock purchase program was suspended. On December 5, 2002, the Board of Directors again approved a program to purchase up to a total of one 1 million shares (6%) of its common stock in the open market or in privately negotiated transactions. The Company indicated that it would be active in the buyback program during the first fiscal quarter 2003. See Note 16 to the financial statements.

Operating Activities

Cash provided by operating activities during fiscal 2002 was \$81.1 million, compared to \$85.0 million in the prior year. This represents a decrease of \$3.8 million, or 5%, compared to fiscal 2001. Net income, adjusted for non-cash items, in fiscal 2002 provided approximately \$89 million compared to approximately \$75 million of cash in fiscal 2001. However, the period ended October 31, 2002 had an increase in working capital and other operating requirements as compared to the prior year.

Investment Activities

Net cash used by investment activities in fiscal 2002 was \$29.8 million compared to a use of cash of \$77.1 million in fiscal 2001. Fiscal 2002 cash from investing activities included the receipt of \$26.1 million of retired executive life insurance proceeds and the use of \$17.3 million for the acquisition of COLONIAL CRAFT, whereas fiscal 2001 cash from investing activities included the acquisition of Temroc Metals for \$17.9 million. Net capital expenditures decreased from \$55.6 million in 2001 to \$34.3 million in 2002. The Company estimates that fiscal 2002 capital expenditures will be approximately \$35 million.

Financing Activities

Net cash used by financing activities for fiscal 2002 was \$62.6 million, compared to \$692 thousand in the prior year. During fiscal 2002, the Company made net bank repayments of \$75 million as well as other debt payments of \$9.8 million. During fiscal 2001, the Company had net bank borrowings of \$30 million, however it used \$3.9 million to purchase subordinated debentures and \$2.2 million to purchase Quanex common stock. Additionally, in fiscal 2001, Quanex repaid \$17.3 million of life insurance cash surrender value policy loans. Dividend payments amounted to \$9.6 million in fiscal 2002 compared to \$8.6 million in fiscal 2001. Proceeds from the issuance of Company common stock in fiscal 2002 totaled \$33.9 million, largely due to the exercise of stock options, compared to \$2.5 million in fiscal 2001.

Contractual Obligations and Commercial Commitments

The following tables set forth certain information concerning the Company's unconditional obligations and commitments to make future payments under contracts with remaining terms in excess of one year, such as debt and lease agreements, and under contingent commitments.

Payments Due by Period

| Contractual Cash Obligations | Total | Less than 1 Year | 1–3 Years | 4–5 Years | After 5 Years |
|--|------------------|-----------------------------|------------------|------------------|--------------------------|
| | | (\$ In thousands) | | | |
| Long-Term Debt | \$ 75,565 | \$ 434 | \$ 4,654 | \$65,928 | \$ 4,549 |
| Operating Leases | 8,552 | 2,428 | 2,764 | 2,162 | 1,198 |
| Unconditional Purchase Obligations | 26,218 | 9,748 | 8,267 | 2,678 | 5,525 |
| Total Contractual Cash Obligations | <u>\$110,335</u> | <u>\$12,610</u> | <u>\$15,685</u> | <u>\$70,768</u> | <u>\$11,272</u> |

Amount of Commitment Expiration Per Period

| Other Commercial Commitments | Total Amounts Committed | Less than 1 Year | 1–3 Years | 4–5 Years | After 5 Years |
|--|--|-----------------------------|------------------|------------------|--------------------------|
| | | (\$ In thousands) | | | |
| Standby Letters of Credit | \$ 2,896 | \$ 2,861 | \$ 35 | \$ — | \$ — |
| Guarantees | 1,050 | — | — | — | 1,050 |
| Total Commercial Commitments | <u>\$ 3,946</u> | <u>\$ 2,861</u> | <u>\$ 35</u> | <u>\$ —</u> | <u>\$ 1,050</u> |

Effects of Inflation

Inflation has not had a significant effect on earnings and other financial statement items.

Critical Accounting Policies

The preparation of these financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying footnotes. 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 the Company's operating environment changes. Actual results could differ from estimates.

The Company believes the following are the most critical accounting policies used in the preparation of the Company's consolidated financial statements as well as the significant judgments and uncertainties affecting the application of these policies.

Revenue Recognition and Allowance for Doubtful Accounts

The Company recognizes revenue when the products are shipped and the title and risk of ownership pass to the customer. Selling prices are fixed based on purchase orders or contractual agreements. Inherent in the Company's revenue recognition policy is the determination of collectibility. This requires management to make frequent judgments and estimates in order to determine appropriate amount of allowance needed for doubtful accounts. The Company's allowance for doubtful accounts is estimated to cover the risk of loss related to accounts receivable. This allowance is maintained at a level the Company considers appropriate based on historical and other factors that affect collectibility. These factors include historical trends of write-offs, recoveries and credit losses, the careful monitoring of portfolio credit quality, and projected economic and market conditions. Different assumptions or changes in economic circumstances could result in changes to the allowance.

Inventory

The Company records inventory valued at the lower of cost or market value. Inventory quantities are regularly reviewed and provisions for excess or obsolete inventory are recorded primarily based on the Company's forecast of future demand and market conditions. Significant unanticipated changes to the Company's forecasts could require a change in the provision for excess or obsolete inventory.

Risk Management and Derivative Instruments

The Company's current risk management strategies include the use of derivative instruments to reduce certain risks. The critical strategies include: (1) the use of commodity futures and options to fix the price of a portion of anticipated future purchases of certain raw materials and energy to offset the effect of fluctuations in the costs of those commodities, and (2) the use of interest rate swaps to fix the rate of interest on a portion of floating rate debt. These hedges have been designated as cash flow hedges. The effective portion of gains and losses is recorded in the accumulated other comprehensive income (loss) component of stockholders' equity in accordance with SFAS No. 133. The Company evaluates all derivative instruments each quarter to determine if they are highly effective. Any ineffectiveness (as defined by SFAS No. 133) is recorded in the statement of income. If the anticipated future transactions are no longer expected to occur, the unrealized gains and losses on the related hedge are reclassified to the consolidated statement of income. (See Note 18 to the financial statements for further explanation.)

Long-Lived Assets

Long-lived assets, which include property, plant and equipment, goodwill and other intangibles, and other assets, comprise a significant amount of the Company's total assets. The Company makes judgments and estimates in conjunction with the carrying value of these assets, including amounts to be capitalized, depreciation and amortization methods and useful lives. Additionally, carrying values of these assets are periodically reviewed for impairment and further reviewed whenever events or changes in circumstances indicate that carrying value may be impaired. The carrying values are compared with the fair value of such assets calculated based on the anticipated future cash flows related to those assets. If the carrying value of a long-lived asset exceeds its fair value, an impairment charge is recorded in the period in which such review is performed. This requires the Company to make long-term forecasts of its future revenues and costs related to the assets subject to review. Forecasts require assumptions about demand for the Company's products and future market conditions. Significant and unanticipated changes to assumptions could require a provision for impairment in a future period.

Income Taxes

The Company records the estimated future tax effects of temporary differences between the tax basis of assets and liabilities and the amounts reported in the Company's consolidated balance sheet, as well as operating loss and tax credit carry forwards. The carrying value of the net deferred tax liability reflects the Company's assumption that the Company will be able to generate sufficient future taxable income in certain jurisdictions to realize its deferred tax assets. If the estimates and assumptions change in the future, the Company may be required to record a valuation allowance against a portion of its deferred tax assets. This could result in additional income tax expense in a future period in the consolidated statement of income.

Retirement and Pension Plans

The Company sponsors a number of defined benefit pension plans and an unfunded postretirement plan that provides health care and life insurance benefits for eligible retirees and dependents. The measurement of liabilities related to these plans is based on management's assumptions related to future events, including expected return on plan assets, rate of compensation increases and health care cost trend rates. The discount rate, which is determined using a model that matches corporate bond securities, is applied against the projected pension and postretirement disbursements. Actual pension plan asset investment performance will either reduce or increase unamortized pension losses at the end of any fiscal year, which ultimately affects future pension costs.

New Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 141 “Business Combinations”. SFAS No. 141 addresses financial accounting and reporting for business combinations. The provisions of this statement apply to all business combinations initiated after June 30, 2001. This statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. The Company followed the guidance of this statement for the business acquisition completed in fiscal 2002. See Note 2 to the consolidated financial statements.

In June 2001, the FASB issued SFAS No. 142, “Goodwill and Other Intangible Assets.” This statement addresses financial accounting and reporting for acquired goodwill and other intangible assets. It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. Under SFAS No. 142, goodwill is no longer amortized, but reviewed for impairment annually, or more frequently if certain indicators arise. The Company adopted this statement on November 1, 2001 for its fiscal year ended October 31, 2002. In accordance with SFAS 142, the Company completed the transitional impairment test of goodwill during the second quarter ended April 30, 2002, which indicated that goodwill was not impaired. The Company again reviewed goodwill for impairment as of August 31, 2002, which indicated that goodwill was not impaired. The Company plans to perform this impairment test as of August 31 each year or more frequently if certain indicators arise. The assessments were based on assumptions regarding estimated future cash flows and other factors, including the discount rate. If these estimates or their related assumptions change in the future, because of changes in events and circumstances, the Company may be required to record impairment charge in a future period.

In August 2001, the FASB issued SFAS No. 143, “Accounting for Asset Retirement Obligations.” SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible, long-lived assets and the associated asset retirement costs. This Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred by capitalizing it as part of the carrying amount of the long-lived assets. The provisions of this statement are required to be applied starting with fiscal years beginning after June 15, 2002 (Quanex’s fiscal year beginning November 1, 2002). The Company does not anticipate any material impact on the Company’s financial position, results of operations, or cash flows as a result of adoption.

In October 2001, the FASB issued SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets.” This Statement establishes a single accounting model for the impairment or disposal of long-lived assets. The provisions of this Statement are effective for financial statements issued for fiscal years beginning after December 15, 2001 (Quanex’s fiscal year beginning November 1, 2002). The Company does not anticipate any material impact on the Company’s financial position, results of operations, or cash flows as a result of adoption.

In April 2002, the FASB issued SFAS No. 145 “Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections”. The rescission of Statement 4 is the only portion of this SFAS which currently has an impact on the Company. Under Statement 4, all gains and losses from extinguishment of debt were required to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. SFAS No. 145 eliminates Statement 4. As a result, gains and losses from extinguishment of debt should be classified as extraordinary items only if they meet the criteria in Accounting Principles Board Opinion 30, “Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary Unusual and Infrequently Occurring Events and Transactions”. The provisions of SFAS No. 145 related to the rescission of Statement 4 shall be applied in fiscal years beginning after May 15, 2002. Any gain or loss on extinguishment of debt that was classified as an extraordinary item in prior periods presented that does not meet the criteria in Opinion 30 for classification as an extraordinary item shall be reclassified. Early application of the provisions of this Statement related to the rescission of Statement 4 was encouraged. The Company adopted this pronouncement effective the third quarter ended July 31, 2002 and restated prior periods.

In June 2002, the FASB issued SFAS No. 146 "Accounting for Costs Associated with Exit or Disposal Activities". SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force ("EITF") Issue No. 94-3 "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The Company does not anticipate any material impact on the Company's financial position, results of operations, or cash flows as a result of adoption.

Item 7A. *Quantitative/Qualitative Disclosure*

The following discussion of the Company and its subsidiaries' exposure to various market risks contains "forward looking statements" that involve risks and uncertainties. These projected results have been prepared utilizing certain assumptions considered reasonable in light of information currently available to the Company. Nevertheless, because of the inherent unpredictability of interest rates, foreign currency rates and metal commodity prices as well as other factors, actual results could differ materially from those projected in such forward looking information. For a description of the Company's significant accounting policies associated with these activities, see Notes 1 and 18 to the Consolidated Financial Statements.

Interest Rate Risk

The Company and its subsidiaries have a Bank Agreement, interest rate swap agreements and other long-term debt which subject the Company to the risk of loss associated with movements in market interest rates.

At October 31, 2002 and 2001, the Company had fixed-rate debt totaling \$4.4 million and \$72.9 million, respectively. This debt is fixed-rate and, therefore, does not expose the Company to the risk of earnings loss due to changes in market interest rates. See Notes 12 and 18 to the Company's Consolidated Financial Statements.

The Company and certain of its subsidiaries' floating-rate obligations total \$71.2 million and \$147.1 million at October 31, 2002 and 2001, respectively. See Note 12 to the Company's consolidated financial statements. The Company has \$100 million of swap agreements to limit the exposure of these obligations to increases in short-term interest rates. These swap agreements effectively fix the interest rate, thus limiting the potential impact that increasing interest rates would have on earnings. Under these swap agreements, payments are made based on a fixed rate (\$50 million at 7.025%, and \$50 million at 6.755%) and received on a LIBOR based variable rate (1.82% and 2.31% at October 31, 2002 and 2001, respectively). At October 31, 2002 and 2001, the fair market value related to the interest rate swap agreements was a loss of \$4.0 million and a loss of \$7.3 million, respectively. If the floating rates were to change by 10% from October 31 levels, the fair market value of these swaps would change by approximately \$79 thousand and \$411 thousand as of October 31, 2002 and 2001, respectively. However, it should be noted that any change in value of these contracts, real or hypothetical, would be substantially offset by an inverse change in the value of the underlying hedged item.

As mentioned above, \$100 million of the floating rate obligations are protected by interest swap agreements. To the extent these obligations are in excess of or less than \$100 million, the Company is subject to changes in the underlying interest rates. For the year ended October 31, 2002, the Company's floating rate obligations were \$28.8 million less than the \$100 million swap agreement. Increases or decreases in the underlying interest rate of the swap agreement would have a direct impact on interest expense for this differential in balances. For the year ended October 31, 2001, the Company's floating rate obligations exceeded the amount covered by the swap agreements by \$47.1 million. Increases or decreases in the underlying interest rates of the obligations would have a direct impact on interest expense for those uncovered balances.

Commodity Price Risk

The Company's aluminum mill sheet products segment, Nichols Aluminum, uses various grades of aluminum scrap as well as prime aluminum ingot as a raw material for its manufacturing process. The price of this aluminum raw material is subject to fluctuations due to many factors in the aluminum market. In the normal course of business, Nichols Aluminum enters into firm price sales commitments with its customers. In an effort to reduce

the risk of fluctuating raw material prices, the Company enters into firm price raw material purchase commitments as well as forward contracts on the London Metal Exchange (“LME”). The Company’s risk management policy as it relates to these LME contracts is to enter into contracts to cover the raw material needs of the Company’s committed sales orders, net of fixed price purchase commitments.

With the use of firm price raw material purchase commitments and LME contracts, the Company aims to protect the gross margins from the effects of changing prices of aluminum. To the extent that the raw material costs factored into the firm price sales commitments are matched with firm price raw material purchase commitments, changes in aluminum prices should have no effect on the Company. Where firm price sales commitments are matched with LME contracts, the Company is subject to the ineffectiveness of LME contracts to perfectly hedge raw material prices.

At October 31, 2002, the Company had no open LME forward contracts and therefore no asset or liability associated with metal exchange derivatives. During the year ended October 31, 2002, Nichols Aluminum used firm price raw material purchase commitments instead of LME forward contracts to lock in raw material prices.

At October 31, 2001, the Company had open futures contracts for aluminum pounds with a fair value of \$27.1 million. The contracts had fair value losses of \$1.8 million at October 31, 2001 and covered a notional volume of 45,415,185 pounds of aluminum. A hypothetical 10% change from the October 31, 2001 average London Metal Exchange (“LME”) ingot price on open contracts of \$.596 per pound would increase or decrease the unrealized pretax gains/losses related to these contracts by approximately \$2.7 million. However, it should be noted that any change in the value of these contracts, real or hypothetical, would be substantially offset by an inverse change in the cost of purchased aluminum scrap. See Note 18 to the financial statements for further information.

Item 8. *Financial Statements and Supplementary Data*

INDEPENDENT AUDITORS' REPORT

Board of Directors and Stockholders
Quanex Corporation
Houston, Texas

We have audited the accompanying consolidated balance sheets of Quanex Corporation and subsidiaries as of October 31, 2002 and 2001, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended October 31, 2002. Our audits also included the financial statement schedule listed in the index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Quanex Corporation and subsidiaries as of October 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended October 31, 2002 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Deloitte & Touche LLP

Deloitte & Touche LLP

Houston, Texas
November 22, 2002

RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying consolidated financial statements of Quanex Corporation and subsidiaries were prepared by management, which is responsible for their integrity and objectivity. The statements were prepared in accordance with accounting principles generally accepted in the United States of America and include amounts that are based on management's best judgments and estimates.

Quanex's system of internal controls is designed to provide reasonable assurance, at justifiable cost, as to the reliability of financial records and reporting and the protection of assets. The system of controls provides for appropriate division of responsibility and the application of policies and procedures that are consistent with high standards of accounting and administration. Internal controls are monitored through recurring internal audit programs and are updated as our businesses and business conditions change.

The Audit Committee, composed solely of outside directors, determines that management is fulfilling its financial responsibilities by meeting periodically with management, Deloitte & Touche LLP, and Quanex's internal auditors, to review internal accounting control and financial reporting matters. The internal and independent auditors have free and complete access to the Audit Committee.

We believe that Quanex's system of internal controls, combined with the activities of the internal and independent auditors and the Audit Committee, provides reasonable assurance of the integrity of our financial reporting.

/s/ RAYMOND A. JEAN

Raymond A. Jean
*Chairman of the Board, President and
Chief Executive Officer*

/s/ TERRY M. MURPHY

Terry M. Murphy
*Vice President—Finance and
Chief Financial Officer*

QUANEX CORPORATION
CONSOLIDATED BALANCE SHEETS

| | October 31, | |
|---|------------------|------------------|
| | 2002 | 2001 |
| | (In thousands) | |
| ASSETS | | |
| Current assets: | | |
| Cash and equivalents | \$ 18,283 | \$ 29,573 |
| Accounts and notes receivable, less allowance for doubtful accounts of \$6,877,000 in 2002 and \$8,953,000 in 2001 | 116,122 | 109,706 |
| Inventories | 90,756 | 83,109 |
| Deferred income taxes | 9,302 | 10,907 |
| Other current assets | 1,338 | 3,583 |
| Total current assets | 235,801 | 236,878 |
| Property, plant and equipment, net | 353,132 | 357,635 |
| Goodwill, net | 66,436 | 59,226 |
| Cash surrender value insurance policies, net | 25,799 | 37,300 |
| Intangible assets | 2,870 | — |
| Other assets | 5,102 | 6,592 |
| | <u>\$689,140</u> | <u>\$697,631</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 76,588 | \$ 76,831 |
| Accrued expenses | 48,973 | 50,659 |
| Income taxes payable | 4,839 | 1,087 |
| Other current assets | 3,970 | 5,593 |
| Current maturities of long-term debt | 434 | 420 |
| Total current liabilities | 134,804 | 134,590 |
| Long-term debt | 75,131 | 219,608 |
| Deferred pension credits | 4,960 | 7,962 |
| Deferred postretirement welfare benefits | 7,928 | 7,777 |
| Deferred income taxes | 29,210 | 29,282 |
| Other liabilities | 15,712 | 18,435 |
| Total liabilities | 267,745 | 417,654 |
| Stockholders' equity: | | |
| Preferred stock, no par value, 1,000,000 shares authorized; issued and outstanding—none in 2002 and 2001 | — | — |
| Common stock, \$.50 par value, 50,000,000 shares authorized; 16,455,633 and 14,085,642 shares issued in 2002 and 2001, respectively | 8,227 | 7,043 |
| Additional paid-in capital | 185,972 | 108,314 |
| Retained earnings | 232,074 | 186,274 |
| Unearned compensation | (418) | (897) |
| Accumulated other comprehensive income | (3,479) | (7,212) |
| | 422,376 | 293,522 |
| Less common stock held by rabbi trust—42,538 and 42,484 shares in 2002 and 2001, respectively, | (981) | (873) |
| Less cost of shares of common stock in treasury (no shares in 2002 and 633,935 shares in 2001) | — | (12,672) |
| Total stockholders' equity | 421,395 | 279,977 |
| | <u>\$689,140</u> | <u>\$697,631</u> |

See notes to consolidated financial statements.

QUANEX CORPORATION
CONSOLIDATED STATEMENTS OF INCOME

| | Years ended October 31, | | |
|---|--|------------------|-------------------|
| | 2002 | 2001 | 2000 |
| | (In thousands, except per share amounts) | | |
| Net sales | \$994,387 | \$924,353 | \$964,518 |
| Costs and expenses: | | | |
| Cost of sales | 812,949 | 769,328 | 796,434 |
| Selling, general and administrative | 54,408 | 54,202 | 53,545 |
| Depreciation and amortization | 43,730 | 43,507 | 47,921 |
| Loss on sale of Piper Impact Europe | — | — | 14,280 |
| Piper Impact asset impairment charge | — | — | 56,300 |
| Operating income (loss) | 83,300 | 57,316 | (3,962) |
| Other income (expense): | | | |
| Interest expense | (14,812) | (16,555) | (15,255) |
| Capitalized interest | 1,879 | 1,666 | 1,941 |
| Retired executive life insurance benefit | 9,020 | — | — |
| Other, net | 2,227 | 3,195 | 2,420 |
| Income (loss) before income taxes | 81,614 | 45,622 | (14,856) |
| Income tax benefit (expense) | (26,132) | (16,428) | 5,191 |
| Net income (loss) attributable to common stockholders | <u>\$ 55,482</u> | <u>\$ 29,194</u> | <u>\$ (9,665)</u> |
| Earnings (loss) per common share: | | | |
| Basic net earnings (loss) | <u>\$ 3.74</u> | <u>\$ 2.18</u> | <u>\$ (0.70)</u> |
| Diluted net earnings (loss) | <u>\$ 3.52</u> | <u>\$ 2.07</u> | <u>\$ (0.70)</u> |
| Weighted average number of shares outstanding | | | |
| Basic | 14,823 | 13,399 | 13,727 |
| Diluted | 16,237 | 15,426 | 13,727 |

See notes to consolidated financial statements.

QUANEX CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

| Years Ended October 31, 2002, 2001, and 2000 | Comprehensive Income | Accumulated Other Comprehensive Income | | | | | | Treasury Stock and Other | Total Stockholders' Equity |
|--|----------------------|--|----------------------------|-------------------|---------------------------|------------------------------|------------------------|--------------------------|----------------------------|
| | | Common Stock | Additional Paid-in Capital | Retained Earnings | Minimum Pension Liability | Foreign Currency Translation | Derivative Gain (Loss) | | |
| | | | | | | | | | |
| (Dollar amounts in thousands) | | | | | | | | | |
| Balance at October 31, 1999 | | \$7,135 | \$110,317 | \$186,867 | \$ (462) | \$(303) | \$ — | \$ (2,493) | \$301,061 |
| Comprehensive loss: | | | | | | | | | |
| Net loss | \$ (9,665) | | | (9,665) | | | | | (9,665) |
| Adjustment for minimum pension liability (net of tax expense of \$103) | 161 | | | | 161 | | | | 161 |
| Foreign currency translation adjustment | 303 | | | | | 303 | | | 303 |
| Total Comprehensive loss | \$ (9,201) | | | | | | | | |
| Common dividends (\$.64 per share) | | | | (8,884) | | | | | (8,884) |
| Common stock held by Rabbi Trust | | | | | | | | (1,027) | (1,027) |
| Cost of common stock in treasury | | | | | | | | (13,398) | (13,398) |
| Other | | (25) | 744 | (2,477) | | | | (296) | (2,054) |
| Balance at October 31, 2000 | | \$7,110 | \$111,061 | \$165,841 | \$ (301) | \$ — | \$ — | \$(17,214) | \$266,497 |
| Comprehensive income: | | | | | | | | | |
| Net income | \$29,194 | | | 29,194 | | | | | 29,194 |
| Adjustment for minimum pension liability (net of tax expense of \$965) | (1,508) | | | | (1,508) | | | | (1,508) |
| Derivative transactions: | | | | | | | | | |
| Current period hedging transactions (net of taxes of \$4,264) | (6,669) | | | | | | (6,669) | | (6,669) |
| Reclassifications into earnings (net of taxes of \$809) | 1,266 | | | | | | 1,266 | | 1,266 |
| Total Comprehensive income | \$22,283 | | | | | | | | |
| Common dividends (\$.64 per share) | | | | (8,621) | | | | | (8,621) |
| Common stock held by Rabbi Trust | | | | | | | | 2,476 | 2,476 |
| Cost of common stock in treasury | | | | | | | | 726 | 726 |
| Other | | (67) | (2,747) | (140) | | | | (430) | (3,384) |
| Balance at October 31, 2001 | | \$7,043 | \$108,314 | \$186,274 | \$(1,809) | \$ — | \$(5,403) | \$(14,442) | \$279,977 |
| Comprehensive income: | | | | | | | | | |
| Net income | \$55,482 | | | 55,482 | | | | | 55,482 |
| Adjustment for minimum pension liability (net of tax expense of \$798) | (1,247) | | | | (1,247) | | | | (1,247) |
| Derivative transactions: | | | | | | | | | |
| Current period hedging transactions (net of taxes of \$511) | (798) | | | | | | (798) | | (798) |
| Reclassifications into earnings (net of taxes of \$3,694) | 5,778 | | | | | | 5,778 | | 5,778 |
| Total Comprehensive income | \$59,215 | | | | | | | | |
| Common dividends (\$.64 per share) | | | | (9,637) | | | | | (9,637) |
| Common stock held by Rabbi Trust | | | | | | | | (108) | (108) |
| Cost of common stock in treasury | | | | | | | | 12,672 | 12,672 |
| Other | | 1,184 | 77,658 | (45) | | | | 479 | 79,276 |
| Balance at October 31, 2002 | | \$8,227 | \$185,972 | \$232,074 | \$(3,056) | \$ — | \$ (423) | \$ (1,399) | \$421,395 |

See notes to consolidated financial statements.

QUANEX CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (Continued)

| | Years Ended October 31, 2002, 2001 and 2000 | | | | |
|---|---|---------------|-----------|----------------|--------------------|
| | Preferred Shares | Common Shares | | | Net Outstanding |
| | | Issued | Treasury | Rabbi Trust | |
| Balance at October 31, 1999 | — | 14,269,800 | — | (94,606) | 14,175,194 |
| Shares purchased and cancelled | | (156,700) | | | (156,700) |
| Treasury shares purchased | | | (677,600) | | (677,600) |
| Stock issued—options exercised (net of trade-ins) . . | | 3,337 | 74 | | 3,411 |
| Stock issued—compensation plans | | 104,229 | | | 104,229 |
| Rabbi Trust | | | | (53,083) | (53,083) |
| Balance at October 31, 2000 | — | 14,220,666 | (677,526) | (147,689) | 13,395,451 |
| Treasury shares purchased | | | (119,000) | | (119,000) |
| Stock issued—options exercised (net of trade-ins) . . | | | 47,960 | | 47,960 |
| Stock issued—compensation plans | | | 84,812 | | 84,812 |
| Rabbi Trust | | (135,024) | 29,819 | 105,205 | — |
| Balance at October 31, 2001 | — | 14,085,642 | (633,935) | (42,484) | 13,409,223 |
| Stock issued—options exercised (net of trade-ins) . . | | 562,926 | 597,284 | | 1,160,210 |
| Stock issued—compensation plans | | (1,902) | 22,797 | | 20,895 |
| Stock issued—conversion of subordinated debentures | | 1,822,594 | 173 | | 1,822,767 |
| Rabbi Trust | | (13,627) | 13,681 | (54) | — |
| Balance at October 31, 2002 | — | 16,455,633 | — | (42,538) | 16,413,095 |

See notes to consolidated financial statements.

QUANEX CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOW

| | Years Ended October 31, | | |
|---|-------------------------|-----------|------------|
| | 2002 | 2001 | 2000 |
| | (In thousands) | | |
| OPERATING ACTIVITIES: | | | |
| Net Income (Loss) | \$ 55,482 | \$ 29,194 | \$ (9,665) |
| Adjustments to reconcile net income (loss) to cash provided by operating activities: | | | |
| Piper Impact asset impairment charge (net of deferred taxes of \$19,705 in fiscal 2000) | — | — | 36,595 |
| Loss on sale of Piper Impact Europe (net of taxes of \$4,998) | — | — | 9,282 |
| Loss (Gain) on early extinguishment of debt | 922 | (573) | (551) |
| Adjustment for retired executive life insurance benefit | (9,020) | | |
| Depreciation and amortization | 43,987 | 43,910 | 48,445 |
| Deferred income taxes | 2,330 | 4,154 | 11,839 |
| Deferred pension and postretirement benefits | (4,734) | (1,231) | 659 |
| Changes in assets and liabilities net of effects from acquisitions and dispositions: | | | |
| Increase in accounts and notes receivable | (5,144) | (7,917) | (9,149) |
| Decrease (increase) in inventory | (5,249) | 20,808 | (12,474) |
| Increase (decrease) in accounts payable | (857) | (2,569) | 5,412 |
| Decrease in accrued expenses | (3,655) | (911) | (6,314) |
| Other, net (including income tax refund) | 7,049 | 85 | 3,791 |
| Cash provided by operating activities | 81,111 | 84,950 | 77,870 |
| INVESTMENT ACTIVITIES: | | | |
| Acquisition of Colonial Craft, net of cash and equivalents acquired | (17,283) | — | — |
| Acquisition of Temroc Metals, Inc., net of cash and equivalents acquired | — | (17,922) | — |
| Acquisition of Golden Aluminum, net of cash and equivalents acquired | — | — | (20,148) |
| Acquisition of Imperial Products, net of cash and equivalents acquired | — | — | (15,303) |
| Capital expenditures, net of retirements | (34,271) | (55,575) | (42,327) |
| Retired executive life insurance proceeds | 26,111 | — | — |
| Other, net | (4,365) | (3,597) | (1,809) |
| Cash used by investment activities | (29,808) | (77,094) | (79,587) |
| Cash provided (used) by operating and investment activities | 51,303 | 7,856 | (1,717) |
| FINANCING ACTIVITIES: | | | |
| Bank borrowings (repayments), net | (75,000) | 30,000 | 33,394 |
| Repayment of borrowing on insurance policies | — | (17,273) | — |
| Prepayment of note payable | (7,029) | — | — |
| Purchase of subordinated debentures | (1,314) | (3,942) | (9,586) |
| Purchase of Quanex common stock | — | (2,226) | (17,185) |
| Common stock dividends paid | (9,637) | (8,621) | (8,884) |
| Issuance of common stock, net | 33,948 | 2,473 | 1,002 |
| Other, net | (3,561) | (1,103) | (556) |
| Cash used by financing activities | (62,593) | (692) | (1,815) |
| Effect of exchange rate changes on cash and equivalents | — | — | 67 |
| Increase (decrease) in cash and equivalents | (11,290) | 7,164 | (3,465) |
| Cash and equivalents at beginning of period | 29,573 | 22,409 | 25,874 |
| Cash and equivalents at end of period | \$ 18,283 | \$ 29,573 | \$ 22,409 |

See notes to consolidated financial statements.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Significant Accounting Policies

The preparation of these financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying footnotes. 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 the Company's operating environment changes. Actual results could differ from estimates.

The Company believes the following are the most critical accounting policies used in the preparation of the Company's consolidated financial statements as well as the significant judgments and uncertainties affecting the application of these policies.

Revenue Recognition and Allowance for Doubtful Accounts

The Company recognizes revenue when the products are shipped and the title and risk of ownership pass to the customer. Selling prices are fixed based on purchase orders or contractual agreements. Inherent in the Company's revenue recognition policy is the determination of collectibility. This requires management to make frequent judgments and estimates in order to determine the appropriate amount of allowance needed for doubtful accounts. The Company's allowance for doubtful accounts is estimated to cover the risk of loss related to accounts receivable. This allowance is maintained at a level the Company considers appropriate based on historical and other factors that affect collectibility. These factors include historical trends of write-offs, recoveries and credit losses, the careful monitoring of portfolio credit quality, and projected economic and market conditions. Different assumptions or changes in economic circumstances could result in changes to the allowance.

Inventory

The Company records inventory valued at the lower of cost or market value. Inventory quantities are regularly reviewed and provisions for excess or obsolete inventory are recorded primarily based on the Company's forecast of future demand and market conditions. Significant unanticipated changes to the Company's forecasts could require a change in the provision for excess or obsolete inventory.

Risk Management and Derivative Instruments

The Company's current risk management strategies include the use of derivative instruments to reduce certain risks. The critical strategies include: (1) the use of commodity futures and options to fix the price of a portion of anticipated future purchases of certain raw materials and energy to offset the effect of fluctuations in the costs of those commodities, and (2) the use of interest rate swaps to fix the rate of interest on a portion of floating rate debt. These hedges have been designated as cash flow hedges. The effective portion of gains and losses is recorded in the accumulated other comprehensive income (loss) component of stockholders' equity in accordance with Statement of Financial Accounting Standards ("SFAS") No. 133 "Accounting for Derivative Instruments and Hedging Activities". The Company evaluates all derivative instruments each quarter to determine if they are highly effective. Any ineffectiveness is recorded in the statement of income. If the anticipated future transactions are no longer expected to occur, the unrealized gains and losses on the related hedge are reclassified to the consolidated statement of income. (See Note 18 to the financial statements for further explanation.)

Long-Lived Assets

Long-lived assets, which include property, plant and equipment, goodwill and other intangibles, and other assets, comprise a significant amount of the Company's total assets. The Company makes judgments and estimates in conjunction with the carrying value of these assets, including amounts to be capitalized, depreciation

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and amortization methods and useful lives. Additionally, carrying values of these assets are periodically reviewed for impairment and further reviewed whenever events or changes in circumstances indicate that carrying value may be impaired. The carrying values are compared with the fair value of such assets calculated based on the anticipated future cash flows related to those assets. If the carrying value of a long-lived asset exceeds its fair value, an impairment charge is recorded in the period in which such review is performed. This requires the Company to make long-term forecasts of its future revenues and costs related to the assets subject to review. Forecasts require assumptions about demand for the Company's products and future market conditions. Significant and unanticipated changes to assumptions could require a provision for impairment in a future period.

Property, plant and equipment is stated at cost and is depreciated using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of certain categories are as follows:

| | <u>Years</u> |
|-----------------------------------|--------------|
| Land improvements | 10 to 25 |
| Buildings | 10 to 40 |
| Machinery and equipment | 3 to 20 |

Income Taxes

The Company records the estimated future tax effects of temporary differences between the tax basis of assets and liabilities and the amounts reported in the Company's consolidated balance sheet, as well as operating loss and tax credit carry forwards. The carrying value of the net deferred tax liability reflects the Company's assumption that the Company will be able to generate sufficient future taxable income in certain jurisdictions to realize its deferred tax assets. If the estimates and assumptions change in the future, the Company may be required to record a valuation allowance against a portion of its deferred tax assets. This could result in additional income tax expense in a future period in the consolidated statement of income.

Retirement and Pension Plans

The Company sponsors a number of defined benefit pension plans and an unfunded postretirement plan that provides health care and life insurance benefits for eligible retirees and dependents. The measurement of liabilities related to these plans is based on management's assumptions related to future events, including expected return on plan assets, rate of compensation increases and health care cost trend rates. The discount rate, which is determined using a model that matches corporate bond securities, is applied against the projected pension and postretirement disbursements. Actual pension plan asset investment performance will either reduce or increase unamortized pension losses at the end of any fiscal year, which ultimately affects future pension costs.

Principles of Consolidation

The consolidated financial statements include the accounts of Quanex Corporation and its subsidiaries (the "Company" or "Quanex"), all of which are wholly owned. All significant intercompany balances and transactions have been eliminated in consolidation.

Earnings Per Share Data

Basic earnings per share excludes dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Scope of Operations

The Company operates primarily in two industry segments: vehicular products and building products. The Company's products include engineered steel bars, coiled aluminum sheet (mill finish and coated), aluminum and steel fabricated products, impact extrusions and hardwood architectural moulding and window and door accessories. The Company's manufacturing operations are conducted primarily in the United States.

Statements of Cash Flows

The Company generally considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents. Similar investments with original maturities beyond three months are considered short-term investments. For fiscal years 2002, 2001, and 2000, cash paid for income taxes was \$17,666,000, \$11,324,000, and \$10,650,000, respectively. These amounts are before refunds of \$135,000, \$219,000, and \$7,290,000, respectively. Cash paid for interest for fiscal 2002, 2001, and 2000 was \$13,070,000, \$15,894,000, and \$14,421,000, respectively.

Foreign Currency Translation

Assets and liabilities of foreign subsidiaries are translated into U.S. dollars at year-end exchange rates, and income and expense items are translated at the average exchange rates for the year. Resulting translation adjustments are reported as a separate component of stockholders' equity.

Reclassification

Certain amounts for prior periods have been reclassified in the accompanying consolidated financial statements to conform to fiscal 2002 presentations.

New Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141 "Business Combinations". SFAS No. 141 addresses financial accounting and reporting for business combinations. The provisions of this statement apply to all business combinations initiated after June 30, 2001. This statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. The Company followed the guidance of this statement for the business acquisition completed in fiscal 2002. See Note 2.

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." This statement addresses financial accounting and reporting for acquired goodwill and other intangible assets. It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. Under SFAS No. 142, goodwill is no longer amortized, but reviewed for impairment annually, or more frequently if certain indicators arise. The Company adopted this statement on November 1, 2001 for its fiscal year ended October 31, 2002. In accordance with SFAS 142, the Company completed the transitional impairment test of goodwill during the second quarter ended April 30, 2002, which indicated that goodwill was not impaired. The Company again reviewed goodwill for impairment as of August 31, 2002, which indicated that goodwill was not impaired. The Company plans to perform this impairment test as of August 31 each year or more frequently if certain indicators arise. The assessments were based on assumptions regarding estimated future cash flows and other factors, including the discount rate. If these estimates or their related assumptions change in the future, because of changes in events and circumstances, the Company may be required to record impairment charges in a future period.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible, long-lived assets and the associated asset retirement costs. This Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred by capitalizing it as part of the carrying amount of the long-lived assets. The provisions of this statement are required to be applied starting with fiscal years beginning after June 15, 2002 (Quanex's fiscal year beginning November 1, 2002). The Company does not anticipate any material impact on the Company's financial position, results of operations, or cash flows as a result of adoption.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This Statement establishes a single accounting model for the impairment or disposal of long-lived assets. The provisions of this Statement are effective for financial statements issued for fiscal years beginning after December 15, 2001 (Quanex's fiscal year beginning November 1, 2002). The Company does not anticipate any material impact on the Company's financial position, results of operations, or cash flows as a result of adoption.

In April 2002, the FASB issued SFAS No. 145 "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections". The rescission of Statement 4 is the only portion of this SFAS which currently has an impact on the Company. Under Statement 4, all gains and losses from extinguishment of debt were required to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. SFAS No. 145 eliminates Statement 4. As a result, gains and losses from extinguishment of debt should be classified as extraordinary items only if they meet the criteria in Accounting Principles Board Opinion 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary Unusual and Infrequently Occurring Events and Transactions". The provisions of SFAS No. 145 related to the rescission of Statement 4 shall be applied in fiscal years beginning after May 15, 2002. Any gain or loss on extinguishment of debt that was classified as an extraordinary item in prior periods presented that does not meet the criteria in Opinion 30 for classification as an extraordinary item shall be reclassified. Early application of the provisions of this Statement related to the rescission of Statement 4 was encouraged. The Company adopted this pronouncement effective the third quarter ended July 31, 2002 and restated prior periods.

In June 2002, the FASB issued SFAS No. 146 "Accounting for Costs Associated with Exit or Disposal Activities". SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force ("EITF") Issue No. 94-3 "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The Company does not anticipate any material impact on the Company's financial position, results of operations, or cash flows as a result of adoption.

2. Acquisitions

Nichols Aluminum—Golden

On January 25, 2000, the Company completed the purchase from Alcoa, Inc. of the Golden Aluminum production facility based in Fort Lupton, Colorado. Quanex acquired the assets of the facility for \$9 million plus working capital valued at approximately \$13 million. The newly acquired facility has become part of Quanex's flat-rolled aluminum sheet division—Nichols Aluminum in the building products segment. It has been renamed Nichols Aluminum—Golden, Inc., ("Nichols Aluminum—Golden"), a wholly owned subsidiary of Quanex.

Operations at Nichols Aluminum—Golden include melting and casting aluminum into sheet made from a blend of primary P1020 ingot and selected grades of scrap metal, cold rolling it to specific gauge, annealing, leveling, custom coating and slitting to width. Nichols Aluminum—Golden can produce up to 60 million pounds annually of high quality metal for engineered applications in niche markets, such as end and tab stock for food and beverage packaging, metal components for computer disks, and home accessory products.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

IMPERIAL PRODUCTS

On April 3, 2000, the Company acquired the stock of Imperial Products, Inc., a leading manufacturer of value-added exterior door components based in Richmond, Indiana, for approximately \$15 million. Imperial Products, Inc., (“IMPERIAL PRODUCTS”), operates as a wholly owned subsidiary of Quanex. This acquisition expands the specialized design and manufacturing operations of Quanex’s building products segment. Goodwill associated with IMPERIAL PRODUCTS is approximately \$11 million.

Temroc

On November 30, 2000, Quanex completed the purchase of all of the capital stock of Temroc Metals, Inc., (“Temroc”), a Minnesota corporation, for approximately \$22 million in cash. Temroc, as a surviving corporation, became a wholly owned subsidiary of the Company. Goodwill associated with Temroc is approximately \$14 million.

Temroc is a leading aluminum extrusion and fabrication company based in Hamel, Minnesota where it manufactures customized aluminum extrusions and fabricated metal products for recreational vehicles, architectural products, electronics and other markets. Temroc has become part of the Company’s vehicular segment and will continue to operate as a manufacturer of aluminum extrusions and fabricated metal products. To finance the acquisition, the Company borrowed against its existing \$250 million unsecured revolving credit and term loan facility with a group of six banks.

COLONIAL CRAFT

This transaction and the following disclosure are in accordance with SFAS No. 141, which was effective for all business combinations initiated after June 30, 2001.

On February 12, 2002, Quanex completed the purchase of certain assets and assumption of certain liabilities of Ekamar, Inc., formerly known as Colonial Craft, Inc., a Minnesota corporation, through its wholly owned subsidiary, Quanex Windows, Inc., for approximately \$17.3 million in cash. Approximately \$1.5 million of this purchase price was set aside in an escrow fund for environmental and certain other issues that may arise. To date, no claims have been made against this escrow fund, and as such, \$500 thousand was released in August of 2002.

The acquired business operates as a wholly owned subsidiary of the Company and has been renamed Colonial Craft, Inc. (“COLONIAL CRAFT”). COLONIAL CRAFT’s financial results since February 12, 2002 have been included in the consolidated financial statements of Quanex.

COLONIAL CRAFT is a manufacturer of value-added fenestration related wood products based in Roseville, Minnesota and Luck, Wisconsin (relocating Roseville facility to Mounds View, Minnesota in December 2002). COLONIAL CRAFT manufactures custom wood window accessories with two primary product lines: wood window grilles and hardwood architectural mouldings. COLONIAL CRAFT has become part of the Engineered Products division within the building products business segment. COLONIAL CRAFT provides direct synergy with one of the Company’s two core businesses, sharing a similar customer base with Engineered Products.

Within the terms of the purchase agreement, both selling and purchasing parties acknowledged that environmental reports showed evidence of minimal soil contamination at the Luck, Wisconsin facility, one of three COLONIAL CRAFT facilities. During the fiscal quarter ended July 31, 2002, the Company received notification from the Wisconsin Department of Commerce which stated that the residual soil and groundwater contamination was at levels below state regulatory limits and that they had determined that this site does not pose a significant threat to the environment or human health. During the fourth fiscal quarter of 2002, the Company closed the monitoring wells, as required, and received a notification from the Wisconsin Department of Commerce in November 2002 that the site was now listed as “closed”.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Below is a condensed balance sheet of the acquired entity disclosing the amounts preliminarily assigned to each major asset and liability at the acquisition date (dollars in thousands):

| <u>Condensed Balance Sheet</u> | <u>February 12, 2002</u> |
|--|------------------------------|
| Current assets | \$ 3,806 |
| Property plant and equipment | 4,775 |
| Goodwill | 7,210 |
| Tradename | 2,200 |
| Patents | 443 |
| Non-compete agreements | 313 |
| Other non-current assets | 29 |
| Total assets | <u>\$18,776</u> |
| Current liabilities | \$ 1,265 |
| Non-current liabilities | 30 |
| Total liabilities | 1,295 |
| Investment | 17,481 |
| Total liabilities and equity | <u>\$18,776</u> |

The patents, which were valued at \$443 thousand, will be amortized on a straight-line basis over a weighted average period of approximately 11 years. The non-compete agreements valued at \$313 thousand will be amortized on the straight-line basis over 5 years. The tradename and goodwill are not subject to amortization, but will be evaluated periodically in accordance with SFAS 142.

Goodwill for COLONIAL CRAFT is deductible for tax purposes. The tax basis of goodwill for COLONIAL CRAFT is approximately \$12 million.

3. Disposed Operations

On July 19, 2000, the Company sold Piper Impact Europe, an impact-extrusion facility based in The Netherlands, to the plant's existing management group for a nominal amount. The transaction was structured as a sale of stock. As a result of this transaction, the Company recorded a pretax charge of \$14.3 million for the fiscal third quarter ending July 31, 2000. In connection with the sale, the Company's range forward foreign currency agreement with a notional amount of 30 million Guilders was cashed in. This agreement was entered into to protect the Company's investment in Piper Impact Europe from foreign currency fluctuations. The settlement of this agreement resulted in a gain, which was offset against the loss on the sale of Piper Impact Europe.

4. Piper Impact Impairment Disclosure

Under SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", companies must review the carrying amount of long-lived assets and certain intangibles, including related goodwill, whenever events or changes in circumstances indicate that the carrying amount of an asset or a group of assets may not be recoverable.

An asset impairment charge in the amount of \$56.3 million was recorded in the fourth quarter of fiscal 2000 related to the property, plant and equipment of Piper Impact. The impairment charge resulted in an after-tax impact on net income of \$36.6 million or \$2.67 per share.

Piper Impact experienced declines in sales and operating cash flow during fiscal 1999 and fiscal 2000. The declining results were primarily due to decreased demand for aluminum airbag components from Piper Impact's

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

most significant customer. Although the management of Piper Impact conducted negotiations with this customer in an attempt to obtain a price increase and a commitment for future sourcing of impacted aluminum and steel airbag components, management became less optimistic about any near-term prospects for price increase without losing a significant amount of business from this customer. Additionally, opportunities for new products did not materialize at a rate necessary to offset the continued declining volume of airbag components. Consequently, in the fourth quarter of fiscal 2000, it became necessary to assess Piper Impact for asset impairment as required under SFAS No. 121.

Management performed an evaluation of the recoverability of all of the assets of Piper Impact as described in SFAS No. 121. Management concluded from the results of this evaluation that a significant impairment of long-lived assets had occurred. An impairment charge was required because the estimated fair value was less than the carrying value of the assets. Fair value of Piper Impact's net assets was determined by discounting estimated future cash flows using a discount rate commensurate with the risks involved. Considerable management judgment is necessary to estimate fair value. Accordingly, actual results may vary significantly from management's estimates.

5. Executive Life Insurance Benefit

During the fiscal year ended October 31, 2002, one of the Company's former executives, on whose life it held life insurance policies, died. As a result, the Company received life insurance proceeds totaling \$26.1 million. Estimates of the cash surrender value of these life insurance policies amounting to \$15.9 million were previously recognized in "Other assets" on the financial statements. The excess of the proceeds over the previously recorded cash surrender value and the liability to the beneficiaries of the executive amounting to \$9.0 million was recognized as a non-taxable benefit on the income statement during the period ended October 31, 2002. The impact on October 31, 2002 earnings per share of this benefit was \$0.61 basic and \$0.56 diluted.

6. Goodwill and Acquired Intangible Assets

As of November 1, 2001, the Company adopted SFAS No. 142 "Goodwill and Other Intangible Assets". Under SFAS 142, goodwill is no longer amortized, but is reviewed for impairment annually or more frequently if certain indicators arise. In accordance with SFAS 142, the Company completed the transitional impairment test of goodwill during the second quarter ended April 30, 2002, which indicated that goodwill was not impaired. The Company again reviewed goodwill for impairment as of August 31, 2002, which indicated that goodwill was not impaired. The Company plans to perform this annual impairment test as of August 31 each year or more frequently if certain indicators arise.

The changes in the carrying amount of goodwill for the twelve months ended October 31, 2002 are as follows:

| | Vehicular Segment | Building Products Segment | Total |
|--|------------------------------|--|-----------------|
| Balance as of October 31, 2001 | \$13,496 | \$45,730 | \$59,226 |
| Goodwill acquired during year | — | 7,210 | 7,210 |
| Balance as of October 31, 2002 | <u>\$13,496</u> | <u>\$52,940</u> | <u>\$66,436</u> |

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Intangible assets consist of the following (dollars in thousands):

| | As of October 31, 2002 | |
|----------------------------------|-------------------------------|---------------------------------|
| | Gross Carrying Amount | Accumulated Amortization |
| Amortized intangible assets: | | |
| Non-compete Agreements | \$ 313 | \$51 |
| Patents | 443 | 35 |
| Total | <u>\$ 756</u> | <u>\$86</u> |
| Unamortized intangible assets: | | |
| Tradename | \$2,200 | |

The aggregate amortization expense for intangible assets for the year ended October 31, 2002 is \$86 thousand. Estimated amortization expense for the next five years follows (dollars in thousands):

| Fiscal years ending October 31, | Estimated Amortization |
|--|-------------------------------|
| 2003 | \$115 |
| 2004 | \$115 |
| 2005 | \$100 |
| 2006 | \$ 86 |
| 2007 | \$ 46 |

Below is a presentation of the prior period's results excluding amortization expense related to assets that are no longer being amortized in accordance with SFAS 142:

| | For the Year Ended October 31, | | |
|--|---------------------------------------|-----------------|------------------|
| | 2002 | 2001 | 2000 |
| Reported Net income (loss) | \$55,482 | \$29,194 | \$(9,665) |
| Add back: Goodwill amortization (net of taxes) | — | 1,487 | 1,245 |
| Adjusted Net income (loss) | <u>\$55,482</u> | <u>\$30,681</u> | <u>\$(8,420)</u> |
| Basic earnings per share: | | | |
| Reported Net income (loss) | \$ 3.74 | \$ 2.18 | \$ (0.70) |
| Goodwill amortization (net of taxes) | — | 0.11 | 0.09 |
| Adjusted Net income (loss) | <u>\$ 3.74</u> | <u>\$ 2.29</u> | <u>\$ (0.61)</u> |
| Diluted earnings per share: | | | |
| Reported Net income (loss) | \$ 3.52 | \$ 2.07 | \$ (0.70) |
| Goodwill amortization (net of taxes) | — | 0.10 | 0.09 |
| Adjusted Net income (loss) | <u>\$ 3.52</u> | <u>\$ 2.17</u> | <u>\$ (0.61)</u> |

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Earnings Per Share

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

| For the Year Ended October 31, 2002 | | | |
|---|-------------------------------|---------------------------------|-----------------------------|
| | Numerator (Income) | Denominator (Shares) | Per Share Amount |
| BASIC EPS | | | |
| Total basic net income | <u>\$55,482</u> | <u>14,823</u> | <u>\$3.74</u> |
| EFFECT OF DILUTIVE SECURITIES | | | |
| Effect of common stock equivalents arising from stock options | — | 284 | |
| Effect of common stock held by rabbi trust | — | 40 | |
| Effect of conversion of subordinated debentures | <u>1,610</u> | <u>1,090</u> | |
| DILUTED EPS | | | |
| Total diluted net income | <u>\$57,092</u> | <u>16,237</u> | <u>\$3.52</u> |

| For the Year Ended October 31, 2001 | | | |
|---|-------------------------------|---------------------------------|-----------------------------|
| | Numerator (Income) | Denominator (Shares) | Per Share Amount |
| BASIC EPS | | | |
| Total basic net income | <u>\$29,194</u> | <u>13,399</u> | <u>\$2.18</u> |
| EFFECT OF DILUTIVE SECURITIES | | | |
| Effect of common stock equivalents arising from stock options | — | 58 | |
| Effect of common stock held by rabbi trust | — | 74 | |
| Effect of conversion of subordinated debentures | <u>2,810</u> | <u>1,895</u> | |
| DILUTED EPS | | | |
| Total diluted net income | <u>\$32,004</u> | <u>15,426</u> | <u>\$2.07</u> |

| For the Year Ended October 31, 2000 | | | |
|--|-------------------------------|---------------------------------|-----------------------------|
| | Numerator (Income) | Denominator (Shares) | Per Share Amount |
| BASIC AND DILUTED⁽¹⁾ EPS | | | |
| Total basic and diluted net loss | <u>\$(9,665)</u> | <u>13,727</u> | <u>\$(0.70)</u> |

(1) The effect of certain securities or debentures are anti-dilutive and, therefore, not included in the diluted earnings per share calculation. As a result, diluted EPS is the same as basic EPS.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Inventories

Inventories consist of the following:

| | October 31, | |
|--|-----------------|-----------------|
| | 2002 | 2001 |
| | (In thousands) | |
| Raw materials | \$24,307 | \$20,097 |
| Finished goods and work in process | 58,108 | 55,757 |
| | 82,415 | 75,854 |
| Other | 8,341 | 7,255 |
| Total | <u>\$90,756</u> | <u>\$83,109</u> |

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

| | | |
|-----------------|-----------------|-----------------|
| LIFO | \$64,269 | \$56,691 |
| FIFO | 26,487 | 26,418 |
| Total | <u>\$90,756</u> | <u>\$83,109</u> |

With respect to inventories valued using the LIFO method, replacement cost exceeded the LIFO value by approximately \$7,884,000 and \$5,400,000 at October 31, 2002 and 2001, respectively.

9. Property Plant and Equipment

Property, plant and equipment consists of the following:

| | October 31, | |
|--|-------------------|-------------------|
| | 2002 | 2001 |
| | (In thousands) | |
| Land and land improvements | \$ 22,339 | \$ 20,389 |
| Buildings | 125,510 | 106,876 |
| Machinery and equipment | 609,888 | 564,300 |
| Construction in progress | 16,118 | 45,387 |
| | 773,855 | 736,952 |
| Less accumulated depreciation and amortization | (420,723) | (379,317) |
| | <u>\$ 353,132</u> | <u>\$ 357,635</u> |

The Company had commitments for the purchase or construction of capital assets amounting to approximately \$5 million at October 31, 2002.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Accrued Expenses

Accrued expenses consist of the following:

| | October 31, | |
|--|-----------------|-----------------|
| | 2002 | 2001 |
| | (In thousands) | |
| Payroll, payroll taxes and employee benefits | \$31,127 | \$28,609 |
| Accrued contribution to pension funds | 1,518 | 1,760 |
| Utilities | 3,940 | 3,359 |
| Interest | 196 | 1,653 |
| State and local taxes | 3,257 | 3,892 |
| Other | 8,935 | 11,386 |
| | <u>\$48,973</u> | <u>\$50,659</u> |

11. Income Taxes

Income taxes are provided on taxable income at the statutory rates applicable to such income.

Income tax expense (benefit) consists of the following:

| | Years Ended October 31, | | |
|--|-------------------------|-----------------|------------------|
| | 2002 | 2001 | 2000 |
| | (In thousands) | | |
| Current: | | | |
| Federal | \$15,043 | \$ 8,101 | \$11,082 |
| State | 1,410 | 1,105 | 847 |
| Foreign | — | — | (1,067) |
| | 16,453 | 9,206 | 10,862 |
| Deferred | 9,679 | 7,222 | (16,053) |
| Income tax expense (benefit) | <u>\$26,132</u> | <u>\$16,428</u> | <u>\$(5,191)</u> |

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

Significant components of the Company's net deferred tax liability are as follows:

| | October 31, | |
|---|-----------------|------------------|
| | 2002 | 2001 |
| | (In thousands) | |
| Deferred tax liability: | | |
| Property, plant and equipment | \$43,794 | \$ 40,791 |
| Other | 11,767 | 21,050 |
| | <u>55,561</u> | <u>61,841</u> |
| Deferred tax assets: | | |
| Intangibles | 12,680 | 13,800 |
| Postretirement benefit obligation | 3,363 | 3,472 |
| Other employee benefit obligations | 7,004 | 9,535 |
| Environmental accruals | 6,518 | 7,583 |
| Other | 6,088 | 9,076 |
| | <u>35,653</u> | <u>43,466</u> |
| Net deferred tax liability | <u>\$19,908</u> | <u>\$ 18,375</u> |
| Deferred income tax non-current liability | \$29,210 | \$ 29,282 |
| Deferred tax current assets | (9,302) | (10,907) |
| Net deferred tax liability | <u>\$19,908</u> | <u>\$ 18,375</u> |

No U.S. deferred taxes were provided on the Company's foreign subsidiary's cumulative undistributed losses of \$(1,782,000). The foreign subsidiary was sold in July 2000.

Income tax expense (benefit) differs from the amount computed by applying the statutory federal income tax rate to income before income taxes and extraordinary gain for the following reasons:

| | Years Ended October 31, | | |
|--|-------------------------|-----------------|------------------|
| | 2002 | 2001 | 2000 |
| | (In thousands) | | |
| Income tax expense (benefit) at statutory tax rate | \$28,565 | \$15,968 | \$(5,200) |
| Increase (decrease) in taxes resulting from: | | | |
| State income taxes, net of federal effect | 2,339 | 772 | (148) |
| Life insurance proceeds | (3,157) | | |
| Goodwill | — | 664 | 420 |
| Other items, net | (1,615) | (976) | (263) |
| | <u>\$26,132</u> | <u>\$16,428</u> | <u>\$(5,191)</u> |

The Company reached a settlement with the Internal Revenue Service with respect to the tax audits of fiscal year 1996 and certain portions of fiscal years 1997 and 1998. The Company has filed a petition in Tax Court regarding the disallowance of a capital loss realized in 1997. Fiscal year 1999 is currently under audit.

During 2002, the Company made tax payments of \$8,304,000 related to the audits. Adequate provision had been made in prior years and the payments did not have a material effect on earnings.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. Long-Term Debt and Financing Arrangements

Long-term debt consists of the following:

| | October 31, | |
|---|-------------------------|-------------------------|
| | 2002 | 2001 |
| | (In thousands) | |
| “Bank Agreement” Revolver | \$ 65,000 | \$140,000 |
| Convertible subordinated debentures | — | 58,727 |
| Industrial Revenue and Economic Development Bonds, unsecured, principle due in the years 2005 and 2010, bearing interest ranging from 6.50% to 8.375% | 1,665 | 3,275 |
| State of Alabama Industrial Development Bonds | 3,800 | 4,500 |
| Scott County, Iowa Industrial Waste Recycling Revenue Bonds | 2,400 | 2,600 |
| Temroc Industrial Development Revenue Bonds | 2,425 | 2,608 |
| Other | 275 | 8,318 |
| | <u>\$ 75,565</u> | <u>\$220,028</u> |
| Less maturities due within one year included in current liabilities | 434 | 420 |
| | <u><u>\$ 75,131</u></u> | <u><u>\$219,608</u></u> |

Old Bank Agreement “Revolver”

In July 1996, the Company entered into an unsecured \$250 million Revolving Credit and Term Loan Agreement (“Bank Agreement”). The Bank Agreement consisted of a revolving line of credit (“Revolver”). In July 1997, the term loan provisions of the Bank Agreement expired. The Bank Agreement had an expiration date of July 23, 2003, and provided for up to \$25 million for standby letters of credit, limited to the undrawn amount available under the Revolver. All borrowings under the Revolver bore interest, at the option of the Company, at either (a) the prime rate or the federal funds rate plus one percent, whichever is higher, or (b) a Eurodollar based rate. At October 31, 2002 and 2001, the Company had \$65 and \$140 million, respectively, outstanding under the Revolver. The weighted average interest rates on borrowings under the Revolver were 2.64%, 6.03%, and 7.0%, in 2002, 2001 and 2000, respectively. This Bank Agreement was replaced with a new Bank Agreement which is described below. The intent and ability to refinance the outstanding balance on this bank agreement on a long-term basis was evidenced by the signing of the new bank agreement in November 2002. Therefore, the outstanding balance under the old bank agreement revolver was classified as non-current as of October 31, 2002.

New Bank Agreement

In November 2002, the Company entered into a secured \$200 million Revolving Credit Agreement (“Bank Agreement”). The new Bank Agreement is secured by all Company assets, excluding land and buildings. The new Bank Agreement expires November 2005 and provides for up to \$25 million for standby letters of credit, limited to the undrawn amount available under the new Bank Agreement. All borrowings under the new bank agreement bear interest, at the option of the Company, at either (a) the prime rate or federal funds rate plus one percent, whichever is higher, or (b) a Eurodollar based rate. The new Bank Agreement requires facility fees, which are not significant, maintenance of certain financial ratios and maintenance of a minimum consolidated tangible net worth. As of October 31, 2002, the company was in compliance with all new Bank Agreement covenants.

Convertible Subordinated Debentures

On June 30, 1995, the Company exercised its right under the terms of its Cumulative Convertible Exchangeable Preferred Stock to exchange such stock for the 6.88% Convertible Subordinated Debentures due

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2007 (“Debentures”). Interest was payable semi-annually on June 30 and December 31 of each year. The Debentures were subordinate to all senior indebtedness of the Company and were convertible, at the option of the holder, into shares of the Company’s common stock at a conversion price of \$31.50 per share.

During fiscal 2001 and 2000, respectively, the Company accepted unsolicited block offers to buy back \$4.6 and \$10.4 million, respectively, principal amount of its Convertible Subordinated Debentures.

On May 9, 2002, the Company announced that it would redeem the remaining \$58.7 million principal amount of its 6.88% Convertible Subordinated Debentures. The Company set a redemption date of June 12, 2002 for all debentures outstanding. Notice of the redemption was mailed on May 10, 2002 to the current holders. The redemption price was 100.688% of the principal amount plus accrued interest to the redemption date. Holders of the debentures had the right, as an alternative to redemption, to convert the debentures into shares of common stock of Quanex Corporation at a conversion price of \$31.50 per share of common stock. The right to convert the debentures expired at the close of business on June 5, 2002. As of June 5, 2002, \$57.4 million aggregate principal amount of the subordinated debentures were converted to 1.8 million shares of Company stock and \$1.3 million of the subordinated debentures were redeemed on June 12, 2002.

As a result of the redemption of the subordinated debentures, a loss of \$930 thousand was recognized due to the early extinguishment of debt. This loss resulted from the write-off of the remaining debt issuance costs associated with the subordinated debentures, as well as the .688% premium paid on the \$1.3 million of debentures, which were redeemed. In accordance with SFAS 145, which was early adopted by the Company in the fiscal year ended October 31, 2002, this loss was classified as ordinary instead of an extraordinary item, net of tax.

Other Debt Instruments

The State of Alabama Industrial Development bonds were assumed as part of the Nichols Aluminum Alabama acquisition. These bonds mature August 1, 2004 with interest payable monthly. The bonds bear interest at the weekly interest rate as determined by the remarketing agent under then prevailing market conditions to be the minimum interest rate, which, if borne by the bonds on the effective date of such rate, would enable the remarketing agent to sell the bonds on such business day at a price (without regard to accrued interest) equal to the principal amount of the bonds. The interest rate, however, may not exceed 13% per annum. Interest rates during the year ended October 31, 2002 ranged from 1.25% to 2.05%. These bonds are secured by a Letter of Credit.

On June 1, 1999, the Company borrowed \$3 million through Scott County, Iowa Variable Rate Demand Industrial Waste Recycling Revenue Bonds Series 1999. The bonds require 15 annual principal payments of \$200 thousand beginning on July 1, 2000. The variable interest rate is established by the remarketing agent based on the lowest weekly rate of interest that would permit the sale of the bonds at par, on the basis of prevailing financial market conditions. Interest is payable on the first business day of each calendar month. Interest rates on these bonds during fiscal 2002 have ranged from 1.4% to 2.3%. These bonds are secured by a Letter of Credit.

The Temroc Industrial Development Revenue Bonds were obtained as part of the acquisition of Temroc. These bonds are due in annual installments through October 2012. Interest is payable semi-annually at fixed rates from 4.5% to 5.6% depending on maturity (average rate of 5.1% over the term of the bonds). These bonds are secured by a mortgage on Temroc’s land and building.

During the year ended October 31, 2001, the Company borrowed on the Revolver to pay back \$17.3 million of loans taken against the cash surrender value of various officer life insurance policies. These loans had previously been netted as an offset to the cash surrender value and classified as “Other assets” on the balance sheet.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the twelve month period ended October 31, 2002, the Company made an early payment in the amount of \$7.0 million on a contingent note classified in "Other" above as well as an early retirement in the amount of \$1.6 million for one of the industrial revenue and economic development bonds.

Aggregate maturities of long-term debt at October 31, 2002, are as follows (in thousands):

| | |
|------------------|-----------------|
| 2003 | \$ 434 |
| 2004 | 4,226 |
| 2005 | 428 |
| 2006 | 65,478 |
| 2007 | 450 |
| Thereafter | 4,549 |
| | <u>\$75,565</u> |

13. Pension Plans and Other Postretirement Benefits

The Company has a number of retirement plans covering substantially all employees. The Company provides both defined benefit and defined contribution plans. In general, the plant or location of his/her employment determines an employee's coverage for retirement benefits. The single employer defined benefit pension plans pay benefits to employees at retirement using formulas based upon years of service and compensation rates near retirement. The Company's funding policy is generally to make the minimum annual contributions required by applicable regulations. However, in fiscal 2002, the Company made the maximum income tax deductible contribution amount allowed. The plans invest primarily in marketable equity and debt securities.

The Company also provides certain healthcare and life insurance benefits for certain eligible retired employees employed prior to January 1, 1993. Certain employees may become eligible for those benefits if they reach normal retirement age while working for the Company. The Company continues to fund benefit costs on a pay-as-you-go basis. For fiscal year 2002, the Company made benefit payments totaling \$458,000, compared to \$411,000 and \$422,000 in fiscal 2001 and 2000, respectively.

A reconciliation of the beginning benefit obligation to the ending benefit obligation follows:

| | Pension Benefits | Postretirement Benefits |
|---|-----------------------------|------------------------------------|
| | October 31, | |
| | 2002 | 2001 |
| | 2002 | 2001 |
| | (In thousands) | |
| Benefit obligation at beginning of year | \$37,151 | \$31,900 |
| Service cost | 2,170 | 1,976 |
| Interest cost | 2,617 | 2,450 |
| Amendments | 19 | — |
| Actuarial loss | 2,734 | 1,653 |
| Benefits paid | (743) | (533) |
| Administrative expenses | (365) | (295) |
| Benefit obligation at end of year | <u>\$43,583</u> | <u>\$37,151</u> |
| | | <u>\$8,434</u> |
| | | <u>\$7,321</u> |

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A reconciliation of the beginning fair value of plan assets to the ending fair value of plan assets follows:

| | Pension Benefits | |
|--|-------------------------|-----------------|
| | October 31, | |
| | 2002 | 2001 |
| | (In thousands) | |
| Fair value of plan assets at beginning of year | \$22,760 | \$23,996 |
| Actual loss on plan assets | (1,407) | (3,517) |
| Employer contributions | 8,182 | 3,109 |
| Benefits paid | (743) | (533) |
| Administrative expenses | (365) | (295) |
| Fair value of plan assets at end of year | <u>\$28,427</u> | <u>\$22,760</u> |

A reconciliation of the funded status of the plans with the amounts recognized in the accompanying balance sheets is set forth below:

| | Pension Benefits | | Postretirement Benefits | |
|--|-------------------------|-------------------|--------------------------------|------------------|
| | October 31, | | | |
| | 2002 | 2001 | 2002 | 2001 |
| | (In thousands) | | | |
| Funded status | \$(15,156) | \$(14,391) | \$(8,434) | \$(7,321) |
| Unrecognized transition asset | (268) | (379) | — | — |
| Unrecognized prior service cost | 1,305 | 1,450 | (595) | (628) |
| Unrecognized net loss | 13,953 | 8,032 | 1,131 | 200 |
| Other | 5 | — | (30) | (28) |
| Accrued benefit cost | <u>\$ (161)</u> | <u>\$ (5,288)</u> | <u>\$(7,928)</u> | <u>\$(7,777)</u> |
| Amounts recognized in the Balance Sheet: | | | | |
| Deferred benefit credit | \$ (4,960) | \$ (7,962) | \$(7,928) | \$(7,777) |
| Accrued contribution to pension | (1,518) | (1,760) | — | — |
| Intangible asset | 1,305 | 1,467 | — | — |
| Accumulated other comprehensive income | 5,012 | 2,967 | — | — |
| Accrued benefit cost | <u>\$ (161)</u> | <u>\$ (5,288)</u> | <u>\$(7,928)</u> | <u>\$(7,777)</u> |

Below is data related to pension plans in which the accumulated benefit obligation exceeds plan assets.

| | Pension Benefits | | Postretirement Benefits | |
|--|-------------------------|-------------|--------------------------------|-------------|
| | October 31, | | | |
| | 2002 | 2001 | 2002 | 2001 |
| | (In thousands) | | | |
| Accumulated benefit obligation | \$34,910 | \$29,699 | \$8,434 | \$7,321 |
| Fair value of plan assets | 28,427 | 22,760 | — | — |

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Below are the assumptions used.

| | Pension Benefits | | | Postretirement Benefits | | |
|--|------------------|--------|--------|-------------------------|-------|-------|
| | October 31, | | | | | |
| | 2002 | 2001 | 2000 | 2002 | 2001 | 2000 |
| | (In thousands) | | | | | |
| Discount rate | 6.75% | 7.25% | 7.75% | 6.75% | 7.25% | 7.75% |
| Expected return on plan assets | 8.50% | 10.00% | 10.00% | — | — | — |
| Rate of compensation increase | 4.00% | 4.00% | 4.50% | — | — | — |

The assumed health care cost trend rate was 6.92% in 2002, decreasing uniformly to 4.75% in the year 2008 and remaining level thereafter. If the health care cost trend rate assumptions were increased by 1%, the accumulated postretirement benefit obligation as of October 31, 2002 would be increased by 1.12%. The effect of this change on the sum of the service cost and interest cost would be an increase of 1.00%. If the health care cost trend rate assumptions were decreased by 1%, the accumulated postretirement benefit obligation as of October 31, 2002 would be decreased by 1.01%. The effect of this change on the sum of the service cost and interest cost would be a decrease of 0.90%.

Net pension costs for the single employer defined benefit pension plans were as follows:

| | Years Ended October 31, | | |
|---|-------------------------|-----------------|-----------------|
| | 2002 | 2001 | 2000 |
| | (In thousands) | | |
| Service Cost | \$ 2,170 | \$ 1,976 | \$ 2,000 |
| Interest cost | 2,617 | 2,450 | 2,215 |
| Expected return on plan assets | (2,044) | (2,421) | (2,228) |
| Amortization of unrecognized transition asset | (111) | (111) | (111) |
| Amortization of unrecognized prior service cost | 163 | 109 | 109 |
| Amortization of unrecognized net loss | 263 | — | — |
| Other | (2) | — | 104 |
| Net periodic pension cost | <u>\$ 3,056</u> | <u>\$ 2,003</u> | <u>\$ 2,089</u> |

Net periodic costs for the postretirement benefit plans other than pensions were as follows:

| | Years Ended October 31, | | |
|--|-------------------------|--------------|--------------|
| | 2002 | 2001 | 2000 |
| | (In thousands) | | |
| Net periodic postretirement benefit cost: | | | |
| Service cost | \$102 | \$100 | \$109 |
| Interest cost | 560 | 521 | 516 |
| Net amortization and deferral | (54) | (65) | (60) |
| Other | — | — | — |
| Net periodic postretirement benefit cost | <u>\$608</u> | <u>\$556</u> | <u>\$565</u> |

One of the Company's subsidiaries, Piper Impact Europe, which was sold in July of 2000, participated in two multi-employer plans. The plans provided defined benefits to substantially all of Piper Impact Europe's employees. Amounts charged to pension cost and contributed to the plans for the year ended October 31, 2000, totaled approximately NLG 1,302,000, or approximately \$575,000.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company has various defined contribution plans in effect for certain eligible employees. The Company makes contributions to the plans subject to certain limitations outlined in the plans. Contributions to these plans were approximately \$5,456,000, \$4,696,000, and \$3,978,000, during fiscal 2002, 2001, and 2000, respectively.

The Company has a Supplemental Benefit Plan covering certain key officers of the Company. Earned vested benefits under the Supplemental Benefit Plan were approximately \$2,234,000, \$5,456,000, \$5,923,000, at October 31, 2002, 2001 and 2000, respectively. These benefits are funded with life insurance policies purchased by the Company.

14. Industry Segment Information

The Company reports segment information in accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information". SFAS No. 131 requires that the Company disclose certain information about its operating segments where operating segments are defined as "components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance". Generally, financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments.

During the latter portion of the fiscal year ending October 31, 2001, the Company completed a strategic review of its business, which resulted in a shift of strategy away from primarily a manufacturing "process" oriented enterprise to a more "market focused" enterprise. The chief executive officer, who is the chief operating decision maker of Quanex, believes the focus on customers will provide a more effective corporate strategy to drive growth and shareholder value. As expected, the review underscored a high concentration of sales in two market segments—vehicular products and building products. The Company has made organizational and reporting changes aligned to this new strategy in fiscal 2002. The chief executive officer evaluates performance and allocates the Company's resources under this new segment structure.

Beginning in 2002, Quanex began reporting under these two market focused segments. The vehicular products segment is comprised of MACSTEEL, Piper Impact (US operations only) and Temroc. The building products segment is comprised of Engineered Products and Nichols Aluminum. Corporate and other will include corporate office charges and intersegment eliminations as well as Piper Impact Europe, which was sold in the fiscal year ended October 31, 2000.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies, with the exception of the inventory valuation method. Quanex measures its inventory at the segment level on a FIFO basis, however at the consolidated Quanex level, the majority of the inventory is measured on a LIFO basis. See Note 8 to the financial statements for more information. The Company accounts for intersegment sales and transfers as though the sales or transfers were to third parties, that is, at current market prices.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the years ended October 31, 2002, 2001 and 2000, no one customer represented 10% or more of the consolidated net sales of the Company.

| | For the Years Ended October 31, | | |
|---|---------------------------------|------------------|-------------------|
| | 2002 | 2001 | 2000 |
| | (\$ in thousands) | | |
| Net Sales | | | |
| Vehicular Products ⁽³⁾ | \$459,531 | \$439,307 | \$444,124 |
| Building Products ⁽⁴⁾⁽⁵⁾⁽⁸⁾ | 534,856 | 485,046 | 502,562 |
| Corporate and Other ⁽¹⁾ | — | — | 17,832 |
| Consolidated | <u>\$994,387</u> | <u>\$924,353</u> | <u>\$964,518</u> |
| Operating Income (Loss): | | | |
| Vehicular Products ⁽³⁾⁽⁷⁾ | \$ 57,606 | \$ 47,466 | \$ (8,052) |
| Building Products ⁽⁴⁾⁽⁵⁾⁽⁸⁾ | 37,985 | 23,662 | 35,830 |
| Corporate & Other ⁽¹⁾⁽⁶⁾ | (12,291) | (13,812) | (31,740) |
| Consolidated | <u>\$ 83,300</u> | <u>\$ 57,316</u> | <u>\$ (3,962)</u> |
| Depreciation and Amortization: | | | |
| Vehicular Products ⁽³⁾ | \$ 27,849 | \$ 25,905 | \$ 28,769 |
| Building Products ⁽⁴⁾⁽⁵⁾⁽⁸⁾ | 15,492 | 17,061 | 16,408 |
| Corporate & Other ⁽¹⁾ | 646 | 944 | 3,268 |
| Consolidated | <u>\$ 43,987</u> | <u>\$ 43,910</u> | <u>\$ 48,445</u> |
| Capital Expenditures: ⁽²⁾ | | | |
| Vehicular Products ⁽³⁾ | \$ 22,931 | \$ 47,234 | \$ 31,196 |
| Building Products ⁽⁴⁾⁽⁵⁾⁽⁸⁾ | 11,464 | 8,241 | 8,295 |
| Corporate & Other ⁽¹⁾ | 118 | 165 | 2,864 |
| Consolidated | <u>\$ 34,513</u> | <u>\$ 55,640</u> | <u>\$ 42,355</u> |
| Identifiable Assets: | | | |
| Vehicular Products ⁽³⁾ | \$363,559 | \$362,442 | \$321,204 |
| Building Products ⁽⁴⁾⁽⁵⁾⁽⁸⁾ | 283,475 | 269,387 | 291,164 |
| Corporate & Other ⁽¹⁾ | 42,106 | 65,802 | 33,491 |
| Consolidated | <u>\$689,140</u> | <u>\$697,631</u> | <u>\$645,859</u> |
| Goodwill, Net | | | |
| Vehicular Products | \$ 13,496 | \$ 13,496 | |
| Building Products | 52,940 | 45,730 | |
| | <u>\$ 66,436</u> | <u>\$ 59,226</u> | |

(1) Included in "Corporate and Other" are intersegment eliminations, corporate expenses and Piper Impact Europe's results until its sale in fiscal 2000.

(2) Includes capitalized interest.

(3) Fiscal 2001 results include Temroc operations since the acquisition date of November 30, 2000. See Note 2 to the financial statements.

(4) Fiscal 2000 results include Nichols Aluminum-Golden operations since the acquisition date of January 25, 2000. See Note 2 to the financial statements.

(5) Fiscal 2000 results include IMPERIAL PRODUCTS operations since the acquisition date of April 3, 2000. See Note 2 to the financial statements.

(6) Fiscal 2000 results include the \$14.3 million pretax loss on the sale of Piper Impact Europe. See Note 3 to the financial statements.

(7) Fiscal 2000 results include the \$56.3 million pretax asset impairment charge on Piper Impact. See Note 4 to the financial statements.

(8) Fiscal 2002 results include COLONIAL CRAFT operations since the acquisition date of February 12, 2002. See Note 2 to the financial statements.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Net Sales by Product Information

| | Years Ended October 31, | | |
|--|-------------------------|------------------|------------------|
| | 2002 | 2001 | 2000 |
| | (\$ In thousands) | | |
| Net Sales | | | |
| Engineered Steel Bars | \$365,393 | \$330,692 | \$355,540 |
| Aluminum Mill Sheet Products | 383,864 | 361,660 | 395,697 |
| Window and Door Components | 150,992 | 123,386 | 106,865 |
| Extruded and Fabricated Products | 94,138 | 108,615 | 106,416 |
| Total | <u>\$994,387</u> | <u>\$924,353</u> | <u>\$964,518</u> |

Geographic Information

| | Years Ended October 31, | | |
|-----------------------------------|-------------------------|------------------|------------------|
| | 2002 | 2001 | 2000 |
| | (\$ In thousands) | | |
| Net Sales⁽¹⁾ | | | |
| United States | \$930,734 | \$870,163 | \$895,702 |
| Mexico | 19,242 | 16,148 | 24,336 |
| Canada | 32,797 | 26,176 | 18,712 |
| Asian countries | 7,882 | 7,128 | 4,415 |
| European countries | 3,533 | 4,315 | 20,423 |
| Other foreign countries | 199 | 423 | 930 |
| Total | <u>\$994,387</u> | <u>\$924,353</u> | <u>\$964,518</u> |

| | Years Ended October 31, | | |
|--------------------------------|-------------------------|------------------|------------------|
| | 2002 | 2001 | 2000 |
| | (\$ in thousands) | | |
| Net Sales⁽²⁾ | | | |
| United States | \$994,387 | \$924,353 | \$946,686 |
| The Netherlands | — | — | 17,832 |
| | <u>\$994,387</u> | <u>\$924,353</u> | <u>\$964,518</u> |

| | Years Ended October 31, | | |
|--|-------------------------|-----------------|-------------------------|
| | 2002 | 2001 | 2000 |
| | (\$ In thousands) | | |
| Operating Income (Loss)⁽⁴⁾ | | | |
| United States | \$83,300 | \$57,316 | \$12,754 ⁽³⁾ |
| The Netherlands | — | — | (16,716) ⁽⁵⁾ |
| | <u>\$83,300</u> | <u>\$57,316</u> | <u>\$ (3,962)</u> |

All identifiable assets are located in the United States.

(1) Net Sales are attributed to countries based on location of customer.

(2) Net sales are attributed to countries based on location of operations.

(3) Including the asset impairment charge of \$56.3 million in FY 2000. See Note 4.

(4) Operating income (loss) is attributed to countries based on location of operations.

(5) Including the loss on sale of Piper Impact Europe. See Note 3.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. Preferred Stock Purchase Rights

The Company declared a dividend in 1986 of one Preferred Stock Purchase Right (a "Right") on each outstanding share of its common stock. This action was intended to assure that all shareholders would receive fair treatment in the event of a proposed takeover of the Company. On April 26, 1989, the Company amended the Rights to provide for additional protection to shareholders and to provide the Board of Directors of the Company with needed flexibility in responding to abusive takeover tactics. On April 15, 1999, the Second Amended and Restated Rights Agreement went into effect. Each Right, when exercisable, entitles the holder to purchase 1/100th of a share of the Company's Series A Junior Participating Preferred Stock at an exercise price of \$90. Each 1/100th of a share of Series A Junior Participating Preferred Stock will be entitled to a dividend equal to the greater of \$.01 or the dividend declared on each share of common stock, and will be entitled to 1/100th of a vote, voting together with the shares of common stock. The Rights will be exercisable only if, without the Company's prior consent, a person or group of persons acquires or announces the intention to acquire 20% or more of the Company's common stock. If the Company is acquired through a merger or other business combination transaction, each Right will entitle the holder to purchase \$120 worth of the surviving company's common stock for \$90. Additionally, if someone acquires 20% or more of the Company's common stock, each Right, not owned by the 20% or greater shareholder, would permit the holder to purchase \$120 worth of the Company's common stock for \$90. The Rights are redeemable, at the option of the Company, at \$.02 per Right at any time until ten days after someone acquires 20% or more of the common stock. The Rights expire April 15, 2009.

As a result of the Rights distribution, 150,000 of the 1,000,000 shares of authorized Preferred Stock were reserved for issuance as Series A Junior Participating Preferred Stock.

16. Stock Repurchase Program and Treasury Stock

In December 1999, Quanex announced that its Board of Directors approved a program to repurchase up to 2 million shares of the Company's common stock in the open market or in privately negotiated transactions. During the fiscal year ended October 31, 2000, the Company repurchased 834,300 shares at a cost of \$17.2 million. During the fiscal year ended October 31, 2001, the Company repurchased 119,000 shares at a cost of \$2.2 million. The Company retired 156,700 of these shares purchased at a cost of approximately \$3.8 million. No shares were purchased during fiscal 2002 and the stock purchase program was suspended.

For shares purchased by the Company and retired: 1) Common stock is charged for the par value of the shares, 2) additional paid-in capital is charged for the pro-rata portion associated with those shares and 3) retained earnings is charged for the remainder of the cost of the retired shares. For the shares purchased and retired in the year ended October 31, 2000, the equity was reduced as shown below:

| <u>Repurchase Cost</u> | <u>Common Stock</u> | <u>Additional Paid-in Capital</u> | <u>Retained Earnings</u> |
|------------------------|-------------------------|---------------------------------------|------------------------------|
| | (In thousands) | | |
| \$3,785 | \$78 | \$1,222 | \$2,485 |

The Company accounted for the remaining shares purchased as treasury stock. The cost of such shares of \$12.7 million at October 31, 2001 was reflected as a reduction of stockholders' equity in the balance sheet.

During the twelve months ended October 31, 2002, the Company issued 1,166,250 shares for stock option exercises (See Note 17). The balance of the shares held in treasury stock was used for the exercise of some of these options and therefore as of October 31, 2002, there were no treasury shares.

On December 5, 2002, the Board of Directors again approved a program to purchase up to a total of one 1 million shares (6%) of its common stock in the open market or in privately negotiated transactions. The Company indicated that it would be active in the buyback program during the first fiscal quarter 2003.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

17. Restricted Stock and Stock Option Plans

Key Employee Plans:

The Company has restricted stock and stock option plans which provide for the granting of common shares or stock options to key employees. Under the Company's restricted stock plan, common stock may be awarded to key employees. The recipient is entitled to all of the rights of a shareholder, except that during the forfeiture period the shares are nontransferable. The awards vest over a specified time period. Upon issuance of stock under the plan, unearned compensation equal to the market value at the date of grant is charged to stockholders' equity and subsequently amortized to expense over the restricted period. There were 0, 44,000, and 22,750 restricted shares granted in 2002, 2001 and 2000, respectively. The amount charged to compensation expense in 2002, 2001 and 2000 was \$479,000, \$368,000 and \$57,000, respectively, relating to restricted stocks granted in 2001, 2000 and 1999.

Under the Company's option plans, options are granted at prices determined by the Board of Directors which may not be less than the fair market value of the shares at the time the options are granted. Unless otherwise provided by the Board at the time of grant, options become exercisable in 33⅓% increments maturing cumulatively on each of the first through third anniversaries of the date of grant and must be exercised no later than ten years from the date of grant. There were 391,597, 388,145, and 650,194 shares available for granting of options at October 31, 2002, 2001, and 2000, respectively. The exercise price for the outstanding options as of October 31, 2002 range from \$18.19 to \$36.00 per share.

Stock option transactions for the three years ended October 31, 2002, were as follows:

| | <u>Shares Exercisable</u> | <u>Shares Under Option</u> | <u>Average Price Per Share</u> |
|---------------------------------------|-------------------------------|--------------------------------|------------------------------------|
| Balance at October 31, 1999 | 966,391 | 1,421,271 | 23 |
| Granted | | 244,250 | 18 |
| Exercised | | (3,000) | 9 |
| Cancelled | | (40,418) | 26 |
| Balance at October 31, 2000 | 1,139,546 | 1,622,103 | 22 |
| Granted | | 382,000 | 24 |
| Exercised | | (70,048) | 20 |
| Cancelled/Lapsed | | (23,751) | 21 |
| Balance at October 31, 2001 | 1,291,129 | 1,910,304 | 23 |
| Granted | | 15,000 | 36 |
| Exercised | | (1,085,250) | 23 |
| Cancelled/Lapsed | | (18,452) | 22 |
| Balance at October 31, 2002 | 489,366 | 821,602 | \$23 |

In December 2002, subsequent to the fiscal year ended October 31, 2002, the Company granted 240,500 options to certain officers and employees at an exercise price of \$32 per share.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Non-Employee Director Plans:

The Company has various non-employee Director plans, which are described below:

1987 Non-Employee Directors Plan

The Company's 1987 Non-employee Directors stock option plan provides for the granting of stock options to non-employee Directors to purchase up to an aggregate amount of 100,000 shares of common stock. The plan provides that each non-employee Director and each future non-employee Director, as of the first anniversary of the date of his/her election as a Director of the Company, will be granted an option to purchase 10,000 shares of common stock at a price per share of common stock equal to the fair market value of the common stock as of the date of the grant. During 1998, the Board of Directors passed a resolution, which reduced the number of options to be granted from 10,000 to 6,000.

Options become exercisable in 33⅓% increments maturing cumulatively on each of the first through third anniversaries of the date of the grant and must be exercised no later than 10 years from the date of grant. No options may be granted under the plan after June 22, 1997. There were no shares available for granting of options at October 31, 2002, 2001, or 2000. The exercise price of the all of the shares outstanding as of October 31, 2002 was \$19.88. Stock option transactions for the three years ended October 31, 2002, were as follows:

| | <u>Shares Exercisable</u> | <u>Shares Under Option</u> | <u>Average Price Per Share</u> |
|-----------------------------------|-------------------------------|------------------------------------|--|
| Balance at October 31, 1999 | <u>20,000</u> | 20,000 | 20 |
| Granted | | — | — |
| Exercised | | — | — |
| Cancelled | | — | — |
| Balance at October 31, 2000 | <u>20,000</u> | 20,000 | 20 |
| Granted | | — | — |
| Exercised | | — | — |
| Cancelled | | — | — |
| Balance at October 31, 2001 | <u>20,000</u> | 20,000 | 20 |
| Granted | | — | — |
| Exercised | | (15,000) | 20 |
| Cancelled | | — | — |
| Balance at October 31, 2002 | <u>5,000</u> | <u>5,000</u> | \$20 |

1989 Non-Employee Directors Plan

The Company's 1989 Non-employee Directors stock option plan provides for the granting of stock options to non-employee Directors to purchase up to an aggregate of 210,000 shares of common stock. Each non-employee Director as of December 6, 1989 was granted an option to purchase 3,000 shares of common stock at a price per share of common stock equal to the fair market value of the common stock as of the date of grant. Also, each non-employee Director who is a director of the Company on any subsequent October 31, while the plan is in effect and shares are available for the granting of options hereunder, shall be granted on such October 31, an option to purchase 3,000 shares of common stock at a price equal to the fair market value of the common stock as of such October 31. During 1998, the Board of Directors passed a resolution, which decreased the number of options to be granted annually as prescribed above from 3,000 to 2,000. Options become exercisable at any time

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

commencing six months after the grant and must be exercised no later than 10 years from the date of grant. No option may be granted under the plan after December 5, 1999. There were no shares available for granting of options at October 31, 2002, 2001 or 2000. The exercise price of the options outstanding as of October 31, 2002 ranged from \$16.88 to \$28.50. Stock option transactions for the three years ended October 31, 2002, were as follows:

| | Shares Exercisable | Shares Under Option | Average Price Per Share |
|-----------------------------------|-----------------------|---------------------------|-------------------------------|
| Balance at October 31, 1999 | <u>124,000</u> | 136,000 | 23 |
| Granted | | — | — |
| Exercised | | (1,000) | 17 |
| Cancelled | | — | — |
| Balance at October 31, 2000 | <u>135,000</u> | 135,000 | 23 |
| Granted | | — | — |
| Exercised | | (14,000) | 20 |
| Cancelled | | (6,000) | 22 |
| Balance at October 31, 2001 | <u>115,000</u> | 115,000 | 24 |
| Granted | | — | — |
| Exercised | | (51,000) | 23 |
| Cancelled | | (3,000) | 19 |
| Balance at October 31, 2002 | <u>61,000</u> | <u>61,000</u> | \$25 |

1997 Non-Employee Directors Plan

The Company's 1997 Non-Employee Directors stock option plan provides for the granting of stock options to non-employee Directors to purchase up to an aggregate of 400,000 shares of common stock. There are two types of grants under this plan which are described below:

Automatic Annual Grants

While this plan is in effect and shares are available for the granting of options hereunder, each non-employee Director who is a director of the Company on October 31 and who has not received options under the 1989 Non-Employee Director plan shall be granted on such October 31, an option to purchase such number of shares of common stock as is determined by the Board of Directors at a price equal to the fair market value of the common stock as of such October 31. These options are exercisable in full immediately upon the date of grant.

New Director Grants

While this plan is in effect and shares are available for the granting of options hereunder, there shall be granted to each non-employee Director who was not granted an option under the 1987 Non-Employee Director Stock Option Plan as of the date upon which such director shall have continuously served as a director of the Company for a period of one year an option to purchase such number of Quanex Corporation shares of stock as is determined by the Board of Directors. These Plan options become exercisable in 33⅓% increments maturing cumulatively on each of the first through third anniversaries of the date of the grant and must be exercised no later than 10 years from the date of grant.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

There were 332,000, 350,000 and 364,000 shares available for granting of options at October 31, 2002, 2001 and 2000, respectively. The exercise price of the options outstanding as of October 31, 2002 ranged from \$18.25 to \$35.85. Stock option transactions for the three years ended October 31, 2002, were as follows:

| | <u>Shares Exercisable</u> | <u>Shares Under Option</u> | <u>Average Price Per Share</u> |
|---------------------------------------|-------------------------------|------------------------------------|--|
| Balance at October 31, 1999 | <u>2,000</u> | 18,000 | 21 |
| Granted | | 18,000 | 20 |
| Exercised | | — | — |
| Cancelled | | — | — |
| Balance at October 31, 2000 | <u>25,333</u> | 36,000 | 21 |
| Granted | | 14,000 | 26 |
| Exercised | | — | — |
| Cancelled | | — | — |
| Balance at October 31, 2001 | <u>44,666</u> | 50,000 | 22 |
| Granted | | 18,000 | 36 |
| Exercised | | (15,000) | 21 |
| Cancelled | | — | — |
| Balance at October 31, 2002 | <u>47,000</u> | <u>53,000</u> | \$27 |

Stock Based Compensation

In accordance with SFAS No. 123, “Accounting for Stock-Based Compensation”, the Company continues to apply the rules for stock-based compensation contained in Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” and discloses the required pro forma effect on net income and earnings per share of the fair value based method of accounting for stock-based compensation as required by SFAS No. 123.

The following pro forma summary of the Company’s consolidated results of operations have been prepared as if the fair value based method of accounting for stock based compensation as required by SFAS No. 123 had been applied:

| | <u>Years Ended October 31,</u> | | |
|---|--------------------------------|-----------------|--------------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| | (In thousands) | | |
| Net income (loss) attributable to common stockholders | \$55,482 | \$29,194 | \$ (9,665) |
| SFAS No. 123 adjustment | (1,407) | (1,154) | (1,042) |
| Pro forma net income (loss) attributable to common stockholders | <u>\$54,075</u> | <u>\$28,040</u> | <u>\$ (10,707)</u> |
| Earnings (loss) per common share: | | | |
| Basic as reported | \$ 3.74 | \$ 2.18 | \$ (0.70) |
| Basic pro forma | \$ 3.65 | \$ 2.09 | \$ (0.78) |
| Diluted as reported | \$ 3.52 | \$ 2.07 | \$ (0.70) |
| Diluted pro forma | \$ 3.43 | \$ 2.00 | \$ (0.78) |

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fair value of the options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions.

| | 2002 | 2001 | 2000 |
|--|---------|---------|---------|
| Risk-free interest rate | 3.58% | 4.28% | 5.75% |
| Dividend yield | 2.01% | 3.10% | 3.33% |
| Volatility factor | 44.14% | 42.87% | 42.89% |
| Weighted average expected life | 5 years | 5 years | 5 years |

18. Financial Instruments and Risk Management

Effective November 1, 2000, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS No. 138, which requires the Company to measure all derivatives at fair value and to recognize them in the balance sheet as an asset or liability, depending on the Company's rights or obligations under the applicable derivative contract. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a forecasted transaction, or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

Metal Exchange Forward Contracts

The Company's aluminum mill sheet products segment, Nichols Aluminum, uses various grades of aluminum scrap as well as prime aluminum ingot as a raw material for its manufacturing process. The price of this aluminum raw material is subject to fluctuations due to many factors in the aluminum market. In the normal course of business, Nichols Aluminum enters into firm price sales commitments with its customers. In an effort to reduce the risk of fluctuating raw material prices, the Company enters into firm price raw material purchase commitments (which are designated as "normal purchases" under SFAS No. 133) as well as forward contracts on the London Metal Exchange ("LME"). The Company's risk management policy as it relates to these LME contracts is to enter into contracts to cover the raw material needs of the Company's committed sales orders, net of fixed price purchase commitments.

With the use of firm price raw material purchase commitments and LME contracts, the Company aims to protect the gross margins from the effects of changing prices of aluminum. To the extent that the raw material costs factored into the firm price sales commitments are matched with firm price raw material purchase commitments, changes in aluminum prices should have no effect on the Company. Where firm price sales commitments are matched with LME contracts, the Company is subject to the ineffectiveness of LME contracts to perfectly hedge raw material prices.

The Company grouped LME contracts into two types: customer specific and non-customer specific. The customer specific contracts have been designated as cash flow hedges of forecasted aluminum raw material purchases in accordance with SFAS No. 133. The non-customer specific LME contracts that were used to manage or balance the raw material needs were designated as hedges and, therefore, did not receive hedge accounting under SFAS No. 133. Both types of contracts were measured at fair market value on the balance sheet.

Accounting before adoption of SFAS No. 133: As the Company did not adopt SFAS No. 133 until November 1, 2000, hedging gains and losses were included in "Cost of sales" in the income statement concurrently with the related sales of inventory.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounting after adoption of SFAS No. 133: On November 1, 2000, when the Company adopted SFAS 133, it recorded a derivative liability of \$372 thousand representing the fair value of these contracts as of that date. A corresponding amount, net of taxes of \$145 thousand, was recorded to other comprehensive income.

At October 31, 2002, the Company had no open LME forward contracts and therefore no asset or liability associated with metal exchange derivatives. During the year ended October 31, 2002, Nichols Aluminum used more firm price raw material purchase commitments instead of LME forward contracts to lock in raw material prices. At October 31, 2001, open LME contracts covered notional volumes of 45,415,185 pounds and had a fair value net loss of approximately \$1.8 million, which is recorded as part of other current and non-current assets and liabilities in the financial statements.

The effective portion of the gains and losses related to the customer specific forward LME contracts designated as hedges are reported in other comprehensive income. These gains and losses are reclassified into earnings in the periods in which the related inventory is sold. As of October 31, 2002, losses of approximately \$428 thousand (\$261 thousand net of taxes) are expected to be reclassified from other comprehensive income into earnings over the next twelve months. Gains and losses on these customer specific hedge contracts, including amounts related to hedge ineffectiveness, are reflected in "Cost of sales" in the income statement. For the year ended October 31, 2002 and 2001, a net gain of \$136 thousand and a net loss of \$283 thousand, respectively, was recognized in "Cost of sales" representing the amount of the hedges' ineffectiveness. (No components of these gains and losses were excluded from the assessment of hedge effectiveness. Additionally, no hedge contracts were discontinued due to the determination that the original forecasted transaction would not occur. Therefore, there was no income statement impact related to that action.)

The entire amount of gains and losses of the non-customer specific forward LME contracts not designated as hedges were reflected in "Cost of sales" in the income statement in the period in which they occurred. These gains and losses included the changes in fair market value during the period for all open and closed contracts.

Interest Rate Swap Agreements

In fiscal 1996, the Company entered into interest rate swap agreements, which effectively converted \$100 million of its variable rate debt under the Bank Agreement Revolver to fixed rate. The Company's risk management policy related to these swap agreements is to hedge the exposure to interest rate movements on a portion of its long-term debt. Under the swap agreements, payments are made based on a fixed rate (\$50 million at 7.025% and \$50 million at 6.755%) and received on a LIBOR based variable rate (1.82% at October 31, 2002). Differentials to be paid or received under the agreements are recognized as interest expense. The agreements mature in 2003. The Company has designated the interest rate swap agreements as cash flow hedges of future interest payments on its variable rate debt under the Bank Agreement Revolver.

Accounting before adoption of SFAS No. 133: Prior to the adoption of SFAS No. 133 on November 1, 2000, hedging gains and losses were included in "Interest Expense" in the income statement based on the quarterly swap settlement.

Accounting after adoption of SFAS No. 133: On November 1, 2000, the Company recorded a derivative liability of \$918 thousand, representing the fair value of the swaps as of that date. A corresponding amount, net of income taxes of \$358 thousand, was recorded to other comprehensive income.

The fair value of the swaps as of October 31, 2002 and 2001 was a loss of \$4.0 million and \$7.3 million, respectively, which is recorded as part of other current liabilities. Gains and losses related to the swap agreements will be reclassified into earnings in the periods in which the related hedged interest payments are made. As of October 31, 2002, losses of approximately \$257 thousand (\$156 thousand net of taxes) are expected to be reclassified into earnings over the next twelve months. Gains and losses on these agreements, including amounts recorded related to hedge ineffectiveness, are reflected in "Interest expense" in the income statement. A net loss

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of \$386 thousand and \$730 thousand, respectively, was recorded in interest expense in the year ended October 31, 2002 and 2001, respectively, representing the amount of the hedge's ineffectiveness. (No components of the swap instruments' losses were excluded from the assessment of hedge effectiveness.)

Discontinuance of cash flow hedge: Based on future cash flow projections that were prepared during the second fiscal quarter period ended April 30, 2002, it was determined that it was probable that the Company would pay down its variable rate debt under the Bank Agreement Revolver to approximately \$65 million by the end of this fiscal year. Based on these projections, a portion of the future projected cash flow being hedged (interest payments) would not occur. Therefore, during the period ended April 30, 2002, the Company discontinued hedge accounting under SFAS 133 for \$35 million of the interest swap agreement and reclassified the related portion of other comprehensive income, a loss of \$1.3 million to interest expense. Additionally, during the fourth fiscal quarter ended October 31, 2002, the timing of the finalization of the new bank agreement was determined. Since the swaps were designated as hedges of interest payments under the old Bank Agreement Revolver, which terminated upon completion of the new Bank Agreement Revolver, the swap no longer qualified as a hedge, as those forecasted transactions will not occur (future interest payments). As a result, the Company discontinued hedge accounting under SFAS 133 on the swaps after the projected new bank agreement date and reclassified the related portion of other comprehensive income, a loss of \$2.1 million to interest expense. The Company however has not terminated or closed any of the \$100 million swap agreement and therefore the entire swap agreement's fair market value is reflected on the balance sheet as indicated in the previous paragraph. Any change in the fair market value, in fiscal 2003, will be recorded in interest expense.

If the floating rates were to change by 10% from October 31, 2002 levels, the fair market value of these swaps would change by approximately \$79 thousand. In terms of the impact on cash flow to the Company, as floating interest rates decline, the market value of the swap agreement rises, thus increasing the quarterly cash settlement of the swaps paid by the Company. However, the interest paid on the floating rate debt balance decreases. The inverse situation occurs with rising interest rates.

Foreign Currency Contracts

In December 1997, the Company entered into a zero-cost range forward (foreign currency swap) agreement on a notional value of 30 million Guilders with a major financial institution to hedge its initial equity investment in its Netherlands subsidiary, Piper Impact Europe. This agreement limited the Company's exposure to large fluctuations in the US Dollar/Dutch Guilder exchange rate. Under the terms of the agreement, Quanex had the option to let the agreement expire at no cost if the exchange rate remained within an established range on the expiration date of October 25, 2000. At October 31, 1999, the Company booked a \$378 thousand gain to the stockholders' equity cumulative foreign currency translation adjustment. During the third quarter ended July 31, 2000, the Company sold the Piper Impact Europe subsidiary. As such, this range forward agreement was closed, realizing a gain of approximately \$1.7 million. This gain was offset against the loss on the sale of Piper Impact Europe as the investment in Piper Impact Europe was the underlying hedged item.

See the Statement of Stockholder's Equity for components of comprehensive income and the disclosure of accumulated other comprehensive income related to hedging transactions.

Other Financial Assets and Liabilities

The fair values of the Company's financial assets approximate the carrying values reported on the consolidated balance sheet. The fair value and carrying value of long-term debt was \$75.6 million and \$220.0 million, as of October 31, 2002 and 2001, respectively. The fair value of long-term debt was based on the quoted market price, recent transactions, or based on rates available to the Company for instruments with similar terms and maturities.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

19. Leases

Quanex has operating leases for certain real estate and equipment. Rental expense for the years ended October 31, 2002, 2001 and 2000 was \$2.2 million, \$2.1 million and \$2.1 million, respectively.

Future minimum payments as of October 31, 2002, by year and in the aggregate under operating leases having non-cancelable lease terms in excess of one year were as follows (in thousands):

| | <u>Operating Leases</u> |
|------------------|-----------------------------|
| 2003 | \$2,428 |
| 2004 | \$1,521 |
| 2005 | \$1,243 |
| 2006 | \$1,110 |
| 2007 | \$1,052 |
| Thereafter | <u>\$1,198</u> |
| Total | <u>\$8,552</u> |

20. Contingencies

Quanex is subject to loss contingencies arising from federal, state, and local environmental laws. Environmental expenditures are expensed or capitalized depending on their future economic benefit. The Company accrues its best estimates of its remediation obligations and adjusts such accruals as further information and circumstances develop. Those estimates may change substantially depending on information about the nature and extent of contamination, appropriate remediation technologies, and regulatory approvals. Costs of future expenditures for environmental remediation are not discounted to their present value. When environmental laws might be deemed to impose joint and several liability for the costs of responding to contamination, the Company accrues its allocable share of liability taking into account the number of companies participating, their ability to pay their shares, the volumes and nature of the wastes involved, the nature of anticipated response actions, and the nature of the Company's alleged connections. It is management's opinion that the Company has established appropriate reserves for environmental remediation obligations at various of its plant sites and disposal facilities. Those amounts are not expected to have a material adverse effect on the Company's financial condition. Total remediation reserves, at October 31, 2002, were approximately \$17 million. These reserves include, without limitation, the Company's best estimate of liabilities related to costs for further investigations, environmental remediation, and corrective actions related to the acquisition of Piper Impact, the acquisition of Nichols Aluminum Alabama and the Company's former Tubing Operations. Actual cleanup costs at the Company's current plant sites, former plants, and disposal facilities could be more or less than the amounts accrued for remediation obligations. Because of uncertainties as to the extent of environmental impact and concurrence of governmental authorities, it is not possible at this point to reasonably estimate the amount of any obligation for remediation in excess of current accruals that would be material to Quanex's financial statements because of uncertainties as to the extent of environmental impact and concurrence of governmental authorities.

During the second quarter of fiscal 2001, some of Nichols Aluminum Casting's aluminum reroll product was damaged in a fire at a third-party offsite warehouse storage facility. The loss was covered under the Company's property insurance policy. As of October 31, 2001, only the Company's cost in the material had been recovered. The Company also filed a claim under the business interruption provisions of the policy to recover additional costs, as well as lost profit sustained due to the fire. The Company received \$858 thousand in the first fiscal quarter ended January 31, 2002 and a final settlement of \$1.6 million in the third fiscal quarter ended July 31, 2002 against the business interruption claim. These proceeds were recorded as a reduction of cost of sales.

QUANEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

From time to time, the Company and its subsidiaries are involved in various litigation matters arising in the ordinary course of their business. Although the ultimate resolution and impact of such litigation on the Company is not presently determinable, the Company's management believes that the eventual outcome of such litigation will not have a material adverse effect on the overall financial condition or results of operations of the Company.

QUANEX CORPORATION
SUPPLEMENTARY FINANCIAL DATA

Quarterly Results of Operations (Unaudited)

The following sets forth the selected quarterly information for the years ended October 31, 2002 and 2001.

| | <u>First Quarter</u> | <u>Second Quarter</u> | <u>Third Quarter</u> | <u>Fourth Quarter</u> |
|--------------------------------------|---|---------------------------|--------------------------|---------------------------|
| | (In thousands except per share amounts) | | | |
| 2002: | | | | |
| Net sales | \$204,243 | \$249,500 | \$266,891 | \$273,753 |
| Gross profit | 22,305 | 34,123 | 39,493 | 43,289 |
| Net income | 5,460 | 10,632 | 24,337 | 15,053 |
| Earnings per share: | | | | |
| Basic earnings per share | 0.41 | 0.77 | 1.56 | 0.92 |
| Diluted earnings per share | \$ 0.39 | \$ 0.70 | \$ 1.42 | \$ 0.97 |
| 2001: | | | | |
| Net sales | \$199,942 | \$220,257 | \$248,121 | \$256,033 |
| Gross profit | 20,845 | 23,762 | 32,761 | 37,958 |
| Net income | 4,057 | 4,289 | 9,608 | 11,240 |
| Earnings per share: | | | | |
| Basic net earnings | 0.30 | 0.32 | 0.72 | 0.84 |
| Diluted net earnings | \$ 0.30 | \$ 0.32 | \$ 0.67 | \$ 0.77 |

SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS

| <u>Description</u> | <u>Balance at Beginning of Year</u> | <u>Charged to Costs & Expenses</u> | <u>Write-offs</u> | <u>Other</u> | <u>Balance at End of Year</u> |
|---|---|--|-------------------|--------------|---------------------------------------|
| | (In thousands) | | | | |
| Allowance for doubtful accounts: | | | | | |
| Year ended October 31, 2002 | \$ 8,953 | \$1,113 | \$(3,227) | \$ 38 | \$ 6,877 |
| Year ended October 31, 2001 | \$11,240 | \$ 868 | \$(3,213) | \$ 58 | \$ 8,953 |
| Year ended October 31, 2000 | \$12,154 | \$ 738 | \$(1,284) | \$(368) | \$11,240 |

Quarterly Financial Results
(from continuing operations)

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--|---------------|---------------|---------------|
| Net Sales (millions) | | | |
| January | 204.24 | 199.94 | 205.90 |
| April | 249.50 | 220.26 | 251.05 |
| July | 266.89 | 248.12 | 262.65 |
| October | 273.76 | 256.03 | 244.92 |
| Total | <u>994.39</u> | <u>924.35</u> | <u>964.52</u> |
| Gross Profit (Loss) (millions) | | | |
| January | 22.31 | 20.85 | 22.24 |
| April | 34.12 | 23.76 | 30.57 |
| July | 39.49 | 32.76 | 19.60 |
| October | 43.29 | 37.96 | (19.51) |
| Total | <u>139.21</u> | <u>115.33</u> | <u>52.90</u> |
| Income (Loss) from Continuing Operations (millions) | | | |
| January | 5.46 | 4.05 | 4.18 |
| April | 10.63 | 4.29 | 9.38 |
| July ⁽¹⁾⁽³⁾ | 24.34 | 9.61 | 0.71 |
| October ⁽²⁾ | 15.05 | 11.24 | (23.94) |
| Total | <u>55.48</u> | <u>29.19</u> | <u>(9.67)</u> |
| Income (Loss) from Continuing Operations Per Basic Common Share | | | |
| January | .41 | .30 | .29 |
| April | .77 | .32 | .68 |
| July ⁽¹⁾⁽³⁾ | 1.56 | .72 | .05 |
| October ⁽²⁾ | .92 | .84 | (1.78) |
| Year | <u>3.74</u> | <u>2.18</u> | <u>(0.70)</u> |
| Quarterly Common Stock Dividends | | | |
| January | .16 | .16 | .16 |
| April | .16 | .16 | .16 |
| July | .16 | .16 | .16 |
| October | .16 | .16 | .16 |
| Total | <u>.64</u> | <u>.64</u> | <u>.64</u> |
| Common Stock Sales Price (High & Low) | | | |
| January | 29.64 | 21 | 26.5625 |
| April | 25.71 | 16.375 | 19.0625 |
| July | 38.35 | 21.15 | 23.6875 |
| October | 28.63 | 17.35 | 16.125 |
| Total | 44.19 | 27.55 | 18.625 |
| Total | 31.01 | 20.70 | 14.375 |
| Total | 40.55 | 27.48 | 20.6875 |
| Total | 33.18 | 20.75 | 17.0625 |

(1) Fiscal 2000 third quarter income from continuing operations includes an after-tax loss of \$9.3 million on the sale of Piper Impact Europe.

(2) Fiscal 2000 fourth quarter loss from continuing operations includes an after-tax asset impairment charge of \$36.6 million or \$2.67 per share.

(3) Fiscal 2002 third quarter income from continuing operations includes a retired executive life insurance benefit of \$9.0 million.

Item 9. *Disagreements on Accounting and Financial Disclosure*

None

PART III

Item 10. *Directors and Executive Officers of the Registrant*

Pursuant to General Instruction G(3) to Form 10-K, information on directors and executive officers of the Registrant is incorporated herein by reference from the Registrant's Definitive Proxy Statement to be filed pursuant to Regulation 14A within 120 days after the close of the fiscal year ended October 31, 2002.

Item 11. *Executive Compensation*

Pursuant to General Instruction G(3) to Form 10-K, information on executive compensation is incorporated herein by reference from the Registrant's Definitive Proxy Statement to be filed pursuant to Regulation 14A within 120 days after the close of the fiscal year ended October 31, 2002.

Item 12. *Security Ownership of Certain Beneficial Owners and Management*

Pursuant to General Instruction G(3) to Form 10-K, information on security ownership of certain beneficial owners and management is incorporated herein by reference from the Registrant's Definitive Proxy Statement to be filed pursuant to Regulation 14A within 120 days after the close of the fiscal year ended October 31, 2002.

Item 13. *Certain Relationships and Related Transactions*

Pursuant to General Instruction G(3) to Form 10-K, information on certain relationships and related transactions is incorporated herein by reference from the Registrant's Definitive Proxy Statement to be filed pursuant to Regulation 14A within 120 days after the close of the fiscal year ended October 31, 2002.

Item 14. *Controls and Procedures*

We have established disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to the officers who certify the Company's financial reports and to other members of senior management and the Board of Directors.

Based on their evaluation as of a date within 90 days of the filing date of this Annual Report on Form 10-K, the principal executive officer and principal financial officer of Quanex have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-14[c] and 15d-14[c] under the Securities Exchange Act of 1934) are effective to ensure that the information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

There were no significant changes in Quanex's internal controls or in other factors that could significantly affect those controls subsequent to the date of their most recent evaluation.

PART IV

Item 15. *Exhibits, Financial Statement Schedules and Reports on Form 8-K*

| | <u>Page</u> |
|---|-------------|
| (a) 1. <i>Financial Statements</i> | |
| Independent Auditors' Report | 28 |
| Consolidated Balance Sheet | 30 |
| Consolidated Statements of Income | 31 |
| Consolidated Statements of Stockholders' Equity | 32 |
| Consolidated Statements of Cash Flow | 34 |
| Notes to Consolidated Financial Statements | 35 |
| 2. <i>Financial Statement Schedule</i> | |
| Schedule II—Valuation and qualifying accounts | 65 |
| Schedules not listed or discussed above have been omitted as they are either inapplicable or the required information has been given in the consolidated financial statements or the notes thereto. | |
| 3. <i>Exhibits</i> | 69 |

| <u>Exhibit Number</u> | <u>Description of Exhibits</u> |
|---------------------------|---|
| 3.1 | Restated Certificate of Incorporation of the Registrant dated as of November 10, 1995, filed as Exhibit 3.1 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1995 and incorporated herein by reference. |
| 3.2 | Certificate of Amendment to Restated Certificate of Incorporation of the Registrant dated as of February 27, 1997, filed as Exhibit 3.2 fiscal year ended October 31, 1999 and incorporated herein by reference. |
| 3.3 | Amendment to Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock of the Registrant dated as of April 15, 1999, filed as Exhibit 3.3 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| 3.4 | Certificate of Correction of Amendment to Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock dated as of April 16, 1999, filed as Exhibit 3.4 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| 3.5 | Amended and Restated Bylaws of the Registrant, as amended through August 26, 1999 filed as Exhibit 3 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the fiscal quarter ended July 31, 1999, and incorporated herein by reference. |
| 4.1 | Form of Registrant's Common Stock certificate, filed as Exhibit 4.1 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 1987, and incorporated herein by reference. |
| 4.2 | Second Amended and Restated Rights agreement dated as of April 15, 1999, between the Registrant and American Stock Transfer & Trust Co. as Rights Agent, filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K (Reg. No. 001-05725) dated April 15, 1999, and incorporated herein by reference. |
| 4.3 | Form of Indenture relating to the Registrant's 6.88% Convertible Subordinated Exhibit Debentures due 2007 between the Registrant and Chemical Bank, as Trustee, filed as 19.2 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 1992, and incorporated herein by reference. |
| *4.4 | Revolving Credit Agreement dated as of November 26, 2002, by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks. Certain schedules and exhibits to this Revolving Credit Agreement have not been filed with this exhibit. The Company agrees to furnish supplementally any omitted schedule or exhibit to the SEC upon request. |
| †10.1 | Quanex Corporation 1988 Stock Option Plan, as amended, and form of Stock Option year Agreement filed as Exhibit 10.4 to the Registrant's annual Report on Form 10-K for the year ended October 31, 1988, together with the amendment filed as Exhibit 10.17 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 1995, and incorporated herein by reference. |
| †10.2 | Amendment to the Quanex Corporation 1988 Stock Option Plan, dated as of December 1997, filed as Exhibit 10.2 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.3 | Amendment to the Quanex Corporation 1988 Stock Option Plan, dated as of December 9, 1999, filed as Exhibit 10.3 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |

| <u>Exhibit Number</u> | <u>Description of Exhibits</u> |
|---------------------------|--|
| †10.4 | Quanex Corporation Deferred Compensation Plan, as amended and restated, dated September 29, 1999, filed as Exhibit 10.4 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.5 | First Amendment to Quanex Corporation Deferred Compensation Plan, dated December 7, 1999, filed as Exhibit 10.5 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.6 | Quanex Corporation Executive Incentive Compensation Plan, as amended and restated, dated October 12, 1995, filed as Exhibit 10.8 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.7 | Quanex Corporation Supplemental Benefit Plan, as amended and restated effective June 1, 1999, filed as Exhibit 10.9 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.8 | Form of Change in Control Agreement, between the Registrant and each executive officer of the Registrant, filed as Exhibit 10.10 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.9 | Quanex Corporation 1987 Non-Employee Director Stock Option Plan, as amended, and the related form of Stock Option Agreement, filed as Exhibit 10.14 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1988, together with the amendment filed as Exhibit 10.14 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 1995, and incorporated herein by reference. |
| †10.10 | Amendment to the Quanex Corporation 1987 Non-Employee Director Stock Option Plan, dated December 1997, filed as Exhibit 10.13 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.11 | Amendment to the Quanex Corporation 1987 Non-Employee Director Stock Option Plan, dated December 9, 1999, filed as Exhibit 10.14 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.12 | Quanex Corporation 1989 Non-Employee Director Stock Option Plan, as amended, filed as Exhibit 4.4 of the Registrant's Form S-8, Registration No. 33-35128, together with the amendment filed as Exhibit 10.15 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 1995, and incorporated herein by reference. |
| †10.13 | Amendment to the Quanex Corporation 1989 Non-Employee Director Stock Option Plan, dated December 1997, filed as Exhibit 10.16 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.14 | Amendment to the Quanex Corporation 1989 Non-Employee Director Stock Option Plan, dated December 9, 1999, filed as Exhibit 10.17 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.15 | Quanex Corporation Employee Stock Option and Restricted Stock Plan, as amended, filed as Exhibit 10.14 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1994, and incorporated herein by reference. |
| †10.16 | Amendment to the Quanex Corporation Employee Stock Option and Restricted Stock Plan, dated December 1997, filed as Exhibit 10.19 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |

| <u>Exhibit Number</u> | <u>Description of Exhibits</u> |
|---------------------------|---|
| †10.17 | Amendment to the Quanex Corporation Employee Stock Option and Restricted Stock Plan, dated December 9, 1999, filed as Exhibit 10.20 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.18 | Amendment to the Quanex Corporation Employee Stock Option and Restricted Stock Plan, effective July 1, 2000 filed as Exhibit 10.18 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 2000 and incorporated herein by reference. |
| †10.19 | Retirement Agreement dated as of September 1, 1992, between the Registrant and Carl E. Pfeiffer, filed as Exhibit 10.20 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1992, and incorporated herein by reference. |
| †10.20 | Stock Option Agreement dated as of October 1, 1992, between the Registrant and Carl E. Pfeiffer, filed as Exhibit 10.21 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1992, and incorporated herein by reference. |
| †10.21 | Deferred Compensation Agreement dated as of July 31, 1992, between the Registrant and Carl E. Pfeiffer, filed as Exhibit 10.22 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1992, and incorporated herein by reference. |
| †10.22 | Quanex Corporation Non-Employee Director Retirement Plan, filed as Exhibit 10.18 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1994, and incorporated herein by reference. |
| †10.23 | Amendment to Quanex Corporation Non-Employee Director Retirement Plan dated May 25, 1995, filed as Exhibit 10.3 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the fiscal quarter ended January 31, 2000 and incorporated herein by reference. |
| †10.24 | Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, filed as Exhibit 10.19 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1996, and incorporated herein by reference. |
| †10.25 | Amendment to Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, dated December 1997, filed as Exhibit 10.26 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.26 | Amendment to Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, dated December 9, 1999, filed as Exhibit 10.27 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.27 | Amendment to Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, effective February 23, 2000, filed as Exhibit 10.2 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the fiscal quarter ended January 31, 2000 and incorporated herein by reference. |
| †10.28 | Amendment to Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, effective July 1, 2000 filed as Exhibit 10.28 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 2000 and incorporated herein by reference. |
| †10.29 | Quanex Corporation Deferred Compensation Trust filed as Exhibit 4.8 of the Registrant's Registration Statement on Form S-3, Registration No. 333-36635, and incorporated herein by reference. |
| †10.30 | Amendment to Quanex Corporation Deferred Compensation Trust, dated December 9, 1999, filed as Exhibit 10.29 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |

| <u>Exhibit Number</u> | <u>Description of Exhibits</u> |
|---------------------------|---|
| †10.31 | Amendment and restatement of the Quanex Corporation Deferred Compensation Plan, effective November 1, 2001 filed as Exhibit 10.5 of the Registrant's Quarterly Report on Form 10-Q dated March 7, 2002, and incorporated herein by reference. |
| †10.32 | Quanex Corporation 1997 Non-Employee Director Stock Option Plan filed as Exhibit 10.21 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1997 and incorporated herein by reference. |
| †10.33 | Amendment to Quanex Corporation 1997 Non-Employee Director Stock Option Plan, dated December 9, 1999, filed as Exhibit 10.31 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.34 | Quanex Corporation 1997 Key Employee Stock Plan (formerly known as the Quanex Corporation 1997 Key Employee Stock Option Plan) as amended and restated, dated October 20, 1999, filed as Exhibit 10.1 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725), dated June 11, 2001. |
| †10.35 | Amendment to Quanex Corporation 1997 Key Employee Stock Plan (formerly known as the Quanex Corporation 1997 Key Employee Stock Option Plan) dated December 9, 1999, filed as Exhibit 10.2 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725), dated June 11, 2001 and incorporated herein by reference. |
| †10.36 | Amendment to Quanex Corporation 1997 Key Employee Stock Plan (formerly known as the Quanex Corporation 1997 Key Employee Stock Option Plan) effective July 1, 2000, filed as Exhibit 10.3 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725), dated June 11, 2001 and incorporated herein by reference. |
| †10.37 | Amendment to the Quanex Corporation 1997 Key Employee Stock Option Plan effective October 25, 2001, filed as Exhibit 10.36 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 2001 and incorporated herein by reference. |
| †10.38 | Quanex Corporation Long-Term Incentive Plan effective November 1, 2001, filed as Exhibit 10.37 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 2001 and incorporated herein by reference. |
| †10.39 | Letter Agreement between Quanex Corporation and Raymond A. Jean, dated February 14, 2001, filed as Exhibit 10.6 of the Registrant's Quarterly Report on Form 10-Q, dated March 7, 2002 and incorporated herein by reference. |
| *10.40 | First Amendment to Quanex Corporation Hourly Bargaining Unit Savings Plan, dated October 30, 2002, and effective December 12, 1994. |
| 10.41 | Asset Purchase Agreement dated July 31, 1996, among the Company, Piper Impact, Inc., a Delaware corporation, Piper Impact, Inc., a Tennessee corporation, B. F. Sammons and M. W. Robbins, filed as Exhibit 2.1 of the Company's Report on Form 8-K (Reg. No. 001-05725), dated August 9, 1996, and incorporated herein by reference. |
| 10.42 | Stock Purchase Agreement dated April 18, 1997, by and among Niagara Corporation, Niagara Cold Drawn Corp., and Quanex Corporation filed as Exhibit 2.1 to the Company's Current Report on Form 8-K (Reg. No. 001-05725), dated May 5, 1997, and incorporated herein by reference. |
| 10.43 | Purchase Agreement dated December 3, 1997, among Quanex Corporation, Vision Metals Holdings, Inc., and Vision Metals, Inc., filed as Exhibit 2.1 to the Company's Current Report on Form 8-K (Reg. No. 001-05725), dated December 3, 1997, and incorporated herein by reference. |

| <u>Exhibit Number</u> | <u>Description of Exhibits</u> |
|---------------------------|--|
| 10.44 | Acquisition Agreement and Plan of Merger, dated October 23, 2000, between Quanex Corporation (“Company”), Quanex Five, Inc., a Delaware corporation and wholly owned subsidiary of the Company, and Temroc Metals, Inc., a Minnesota corporation, filed as Exhibit 2.1 to the Company’s Report on Form 8-K (Reg. No. 001-05725), dated November 30, 2000, and incorporated herein by reference. |
| 10.45 | First Amendment to Agreement and Plan of Merger dated November 15, 2000 between Quanex Corporation (“Company”), Quanex Five, Inc., a Delaware corporation and wholly owned subsidiary of the Company, and Temroc Metals, Inc., a Minnesota corporation, filed as Exhibit 3.1 to the Company’s Report on Form 8-K (Reg. No. 001-05725), dated November 30, 2000 and incorporated herein by reference. |
| 10.46 | Lease Agreement between The Industrial Development Board of the City of Decatur and Fruehauf Trailer Company dated May 1, 1963, filed as Exhibit 10.22 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.47 | Lease Agreement between The Industrial Development Board of the City of Decatur and Fruehauf Corporation dated May 1, 1964, filed as Exhibit 10.23 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.48 | Lease Agreement between The Industrial Development Board of the City of Decatur and Fruehauf Corporation dated October 1, 1965, filed as Exhibit 10.24 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.49 | Lease Agreement between The Industrial Development Board of the City of Decatur (Alabama) and Fruehauf Corporation dated December 1, 1978, filed as Exhibit 10.25 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.50 | Assignment and Assumption Agreement between Fruehauf Trailer Corporation and Decatur Aluminum Corp. (subsequently renamed Nichols Aluminum–Alabama, Inc.) dated October 9, 1998, filed as Exhibit 10.26 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.51 | Agreement between The Industrial Development Board of the City of Decatur and Decatur Aluminum Corp. (subsequently renamed Nichols Aluminum–Alabama, Inc.) dated September 23, 1998, filed as Exhibit 10.27 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| *10.52 | Lease Agreement between Cabot Industrial Properties, L.P. and Quanex Corporation dated August 30, 2002. |
| *21 | Subsidiaries of the Registrant. |
| *23 | Consent of Deloitte & Touche LLP. |
| *99.1 | Certification by chief financial officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| *99.2 | Certification by chief executive officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

† Management Compensation or Incentive Plan

* Filed herewith

As permitted by Item 601(b)(4)(iii)(A) of Regulation S-K, the Registrant has not filed with this Annual Report on Form 10-K 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.

(b) *Reports on Form 8-K*

No Reports on Form 8-K were filed by the Company during the quarter ended October 31, 2002.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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 CORPORATION

By: /s/ RAYMOND A. JEAN December 20, 2002
 Raymond A. Jean
 Chairman of the Board, President and
 Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| <u>Name</u> | <u>Title</u> | <u>Date</u> |
|---|--|-------------------|
| <u> /s/ RAYMOND A. JEAN </u> Raymond A. Jean | Chairman of the Board, President and Chief Executive Officer | December 20, 2002 |
| <u> /s/ DONALD G. BARGER, JR. </u> Donald G. Barger, Jr. | Director | December 20, 2002 |
| <u> /s/ VINCENT R. SCORSONE </u> Vincent R. Scorsone | Director | December 20, 2002 |
| <u> /s/ MICHAEL J. SEBASTIAN </u> Michael J. Sebastian | Director | December 20, 2002 |
| <u> /s/ RUSSELL M. FLAUM </u> Russell M. Flaum | Director | December 20, 2002 |
| <u> /s/ SUSAN F. DAVIS </u> Susan F. Davis | Director | December 20, 2002 |
| <u> /s/ JOSEPH J. ROSS </u> Joseph J. Ross | Director | December 20, 2002 |
| <u> /s/ TERRY M. MURPHY </u> Terry M. Murphy | Vice President—Finance and Chief Financial Officer (Principal Financial Officer) | December 20, 2002 |
| <u> /s/ VIREN M. PARIKH </u> Viren M. Parikh | Controller (Principal Accounting Officer) | December 20, 2002 |

CERTIFICATIONS

I, Raymond A. Jean, certify that:

1. I have reviewed this annual report on Form 10-K of Quanex Corporation;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a. Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
 - c. Presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control; and
6. The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ RAYMOND A. JEAN

December 20, 2002

Raymond A. Jean
*Chairman of the Board, President and
Chief Executive Officer
(Principal Executive Officer)*

I, Terry M. Murphy, certify that:

1. I have reviewed this annual report on Form 10-K of Quanex Corporation;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a. Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
 - c. Presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control; and
6. The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ TERRY M. MURPHY

December 20, 2002

Terry M. Murphy
*Vice President—Finance and
Chief Financial Officer
(Principal Financial Officer)*

INDEX TO EXHIBITS

| Exhibit Number | Description of Exhibits |
|-------------------|---|
| 3.1 | Restated Certificate of Incorporation of the Registrant dated as of November 10, 1995, filed as Exhibit 3.1 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1995 and incorporated herein by reference. |
| 3.2 | Certificate of Amendment to Restated Certificate of Incorporation of the Registrant dated as of February 27, 1997, filed as Exhibit 3.2 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| 3.3 | Amendment to Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock of the Registrant dated as of April 15, 1999, filed as Exhibit 3.3 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| 3.4 | Certificate of Correction of Amendment to Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock dated as of April 16, 1999, filed as Exhibit 3.4 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| 3.5 | Amended and Restated Bylaws of the Registrant, as amended through August 26, 1999 filed as Exhibit 3 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the fiscal quarter ended July 31, 1999, and incorporated herein by reference. |
| 4.1 | Form of Registrant's Common Stock certificate, filed as Exhibit 4.1 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 1987, and incorporated herein by reference. |
| 4.2 | Second Amended and Restated Rights agreement dated as of April 15, 1999, between the Registrant and American Stock Transfer & Trust Co. as Rights Agent, filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K (Reg. No. 001-05725) dated April 15, 1999, and incorporated herein by reference. |
| 4.3 | Form of Indenture relating to the Registrant's 6.88% Convertible Subordinated Exhibit Debentures due 2007 between the Registrant and Chemical Bank, as Trustee, filed as 19.2 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 1992, and incorporated herein by reference. |
| *4.4 | Revolving Credit Agreement dated as of November 26, 2002, by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks. Certain schedules and exhibits to this Revolving Credit Agreement have not been filed with this exhibit. The Company agrees to furnish supplementally any omitted schedule or exhibit to the SEC upon request. Quanex Corporation 1988 Stock Option Plan, as amended, and form of Stock Option year Agreement filed as Exhibit 10.4 to the Registrant's. |
| †10.1 | Annual Report on Form 10-K for the year ended October 31, 1988, together with the amendment filed as Exhibit 10.17 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 1995, and incorporated herein by reference. |
| †10.2 | Amendment to the Quanex Corporation 1988 Stock Option Plan, dated as of December 1997, filed as Exhibit 10.2 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.3 | Amendment to the Quanex Corporation 1988 Stock Option Plan, dated as of December 9, 1999, filed as Exhibit 10.3 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |

| <u>Exhibit Number</u> | <u>Description of Exhibits</u> |
|---------------------------|--|
| †10.4 | Quanex Corporation Deferred Compensation Plan, as amended and restated, dated September 29, 1999, filed as Exhibit 10.4 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.5 | First Amendment to Quanex Corporation Deferred Compensation Plan, dated December 7, 1999, filed as Exhibit 10.5 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.6 | Quanex Corporation Executive Incentive Compensation Plan, as amended and restated, dated October 12, 1995, filed as Exhibit 10.8 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.7 | Quanex Corporation Supplemental Benefit Plan, as amended and restated effective June 1, 1999, filed as Exhibit 10.9 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.8 | Form of Change in Control Agreement, between the Registrant and each executive officer of the Registrant, filed as Exhibit 10.10 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.9 | Quanex Corporation 1987 Non-Employee Director Stock Option Plan, as amended, and the related form of Stock Option Agreement, filed as Exhibit 10.14 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1988, together with the amendment filed as Exhibit 10.14 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 1995, and incorporated herein by reference. |
| †10.10 | Amendment to the Quanex Corporation 1987 Non-Employee Director Stock Option Plan, dated December 1997, filed as Exhibit 10.13 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.11 | Amendment to the Quanex Corporation 1987 Non-Employee Director Stock Option Plan, dated December 9, 1999, filed as Exhibit 10.14 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.12 | Quanex Corporation 1989 Non-Employee Director Stock Option Plan, as amended, filed as Exhibit 4.4 of the Registrant's Form S-8, Registration No. 33-35128, together with the amendment filed as Exhibit 10.15 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 1995, and incorporated herein by reference. |
| †10.13 | Amendment to the Quanex Corporation 1989 Non-Employee Director Stock Option Plan, dated December 1997, filed as Exhibit 10.16 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.14 | Amendment to the Quanex Corporation 1989 Non-Employee Director Stock Option Plan, dated December 9, 1999, filed as Exhibit 10.17 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.15 | Quanex Corporation Employee Stock Option and Restricted Stock Plan, as amended, filed as Exhibit 10.14 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1994, and incorporated herein by reference. |
| †10.16 | Amendment to the Quanex Corporation Employee Stock Option and Restricted Stock Plan, dated December 1997, filed as Exhibit 10.19 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |

| <u>Exhibit Number</u> | <u>Description of Exhibits</u> |
|---------------------------|---|
| †10.17 | Amendment to the Quanex Corporation Employee Stock Option and Restricted Stock Plan, dated December 9, 1999, filed as Exhibit 10.20 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.18 | Amendment to the Quanex Corporation Employee Stock Option and Restricted Stock Plan, effective July 1, 2000 filed as Exhibit 10.18 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 2000 and incorporated herein by reference. |
| †10.19 | Retirement Agreement dated as of September 1, 1992, between the Registrant and Carl E. Pfeiffer, filed as Exhibit 10.20 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1992, and incorporated herein by reference. |
| †10.20 | Stock Option Agreement dated as of October 1, 1992, between the Registrant and Carl E. Pfeiffer, filed as Exhibit 10.21 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1992, and incorporated herein by reference. |
| †10.21 | Deferred Compensation Agreement dated as of July 31, 1992, between the Registrant and Carl E. Pfeiffer, filed as Exhibit 10.22 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1992, and incorporated herein by reference. |
| †10.22 | Quanex Corporation Non-Employee Director Retirement Plan, filed as Exhibit 10.18 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1994, and incorporated herein by reference. |
| †10.23 | Amendment to Quanex Corporation Non-Employee Director Retirement Plan dated May 25, 1995, filed as Exhibit 10.3 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the fiscal quarter ended January 31, 2000 and incorporated herein by reference. |
| †10.24 | Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, filed as Exhibit 10.19 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1996, and incorporated herein by reference. |
| †10.25 | Amendment to Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, dated December 1997, filed as Exhibit 10.26 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.26 | Amendment to Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, dated December 9, 1999, filed as Exhibit 10.27 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.27 | Amendment to Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, effective February 23, 2000, filed as Exhibit 10.2 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the fiscal quarter ended January 31, 2000 and incorporated herein by reference. |
| †10.28 | Amendment to Quanex Corporation 1996 Employee Stock Option and Restricted Stock Plan, effective July 1, 2000 filed as Exhibit 10.28 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 2000 and incorporated herein by reference. |
| †10.29 | Quanex Corporation Deferred Compensation Trust filed as Exhibit 4.8 of the Registrant's Registration Statement on Form S-3, Registration No. 333-36635, and incorporated herein by reference. |
| †10.30 | Amendment to Quanex Corporation Deferred Compensation Trust, dated December 9, 1999, filed as Exhibit 10.29 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |

| <u>Exhibit Number</u> | <u>Description of Exhibits</u> |
|---------------------------|---|
| †10.31 | Amendment and restatement of the Quanex Corporation Deferred Compensation Plan, effective November 1, 2001 filed as Exhibit 10.5 of the Registrant's Quarterly Report on Form 10-Q dated March 7, 2002, and incorporated herein by reference. |
| †10.32 | Quanex Corporation 1997 Non-Employee Director Stock Option Plan filed as Exhibit 10.21 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1997 and incorporated herein by reference. |
| †10.33 | Amendment to Quanex Corporation 1997 Non-Employee Director Stock Option Plan, dated December 9, 1999, filed as Exhibit 10.31 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference. |
| †10.34 | Quanex Corporation 1997 Key Employee Stock Plan, (formerly known as the Quanex Corporation 1997 Key Employee Stock Option Plan) as amended and restated, dated October 20, 1999, filed as Exhibit 10.1 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725), dated June 11, 2001. |
| †10.35 | Amendment to Quanex Corporation 1997 Key Employee Stock Plan, (formerly known as the Quanex Corporation 1997 Key Employee Stock Option Plan) dated December 9, 1999, filed as Exhibit 10.2 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725), dated June 11, 2001 and incorporated herein by reference. |
| †10.36 | Amendment to Quanex Corporation 1997 Key Employee Stock Plan, (formerly known as the Quanex Corporation 1997 Key Employee Stock Option Plan) effective July 1, 2000, filed as Exhibit 10.3 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725), dated June 11, 2001 and incorporated herein by reference. |
| †10.37 | Amendment to the Quanex Corporation 1997 Key Employee Stock Option Plan effective October 25, 2001, filed as Exhibit 10.36 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 2001 and incorporated herein by reference. |
| †10.38 | Quanex Corporation Long-Term Incentive Plan effective November 1, 2001, filed as Exhibit 10.37 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 2001 and incorporated herein by reference. |
| †10.39 | Letter Agreement between Quanex Corporation and Raymond A. Jean, dated February 14, 2001, filed as Exhibit 10.6 of the Registrant's Quarterly Report on Form 10-Q, dated March 7, 2002 and incorporated herein by reference. |
| *10.40 | First Amendment to Quanex Corporation Hourly Bargaining Unit Savings Plan, dated October 30, 2002, and effective December 12, 1994. |
| 10.41 | Asset Purchase Agreement dated July 31, 1996, among the Company, Piper Impact, Inc., a Delaware corporation, Piper Impact, Inc., a Tennessee corporation, B. F. Sammons and M. W. Robbins, filed as Exhibit 2.1 of the Company's Report on Form 8-K (Reg. No. 001-05725), dated August 9, 1996, and incorporated herein by reference. |
| 10.42 | Stock Purchase Agreement dated April 18, 1997, by and among Niagara Corporation, Niagara Cold Drawn Corp., and Quanex Corporation filed as Exhibit 2.1 to the Company's Current Report on Form 8-K (Reg. No. 001-05725), dated May 5, 1997, and incorporated herein by reference. |
| 10.43 | Purchase Agreement dated December 3, 1997, among Quanex Corporation, Vision Metals Holdings, Inc., and Vision Metals, Inc., filed as Exhibit 2.1 to the Company's Current Report on Form 8-K (Reg. No. 001-05725), dated December 3, 1997, and incorporated herein by reference. |

| <u>Exhibit Number</u> | <u>Description of Exhibits</u> |
|---------------------------|--|
| 10.44 | Acquisition Agreement and Plan of Merger, dated October 23, 2000, between Quanex Corporation (“Company”), Quanex Five, Inc., a Delaware corporation and wholly owned subsidiary of the Company, and Temroc Metals, Inc., a Minnesota corporation, filed as Exhibit 2.1 to the Company’s Report on Form 8-K (Reg. No. 001-05725), dated November 30, 2000, and incorporated herein by reference. |
| 10.45 | First Amendment to Agreement and Plan of Merger dated November 15, 2000 between Quanex Corporation (“Company”), Quanex Five, Inc., a Delaware corporation and wholly owned subsidiary of the Company, and Temroc Metals, Inc., a Minnesota corporation, filed as Exhibit 3.1 to the Company’s Report on Form 8-K (Reg. No. 001-05725), dated November 30, 2000 and incorporated herein by reference. |
| 10.46 | Lease Agreement between The Industrial Development Board of the City of Decatur and Fruehauf Trailer Company dated May 1, 1963, filed as Exhibit 10.22 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.47 | Lease Agreement between The Industrial Development Board of the City of Decatur and Fruehauf Corporation dated May 1, 1964, filed as Exhibit 10.23 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.48 | Lease Agreement between The Industrial Development Board of the City of Decatur and Fruehauf Corporation dated October 1, 1965, filed as Exhibit 10.24 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.49 | Lease Agreement between The Industrial Development Board of the City of Decatur (Alabama) and Fruehauf Corporation dated December 1, 1978, filed as Exhibit 10.25 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.50 | Assignment and Assumption Agreement between Fruehauf Trailer Corporation and Decatur Aluminum Corp. (subsequently renamed Nichols Aluminum–Alabama, Inc.) dated October 9, 1998, filed as Exhibit 10.26 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| 10.51 | Agreement between The Industrial Development Board of the City of Decatur and Decatur Aluminum Corp. (subsequently renamed Nichols Aluminum–Alabama, Inc.) dated September 23, 1998, filed as Exhibit 10.27 of the Registrant’s Annual Report on Form 10-K (Reg. No. 001-05725) for the year ended October 31, 1998 and incorporated herein by reference. |
| *10.52 | Lease Agreement between Cabot Industrial Properties, L.P. and Quanex Corporation dated August 30, 2002. |
| *21 | Subsidiaries of the Registrant. |
| *23 | Consent of Deloitte & Touche LLP. |
| *99.1 | Certification by chief financial officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| *99.2 | Certification by chief executive officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

† Management Compensation or Incentive Plan

* Filed herewith