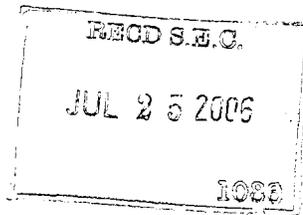


# CHAPARRAL

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FINANCIAL



2006 ANNUAL REPORT

Dear Stockholders:

July 29, 2006 marked the first full year of operation for Chaparral Steel as a stand alone, publicly traded Company. This could not have become a reality had it not been for the hard work and dedication of the 1450 people that make the Company what it is today. I am extremely proud to be associated with such a talented group that make up the "Chaparral Team" and know that we will look back on 2006 as the beginning of a new era.

Fiscal 2006 was a year that can be characterized as one that set many new records. We had record operating profit of \$271.4 million that beat last year's record amount by 62%. Net income of \$157 million beat last year's record by \$79 million. Our Texas and Virginia facilities had a combined record breaking production of almost 2.2 million tons and sales of over 2.3 million tons. We generated over \$197 million in free cash flow and increased the Company's enterprise value from \$769 million to \$2.0 billion at July 10, 2006.

Chaparral common stock also performed well as it increased from \$18.40 per share after the first day of trading and closed at \$73.56 per share on July 10th, just a little less than one year after the spin-off.

Our financial results reflect a combination of factors including: strong domestic and international demand, improvements in the non-residential construction market, consolidation in the steel industry, favorable monetary exchange rates, and most importantly our employees who relentlessly focus every day on doing things right.

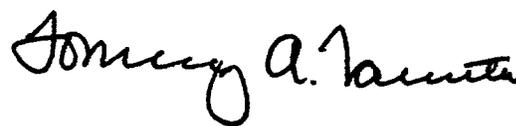
Both of our production facilities improved over the last year. Our Texas plant ran at near full capacity without a major shutdown. I would especially like to recognize the progress made by our Virginia plant during the last year. This facility enjoyed its best production year in its history while expanding our product offering in both wide flange beams and PZC sheet piling. We continue to steadily improve the efficiencies and the production capabilities at both our facilities. We have developed an energy strategy to help reduce the volatility of our energy costs and guarantee supply, even on hot summer days.

Our business strategy remains to focus on our core business and our customers' needs, preserve our low cost position and maintain a strong balance sheet with ample liquidity. Today, we are one of three low-cost producers of wide flange beams in North America. This is a substantial change from the 1980's and 1990's when we competed against less efficient, high-cost producers. This change in the market structure has helped rationalize our markets and provides a driver for continued long-term profitability. We continually work to support our customers and provide them with a broader range of products. It is this attention to detail that helped us achieve a Class 1 rating from Caterpillar Equipment Company, develop our FastFrame™ building design systems, and produce the widest selection of piling products in North America. Our financial position is strong and we look forward to reducing our debt when we can do so on favorable terms.

Our strategic plan is relatively simple – explore opportunities in niche markets to enhance stockholder value. The future for the steel industry is bright. Global demand generated by developing countries throughout the world should continue to drive demand over the next decade and we want to be a part of that growth. We are working hard to find growth opportunities within our current operations and the segments of the steel industry in which we compete, as well as other niche markets that offer an opportunity for growth and a low cost position. However, these types of transactions are a challenge to complete. If we can not find suitable opportunities, we will work to return value to stockholders by debt retirement, dividends and/or share repurchases.

Our foundation is firmly in place for continued strong results. Our organization is comprised of committed, talented people in production, sales, engineering, logistics and administration functions. The market place for our products is vibrant, both domestically and internationally. Our financial flexibility and strength provides us a platform to make the substantial investments in our business necessary to sustain Chaparral's leadership position.

We are optimistic about our future and our abilities to meet whatever challenges lie ahead. Thank you for your support.



**Tommy A. Valenta**  
President and CEO

**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 May 31, 2006

or

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

For the transition period from

to

Commission File Number 000-51307

**CHAPARRAL STEEL COMPANY**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction  
of incorporation or organization)

300 Ward Road Midlothian, Texas  
(Address of principal executive offices)

(972) 775-8241

(Registrant's telephone number, including area code)

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

NONE

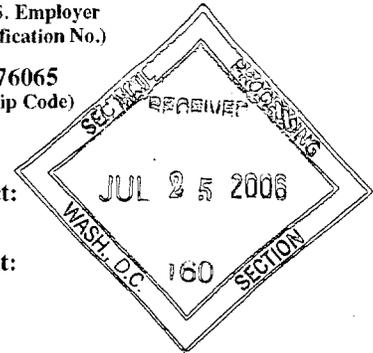
Securities registered pursuant to Section 12(g) of the Act:

Title of Class

Common Stock, Par Value \$0.01 Per Share

20-2373478  
(I.R.S. Employer  
Identification No.)

76065  
(Zip Code)



Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes  No

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.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates as of November 30, 2005 (computed by reference to the price at which the common equity was last sold on such date as reported by the Nasdaq Global Select Market) was \$527,755,375.

There were 23,106,857 shares of common stock, \$0.01 par value per share, outstanding on July 3, 2006.

**DOCUMENTS INCORPORATED BY REFERENCE:**

Portions of the registrant's proxy statement to be filed within 120 days of the close of the registrant's fiscal year in connection with the registrant's Annual Meeting of Stockholders to be held August 29, 2006, are incorporated by reference into Part III.

For purposes of this Annual Report, references to the "Company," "we," "us," "our" and "Chaparral" mean Chaparral Steel Company collectively with all of our subsidiaries.

### FORWARD-LOOKING STATEMENTS

This Annual Report contains "forward-looking statements". All statements other than statements of historical fact are "forward-looking statements." Forward-looking statements may include the words "may," "will," "estimate," "intend," "continue," "believe," "expect," "plan," or "anticipate" and other similar words. Such forward-looking statements may be contained in the sections "Business," "Industry Overview," "Our Business," "Risk Factors," and "Management's Discussion and Analysis of Financial Condition and Results of Operations," among other places. Forward-looking statements include statements concerning:

- future results of operations;
- future cash flows and liquidity;
- future capital expenditures;
- competitive pressures and general economic and financial conditions;
- levels of construction activity;
- levels of import activity;
- inclement weather;
- the occurrence of unanticipated equipment failures and plant outages;
- cost and availability of raw materials, fuel and energy;
- environmental conditions and regulations; and
- any assumptions underlying any of the foregoing.

Although we believe the expectations reflected in our forward-looking statements are reasonable, actual results could differ materially from those projected or assumed in our forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to change and are subject to inherent risks and uncertainties, such as those disclosed in this Annual Report. Each forward-looking statement speaks only as of the date of the particular statement. We urge you to review carefully "Item 1A. Risk Factors" in this Annual Report for a more complete discussion of the risks of owning our common stock.

# CHAPARRAL STEEL COMPANY

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## PART I

### ITEM 1. BUSINESS.

#### INDUSTRY OVERVIEW

*The following discussion is intended to provide background information concerning the industry in which we operate. Please note, however, that industry trends or other factors discussed below may not affect our business in the same manner or to the same degree as the industry generally. Some of the information included in the following discussion is based on predictions and projections. These predictions and projections are subject to inherent uncertainties. Consequently, actual results may differ materially from those expressed in or implied by these predictions and projections. See "Forward-Looking Statements". For specific information about our business and operating results, see "Business" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the other information contained in this Annual Report.*

The steel industry is generally composed of two major types of producers: integrated mills and mini-mills. Integrated mills, which use blast furnaces to make molten steel from iron ore and coke, are more energy and capital-intensive than mini-mills, which melt recycled steel scrap with electric arc furnaces. As a group, mini-mills are generally characterized by a lower cost of production and higher productivity than integrated mills. Moreover, mini-mills have tended to employ a management culture that emphasizes flexible, incentive-oriented non-union labor practices designed to encourage productivity and efficiency. The smaller plant size of a mini-mill also permits greater flexibility in the choice of location for the mini-mill to optimize scrap supply, energy costs, infrastructure and distribution. As mini-mill production technologies have evolved, mini-mill producers have displaced integrated producers as manufacturers of numerous steel products. Today the primary producers of structural steel and steel bar products in the United States utilize the mini-mill process.

The market for structural steel, our primary steel product, is a niche market in the U.S. steel industry, with supply totaling approximately 8.7 million tons in 2005, or approximately 6.8% of total U.S. steel supply. Structural steel products include wide flange beams, standard beams, channels and other shapes that are primarily used in commercial, retail, industrial, institutional and warehouse construction. Additional markets for these products include manufactured housing and public works.

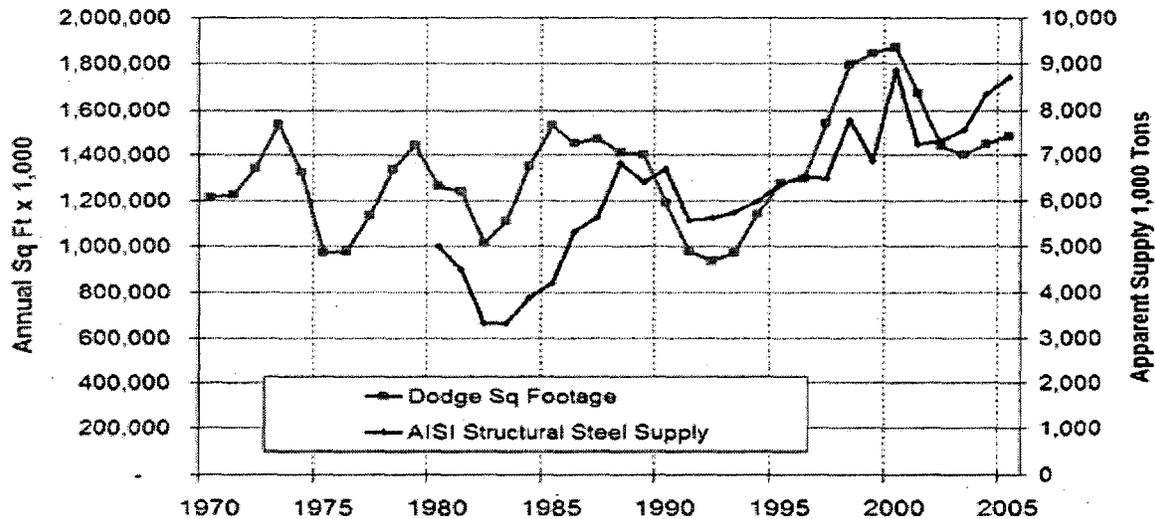
The U.S. steel industry, including the market for structural steel products, is currently experiencing a period of strong profitability due in part to the following factors:

- higher global levels of demand for steel driven by increased economic activity;
- recent consolidation trends in the industry;
- the weakness of the U.S. dollar relative to other major currencies; and
- higher maritime transportation costs.

These factors have contributed to strong steel prices and profitability for U.S. producers as increases in pricing have outpaced increases in raw materials costs. The improving U.S. economy has contributed to higher global demand for steel products. Further recovery in domestic non-residential construction will strengthen demand. Competition from foreign producers has historically been strong, but imports of structural products have declined from their high levels due to the factors previously noted.

The following chart highlights the cyclical nature of the non-residential construction industry and the correlation between the usage of structural steel and non-residential construction activity.

**Dodge Sq Ft of Non Residential Construction Starts  
and Structural Steel Supply, 1970 to 2005**



Source: FW Dodge for non-residential construction; AISA for U.S. structural steel.

Steel bar products consist of specialty bar products and reinforcing bar, a commodity product. In calendar 2005, the hot-rolled bar (including specialty bar) and reinforcing bar markets in the United States were approximately 9.9 million and 8.9 million tons, respectively. Specialty bar products include merchant bar quality products and special bar quality products or engineering steels that are used in applications where the service conditions or component design requirements are exacting. Such applications include oil country goods, automotive and defense components, off-highway equipment, industrial hardware and tools. Because higher quality specifications are required to make these products, fewer bar producers compete for this market. Reinforcing bar is used in concrete structures to increase tensile strength. It is relatively easy to make and is therefore made by a large number of producers, resulting in a regional market for this product.

## OUR BUSINESS

We were incorporated in Delaware on February 22, 2005, as a wholly-owned subsidiary of Texas Industries, Inc. ("TXI") to serve as the holding company for its steel business in anticipation of our spin-off. On July 29, 2005, the spin-off was completed and we became an independent, public company. We are the second largest producer of structural steel products in North America, based on tons shipped in the 2005 calendar year. We are also a major producer of steel bar products. We operate two mini-mill plants located in Midlothian, Texas and Dinwiddie County, Virginia that together have an annual production capacity of approximately 2.6 million tons of steel. We began operations in our Texas plant in July 1973 as a mini-mill producer of steel bar products with an annual capacity of 0.25 million tons and have since grown through internal expansion. In 1999, we completed construction of our modern structural steel plant in Virginia, which nearly doubled our structural steel capacity and expanded our product line.

We utilize mini-mill technology, whereby recycled scrap steel is melted in electric arc furnaces, and continuous casting systems form the molten steel into a broad range of products. For the year ended May 31, 2006 we shipped 2.3 million tons of finished product and generated sales of \$1.5 billion. For the year ended

May 31, 2005 we shipped 1.8 million tons of finished product and generated sales of \$1.1 billion. Recent profitability has been high despite low levels of non-residential construction, the primary driver of demand for our products. We believe non-residential construction will continue to recover resulting in increased production and sales.

Through our plant expansions and product innovation, we have significantly expanded and diversified our product mix. We currently manufacture over 230 different types, sizes and grades of structural steel and steel bar products. Our structural steel products include wide flange beams, channels, piling products and other shapes, and our steel bar products include specialty bar products and, to a lesser extent, reinforcing bar. The following table summarizes our net sales by product line.

	Year Ended May 31,		
	2006	2005	2004
	(in thousands)		
Net sales			
Structural mills .....	\$1,103,075	\$ 790,789	\$643,043
Bar mill .....	239,886	238,934	177,967
Other products .....	41,871	32,254	27,076
Delivery fees .....	81,897	54,399	57,238
	<u>\$1,466,729</u>	<u>\$1,116,376</u>	<u>\$905,324</u>

We market our products throughout the United States, Canada and Mexico, and to a limited extent in Europe. We sell to steel service centers and steel fabricators for use in the construction industry, as well as to cold finishers, forgers and original equipment manufacturers for use in the railroad, defense, automotive, manufactured housing and energy industries.

### Our Strengths

*Low Cost Producer and Supplier.* The following factors enable us to be a low-cost producer and supplier of steel products:

- *Modern Plants with Low Ongoing Capital Requirements.* We believe our steel plants are among the most modern and efficient in the industry. Our electric arc furnaces are periodically upgraded and maintained to yield high levels of efficiency. In addition, the employment of continuous casting and automated rolling mill technology gives our plants a strong competitive position. Both of our plants utilize our patented near net shape casting technology that was developed by our employees. Our Virginia plant utilizes a vertical shaft electric arc furnace that enables us to pre-heat our recycled steel scrap prior to melting, thus significantly reducing our energy costs. By using the latest technology available, the shaft furnace is among the most energy efficient in the world. Because our plants are modern and efficient, we expect the capital requirements of our plants for the foreseeable future to be low.
- *On-Site Shredder Operations.* The most significant component of our operating costs is scrap steel. Shredded steel represents approximately 40% of the raw material mix that is melted in electric-arc furnaces. We believe we are one of the only domestic structural steel producers with on-site scrap shredders at our plants. Our Texas plant benefits from the operation of our steel shredder, which currently supplies a major portion of the plant's shredded steel requirements. We have outsourced the operation of our shredder at our Virginia plant to a third party, the operation of which began in the fourth quarter of fiscal year 2005. The shredders enable us to purchase lower cost, readily available, unprocessed recycled steel scrap rather than high cost, preprocessed recycled steel scrap. We believe this flexibility in acquiring a range of scrap types leads to a lower overall cost of scrap.
- *Efficient, Non-Union Workforce.* Our flexible, non-union workforce allows us to maintain high levels of labor efficiency without incurring material post-retirement employee liabilities. All of our employees

participate in incentive compensation plans that award compensation for meeting and exceeding selected operational goals. We believe our competitive compensation and benefit packages as well as our organizational structure and employee practices enable us to attract and retain highly talented, motivated and productive employees who are committed to making us a leader in the steel industry.

- *Commitment to Innovation.* We pride ourselves on being at the technical forefront of the steel industry. In 1982, we were one of the first companies to build and operate a structural steel mini-mill, and in 1991 we implemented our patented near net shape casting technology for structural steel. In addition, we have patented a number of recycling related processes. In our Texas plant, we license a patented process that we call STAR. The patented process separates the waste material from our shredding operations into distinct products such as aluminum, copper and coins, which are then sold. This further reduction in the net cost of scrap improves our competitive cost position.

*Strategic Geographic Locations.* Our facilities are near sources of scrap materials and a large portion of our customer base. This allows us to realize freight savings for inbound scrap as well as for outbound steel products destined for our customers. Our Virginia plant is the closest structural steel plant to the northeastern region of United States, which is the highest consuming region of structural products in North America. Our Texas mill is located in a region that generates an abundance of scrap, which we believe provides us with a competitive advantage as one of the largest consumers of scrap in the region.

*Diversified Product Mix and End-User Markets.* Our products include over 230 different types, sizes and grades of structural steel and steel bar products. Our structural steel products include wide flange beams, channels, piling products and other shapes and our steel bar products include specialty bar products and, to a lesser extent, reinforcing bar. Our steel products are sold to steel service centers and steel fabricators for use in the construction industry, the public works sector and to cold finishers, forgers and original equipment manufacturers for use in the railroad, defense, automotive, manufactured housing and energy industries. We believe this diversified mix of products enables us to access a broad range of end-user markets, serve a broad customer base and reduce our exposure to cyclical downturns. With our commitment to innovation, we are continuously working to develop more steel products for our customers. For example, we have developed the capacity to make piling products for retaining wall applications used primarily in the public works sectors. Our Virginia plant provides the capability to produce Z sheet piling products, which are high margin steel products used primarily in retaining wall applications. Demand for Z sheet piling is driven primarily by public works instead of non-residential construction, and has historically been met by imports. We believe our Virginia plant is one of only four steel mills in the world that produce hot rolled Z sheet piling.

*Long-Standing, Diverse Customer Relationships.* We have established a solid base of long-standing relationships with a highly diversified customer base. No single customer represented more than 10% of our revenues in fiscal year 2006. We believe our long-standing relationships help to provide additional stability to our operating performance and make us a preferred supplier. We are committed to meeting customer requirements. We strive to maintain modern equipment at our facilities and to adopt new and innovative production technologies, all with the objective of meeting our customers' needs.

*Strong Management Team and Entrepreneurial Corporate Culture.* Over the last several years, the structural steel niche of the U.S. steel industry has endured periods of intense competition from domestic and foreign producers. During this time, the steel industry has undergone significant consolidation. The industry has operated in an environment that rewarded efficient, innovative operations and strong management. We believe our industry position demonstrates the strength and vision of our management team. We also believe our corporate culture and operating philosophy creates an environment that drives our innovation and brings an entrepreneurial spirit to us. Empowerment is a core concept of our management model. We empower our employees to make the decisions necessary to efficiently run their operations and to meet our corporate mission. Management's responsibility is to provide our employees with the tools and resources to make these decisions.

## **Our Strategy**

*Maintain Our Low Cost Profile.* We are focused on continuing to maintain one of the lowest operating cost structures in the steel segments we serve. We will continue to optimize the use of our equipment, enhance our productivity, apply new technologies and encourage our employees to further reduce our cost of production.

*Expand Our Product Offerings.* We intend to build on our low cost profile, our customer focus and our innovative culture to develop new and expand existing product lines. We produce commercial quantities of piling products desired by the public works sector, and we believe we are now the only steel company in North America that has developed this capability and is making a wide range of preferred piling products. Our range of structural products has expanded from light and small beams that addressed less than 22% of the market in 1982 to today's offering that covers almost the entire product range needed for non-residential construction. The commodity bar products we produced when we started making steel over thirty years ago are a very small part of our current product offerings. Today our bar products principally address high value added niche markets and we are building on expanded capabilities in our bar mill to meet growing customer needs and requirements. Entering and expanding our product offering in the specialty bar market has further separated us from the commodity markets.

*Provide Superior Customer Service.* We work to understand our customers to provide them with value-added solutions. We extend our focus to users of our products throughout the distribution channel. This includes owners, developers, engineers and architects as well as service center operators and fabricators. As an example, our Fast-Frame process is designed to reduce the construction period for building projects, thereby accelerating revenue generation to developers and reducing their cost of capital for the project.

*Maintain Strong Financial Position and Financial Flexibility.* We believe our capital structure provides us a conservative financial profile and flexibility. Our strong balance sheet allows us to be opportunistic regarding strategic investments, to build strong relationships with our customers and suppliers and to recruit and retain the best employees.

*Selectively Pursue Additional Growth through a Disciplined Approach to Acquisitions.* We are focused on enhancing our product offerings and strengthening our market position to continue to improve our competitive position. We believe we have opportunities for future growth through internal product expansions and selective acquisitions. We intend to pursue opportunities to grow our business that we believe will add value and meet our return requirements.

## **Our Plants and Products**

Our steel plants, located in Midlothian, Texas and Dinwiddie County, Virginia, produce a broader array of steel products than a traditional mini-mill. We use our patented near net shape casting technology at both facilities. This process involves casting molten steel into a shape that is closer to a product's final shape than traditional casting methods. This technology provides energy and capital cost savings in the making of wide flange beams and other structural steel products. The Texas plant has two electric arc furnaces with three continuous casters that feed semi-finished billets to a bar mill, a medium structural mill and a large structural mill. Finished (rolled) products produced include standard beams up to twenty-four inches wide, merchant bar quality rounds, special bar quality rounds, reinforcing bar, H-piling, flat sheet piling and channels. The Virginia plant has one electric arc furnace and in-line processing units consisting of two near-net shape casters and a sophisticated rolling mill. Finished products include standard beams up to thirty-six inches wide, sheet piling and H-piling.

The annual capacities of the plants are as follows:

<u>Location</u>	<u>Annual Productive Capacity (Tons)</u>	<u>Approximate Plant Square Footage</u>
Texas:		
Melting .....	1,800,000	275,000
Rolling .....	1,600,000	615,000
Virginia:		
Melting .....	1,300,000	220,000
Rolling .....	1,000,000	460,000

The bar and structural mills produced approximately 2.2 million tons of finished products in the fiscal year ended May 31, 2006, 1.9 million tons in fiscal year 2005 and 2.1 million tons in fiscal year 2004.

### **Sales and Marketing**

Our sales organization markets our steel products throughout the United States, Canada and Mexico, and to a limited extent in Europe. Foreign sales, including Canada and Mexico, represented 11.4%, 12.7%, and 11.7% of our total sales for fiscal years 2006, 2005 and 2004, respectively, and no individual country represented more than 10% of total sales during any such period.

To serve our customer base, we have a dedicated sales force of 34 employees, who are principally aligned along product lines. Management directs our overall sales strategy, which our sales group implements. Orders are generally filled the next day and are cancelable. Delivery of finished products is accomplished by common carrier, customer-owned trucks, rail, overseas container or barge.

### **Customers**

We sell our products to a highly diversified customer base representing various steel consuming markets. Our customers are primarily in the Southwest and the eastern seaboard of the United States. No single customer represented more than 10% of our total consolidated revenues in fiscal year 2006.

A significant portion of our sales are to steel service centers, fabricators and processors. These customers typically act as intermediaries between steel producers and various end-user manufacturers that require further processing or inventory programs. The additional services performed by steel service centers and processors include cutting to length, providing camber, drilling holes, splitting the product, and minimizing load size. We also sell to cold finishers, forgers and original equipment manufacturers for use in the railroad, defense, automotive, manufactured housing and energy industries. Our special bar quality customers transform our hot-rolled steel bars into a variety of demanding end-use components through processes such as forging, cold-finishing, machining and heat treating. We do not place heavy reliance on franchises, licenses or concessions.

### **Raw Materials and Energy**

Our business depends on continued access to reliable supplies of various raw materials, principally steel scrap, energy and industrial gases. We believe there will be adequate sources of our principal raw materials to meet our near term needs, although probably at higher prices than has historically been the case.

Our principal raw material is recycled steel scrap. Shredded steel represents approximately 40% of our raw material mix. A major portion of the shredded steel requirements of our Texas plant is produced by an on-site shredder operation utilizing primarily crushed auto bodies purchased on the open market. We have historically purchased shredded steel on the open market to meet all requirements for our Virginia facility. Our Virginia shredder, which is operated by a third party, began to generate scrap in the fourth quarter of fiscal 2005. Another

grade of recycled steel scrap, Heavy Melt, represents approximately 40% of our raw material mix. We also purchase Heavy Melt on the open market. The purchase price of recycled steel scrap is subject to market forces largely beyond our control. We expect scrap to continue to be in sufficient supply to satisfy our needs. We have no long-term scrap contracts and all purchases are in the form of short-term open market transactions.

Steel mini-mills consume large amounts of electricity and natural gas. The electric industry has been deregulated in Texas since January 2002. The Texas plant purchases electricity through a local retail electric provider using various long and short term supply arrangements. We have entered into agreements to purchase minimum amounts of electricity and natural gas for our Texas facility. As of May 31, 2006, our commitments under these agreements extend through October 2006 which will allow our production facility to operate without the threat of interruption caused by volatile energy prices during the summer months and the majority of the Gulf Coast hurricane season. The Commonwealth of Virginia is in transition to a deregulated market for electricity. Electricity for the Virginia plant is purchased through the local utility under an interruptible supply contract with periodic adjustments for fuel costs. Natural gas is purchased from local gas marketers and delivered to our plants through local transportation agreements. Historically, we have not used financial instruments to mitigate price fluctuations on such purchases, however we may use such financial instruments when appropriate. We believe adequate supplies of electricity and natural gas are readily available, although some fluctuations in supply and cost will occur.

### **Competition**

All of the markets in which we participate are highly competitive. We compete on the basis of price, quality and the ability to meet our customers' product needs and delivery schedules.

We compete with domestic and international producers of steel products. Our principal domestic competitors in structural products are Nucor Corporation and Steel Dynamics, Inc. Other domestic competitors include Gerdau AmeriSteel Corporation, Commercial Metals Company and Bayou Steel Corporation. Our domestic competitors in bar products include Nucor Corporation, Quanex—MACSTEEL and Republic Engineered Products LLC. Depending on economic conditions, from time to time international producers have entered our markets by offering steel delivered to port cities. These international producers include Arcelor, Corus, Gerdau, Mittal, Nizhny Tagil, INI Steel, Wuhan Iron and Steel, Dragon Steel, Hiveld, Salzgitter and Iscor. Certain of the foreign and domestic competitors, including both large integrated steel producers and mini-mills, have substantially greater assets and larger sales organizations than ours.

The steel industry is highly cyclical and subject to significant fluctuations in demand as a result of macroeconomic changes in global economies, including those resulting from currency volatility. The global steel industry has historically been characterized by overcapacity, which has at times resulted in downward pressure on steel prices and gross margins. On occasion, steel imports into the United States have decreased our prices and negatively affected our operating results.

### **Employees**

At July 1, 2006, we had approximately 1,450 employees, none of whom are represented by unions.

### **Research and Development**

In the course of our operations we continually work to enhance our production processes and develop new or improved products. We have been successful in producing our patented PZC piling, a new type of Z piling which we achieved through the use of research and development technologies such as computer modeling and trial rollings of metallic lead bars on a scaled down research rolling mill. Our new PZC piling features a ball-in-socket interlock connection that we believe is superior to connectors used in much of the world.

## **Intellectual Property**

We own a number of U.S. patents relating to a wide variety of products and processes and are licensed under a number of patents. However, we believe no single patent or license, or group of patents or licenses, is of material importance to our overall business. We also own registered trademarks for certain of our products and service marks for certain of our services, which, unlike patents and licenses, are renewable so long as they are continued in use and properly protected.

## **Seasonality**

While there is generally no seasonality in demand for our products, production at the mills is shutdown periodically for up to two weeks to conduct comprehensive maintenance and to install capital improvements. Normal maintenance is performed throughout the year.

## **Environmental**

We are subject to federal, state and local environmental, health and safety laws and regulations including the Resource Conservation and Recovery Act ("RCRA"), the Clean Air Act, and the Clean Water Act. These laws and regulations address, among other matters, electric arc furnace dust disposal, air emissions and storm water discharge. We believe we are in substantial compliance with applicable environmental laws and regulations; however, from time to time we receive claims from federal, state and local regulatory agencies and entities, as well as from private parties, asserting that we are or may be in violation of certain of these laws and regulations. Based on our experience in dealing with such claims in the past and the information currently available to us regarding any potential or outstanding claims, we believe that such claims will not have a material impact on our financial condition or results of operations. Despite our compliance and experience, it is possible we could be held liable for future charges that might be material but are not currently known or estimable. In addition, changes in applicable laws, regulations or requirements or discovery of currently unknown conditions could require us to make additional expenditures, interrupt production or hinder our ability to build new or expand production facilities. See "Risk Factors—Risks Related to Our Company" for more detail.

Under RCRA, CERCLA (Comprehensive Environmental Response, Compensation, and Liability Act), and similar state programs, the owners of certain facilities that manage hazardous wastes are required to investigate and, if appropriate, remediate historic environmental contamination. All of our facilities are or may be subject to a corrective action program or other laws and regulations relating to environmental remediation, including projects relating to the reclamation of industrial properties.

The U.S. Environmental Protection Agency (the "EPA") is expected to propose regulations under the Clean Air Act in the near future aimed at reducing emissions of certain metals and volatile organic compounds into the air. In addition, laws have been passed in Texas, Virginia and other states that will reduce the amount of mercury in the scrap metal we recycle and thus the amount of mercury emitted from our plants. Additionally, the steel industry, automobile industry, automobile dismantlers, scrap metal recycling industry, states, and environmental groups are participating in an EPA-sponsored initiative to develop a nationwide, voluntary program to reduce the amount of mercury in scrap metal destined for recycling. We expect to participate in this program by contributing to an implementation fund and by developing and implementing company-specific means to strongly encourage our suppliers and others in the supply chain to participate in this voluntary program.

The implementation of the Clean Air Act may cause additional environmental requirements, such as additional requirements resulting from revisions to national ambient air quality standards and designation of new nonattainment areas. These additional requirements may have significant impacts on us in the future, although whether and how they will affect us may not be determined for many years. We also may be affected if federal, state or local governments begin to regulate emissions of greenhouse gases such as carbon dioxide. We cannot predict what requirements might be imposed on our operations or the timing of such requirements. Consequently, we are not able to evaluate the cost of future Clean Air Act requirements.

Our facilities also are subject to a variety of permitting requirements under the Clean Water Act, which restricts the type and amount of pollutants that may be discharged from regulated sources into receiving bodies of waters, such as rivers, lakes and oceans. Our facilities are designed to operate without discharging process wastewater. Our facilities are subject to, and in compliance with, storm water discharge permits issued under an EPA program that has been delegated to the states.

In addition to the above matters, we may receive notices of violation relating to minor environmental matters from time to time in the ordinary course of business. We do not expect any material fines or penalties to arise from these items and none of these involve potential individual monetary sanctions in excess of \$100,000.

We intend to comply with all legal requirements regarding the environmental, health and safety matters, but since many of these requirements are subjective and therefore not quantifiable, are presently not determinable, or are likely to be affected by future legislation or rule making by government agencies, it is not possible to accurately predict the aggregate future costs of compliance and their effect on our operations, future net income or financial condition. Notwithstanding our intentions to comply with all legal requirements, if injury to persons or damage to property or contamination of the environment has been or is caused by the conduct of our business or hazardous substances or wastes used in, generated or disposed of by us, we may be liable for such injuries and damages, and be required to pay the cost of investigation and remediation of such contaminations. The amount of such liability could be material and we may incur material liability in connection with possible claims related to our operations and properties under environmental, health and safety laws.

#### **Principal Executive Offices and Additional Information**

Our principal executive offices are located at 300 Ward Road, Midlothian, Texas 76065. Our telephone number is (972) 775-8241 and our website is [www.chapusa.com](http://www.chapusa.com). We do not intend for information contained on our website to be part of this Annual Report. Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished to the Securities and Exchange Commission (the "SEC") pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 are available, free of charge, on the Investor Relations web page of our website under the caption "SEC Filings" promptly after we electronically file such materials with, or furnish such materials to, the Securities and Exchange Commission. Information relating to our corporate governance including our Corporate Governance Guidelines and Bylaws, our Ethical Business Conduct Policy for all directors, officers, and employees, our Code of Ethics for CEO and Senior Financial Officers, and information concerning our directors, Committees of the Board, including Committee charters, and transactions in our securities by directors and executive officers, is available at our website under the captions "Corporate Governance" and "SEC Filings". Paper copies of these filings and corporate governance documents are available to stockholders without charge by written request to Investor Relations, 300 Ward Road, Midlothian, Texas 76065. All materials that we file with the SEC are available at the SEC's Public Reference Room, 100 F Street, NW, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. All materials that we file with the SEC are also available at the website maintained by the SEC, <http://www.sec.gov>.

## RECENT DEVELOPMENTS

We were incorporated in Delaware on February 22, 2005, as a wholly-owned subsidiary of TXI to serve as the holding company for its steel business in anticipation of our spin-off. In anticipation of the spin-off, we and TXI engaged in the transactions described below.

On June 25, 2005, TXI transferred all of the stock of its subsidiaries that were engaged in its steel business to us. These transactions were accounted for as a reorganization of entities under common control. As a result, the assets and liabilities transferred to us were recorded at historical cost. On July 6, 2005, TXI also contributed or transferred to us the real estate and transportation assets used in its steel business. We have assumed all liabilities arising out of the steel business and the transferred assets.

On June 16, 2005, we entered into a senior secured revolving credit facility (the "Credit Facility") which provides up to \$150 million of available borrowings. On July 6, 2005, we borrowed \$50 million under the Credit Facility. In addition, on July 6, 2005, we issued \$300 million aggregate principal amount of 10% senior notes (the "Senior Notes") due July 15, 2013. We used the net proceeds from the Credit Facility and Senior Notes to pay a cash dividend of \$341.1 million to TXI on July 6, 2005.

On July 29, 2005, the spin-off was completed and we became an independent, public company.

TXI has no further ownership interest in us, and we have no ownership interest in TXI. In addition, we are not guarantors of any of TXI's indebtedness nor is TXI a guarantor of any of our indebtedness. Our relationship with TXI is now governed by the terms of our separation and distribution agreement and the ancillary agreements described in that agreement. Among other things, the separation and distribution agreement provides that we and TXI will indemnify each other against certain liabilities.

### ITEM 1A. RISK FACTORS

*You should carefully consider the risks described below and all the other information contained in this Annual Report in evaluating us and our common stock. Any of the following risks, as well as additional risks and uncertainties not currently known to us or that we currently deem immaterial, could materially and adversely affect our business and operations. This Annual Report also contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including the risks faced by us described below or elsewhere in this Annual Report.*

#### **Risks Related to Our Spin-Off from TXI**

*We have a limited history operating as an independent public company upon which you can evaluate us.*

We previously operated as wholly-owned subsidiaries of TXI since December 1997. As an independent public company following the spin-off, our ability to satisfy our obligations and maintain profitability is solely dependent on the future performance of the businesses we own and operate, and we will not be able to rely upon the capital resources and cash flows of those business lines remaining with TXI. In addition, our historical financial statements reflect the allocation to us of a portion of TXI's cost for certain corporate functions, but they do not reflect the costs of being an independent public company.

TXI no longer has an obligation to perform any corporate or public company functions for us. We have created our own, or engaged third parties to provide, corporate and public company functions to replace those previously performed by TXI. We may incur costs for these functions that are higher than the amounts reflected in our historical financial statements.

***As a stand-alone company following the spin-off, our results may be different from those indicated by our historical financial statements.***

The historical financial information we have included in this Annual Report may not reflect what our results of operations, financial position and cash flows would have been had we been an independent company during the periods presented or what our results of operations, financial position and cash flows will be in the future, for the following reasons:

- while our historical results of operations include all costs of our steel business, our historical costs and expenses are not necessarily indicative of the costs that would have been or will be incurred by us as an independent public company;
- we have not made adjustments to our historical financial information to reflect changes that have occurred in our cost structure, financing and operations as a result of our spin-off from TXI; and
- our historical effective tax rate may not be indicative of our future effective tax rate due to changes in tax laws and the mix of our earnings in the various states where we operate.

Therefore, our historical financial statements may not be indicative of our future performance as an independent company.

***The spin-off could result in significant tax liability.***

The distribution of our common stock was conditioned upon TXI's receipt of an opinion from Thompson & Knight LLP to the effect that, among other things, the distribution would qualify as a tax-free spin-off under section 355 of the Internal Revenue Code of 1986, as amended (the "Code"), to TXI and its stockholders for U.S. federal income tax purposes. The opinion was based upon various factual representations and assumptions, as well as upon certain undertakings. We are not aware of any facts or circumstances that would cause the representations and assumptions to be untrue or incomplete in any material respect. If, however, any of those factual representations or assumptions were untrue or incomplete in any material respect, any undertaking was not complied with, or the facts upon which the opinion was based were materially different from the facts at the time of the distribution, the distribution may not qualify for tax-free treatment.

Under current Internal Revenue Service policy, advance rulings will not be issued for certain significant aspects of spin-off transactions. Therefore, TXI did not apply for an advance ruling from the IRS with respect to the U.S. federal income tax consequences of the distribution. Opinions of counsel are not binding on the courts or the IRS, and the conclusions expressed in the opinion delivered to TXI could be challenged by the Internal Revenue Service (the "IRS").

If the spin-off fails to qualify for tax-free treatment for U.S. federal income tax purposes, then, in general, TXI would be subject to tax as if it had sold our common stock in a taxable sale for its fair market value. TXI's stockholders would be treated as if they had received a taxable dividend equal to the fair market value of our common stock that was distributed to them, taxed as a dividend (without reduction for any portion of a TXI stockholder's basis in its shares of TXI common stock) for U.S. federal income tax purposes and possibly for purposes of state and local tax law, to the extent of a TXI stockholder's pro rata share of TXI's current and accumulated earnings and profits (including any taxable gain of TXI with respect to the spin-off). It is expected the amount of any such taxes to TXI's stockholders and TXI would be substantial. Although the taxes described above generally would be imposed on TXI and its stockholders, we would, in certain circumstances, be liable for all or a portion of such taxes.

***Our ability to engage in acquisitions and other strategic transactions is subject to limitations because we agreed to certain restrictions to comply with United States federal income tax requirements for a tax-free spin-off.***

Current U.S. tax law which applies to spin-offs generally creates a presumption that the spin-off would be taxable to TXI but not to its stockholders if we engage in, or enter into an agreement to engage in, a transaction (or series of transactions) that would result in a 50% or greater change by vote or by value in our stock ownership

during the four-year period beginning on the date that begins two years before the distribution date, unless it is established that the transaction (or a series of transactions) is not pursuant to a plan related to the spin-off. United States Treasury regulations generally provide that whether an acquisition transaction and a spin-off transaction are part of a plan is determined based on all of the facts and circumstances, including specific factors listed in the regulations. In addition, the regulations provide certain "safe harbors" for acquisition transactions that are not considered to be part of a plan.

There are other restrictions imposed on us under current U.S. federal income tax laws for spin-offs and with which we will need to comply to preserve the favorable tax treatment of the distribution, such as continuing to own and manage our steel business and limitations on sales or redemptions of our common stock for cash or other property following the distribution.

In connection with the spin-off, we entered into a tax sharing and indemnification agreement with TXI. In the tax sharing and indemnification agreement, we agreed that, among other things, we will not take any actions that would result in any tax being imposed on the spin-off. Further, we may not repurchase any of our stock for two years following the spin-off except in certain circumstances permitted by the IRS guidelines. We may, however, take certain actions prohibited by the tax sharing and indemnification agreement if we provide TXI with an unqualified opinion of tax counsel or a private letter ruling from the IRS, acceptable to TXI, to the effect that these actions will not affect the tax-free nature of the spin-off. These restrictions could substantially limit our strategic and operational flexibility, including our ability to finance our operations by issuing equity securities, make acquisitions using equity securities, repurchase our equity securities, raise money by selling assets or enter into business combination transactions.

*We may be required to satisfy certain indemnification obligations to TXI or may not be able to collect on indemnification rights from TXI.*

In the tax sharing and indemnification agreement, we agreed to indemnify TXI and its subsidiaries for any loss, including any adjustment to taxes of TXI, resulting from (1) any action or failure to act by us or any of our subsidiaries following the completion of the spin-off that would be inconsistent with or prohibit the spin-off from qualifying as a tax-free transaction to TXI under section 355 of the Code, (2) certain acquisitions of our equity securities or assets or those of certain of our subsidiaries, and (3) any breach of any representation or covenant given by us or our subsidiaries in the separation documents or in connection with the tax opinion delivered to TXI by Thompson & Knight LLP. Our indemnification obligations to TXI and its subsidiaries are not limited in amount or subject to any cap.

Under the terms of the separation and distribution agreement, we and TXI each have agreed to indemnify each other after the spin-off with respect to the indebtedness, liabilities and obligations that will be retained by our respective companies. These indemnification obligations could be significant.

The ability to satisfy these indemnities if called upon to do so will depend upon our future strength and the future financial strength of each of our companies. We cannot determine whether we will have to indemnify TXI for any substantial obligations. We also cannot be assured that, if TXI has to indemnify us for any substantial obligations, TXI will have the ability to satisfy those obligations to us. If we are required to indemnify TXI and its subsidiaries, officers and directors for any obligations under the circumstances set forth above, we may be subject to substantial liabilities that could exceed our net equity value at that time.

### **Risks Related to Our Company**

*We face significant competition, and some of our competitors have resources in excess of our available resources and less financial leverage than we do.*

We compete with domestic and international producers of steel products. Competition within the steel industry, both domestically and worldwide, is intense and is expected to remain so. We compete on the basis of price, quality and the ability to meet our customers' product needs and delivery schedules. The highly competitive nature of the steel industry has at times exerted downward pressure on prices.

Due to the high fixed cost nature of our business, our operating results may be significantly affected by relatively small changes in production volumes. In addition, some of our competitors are larger, have greater financial resources and may have less financial leverage or lower cost structures than we do. As a result, these competitors may cope better with downward pricing pressure and adverse economic or industry conditions than we would. See “Business—Competition”.

***The availability and pricing of raw materials and energy could lower our results of operations and harm our financial condition.***

In the past our results of operations and financial condition have been, and may again in the future be, worsened by increases in raw material or energy costs, or their lack of availability. We have generally not entered into long-term contracts to satisfy our fuel and electricity needs or recycled steel scrap requirements. We do have one long-term scrap supply agreement with the company that leases and operates our Virginia shredder. If we are unable to meet our requirements for fuel, electricity or recycled steel scrap, we may experience interruptions in our production, which could adversely affect our results of operations.

Prices for energy and scrap are subject to market forces largely beyond our control, including demand by U.S. and international steel producers, freight costs and speculation. A combination of a weak U.S. dollar and exceptionally strong global demand for scrap has caused the price of domestic scrap to dramatically increase over the past three years. Integrated steel producer competitors are not as dependent as we are on scrap as a major part of their raw material melt mix. This may give them a raw material cost advantage over mini-mills during periods of high scrap costs relative to the cost of blast furnace iron used by the integrated producers, even with the higher costs they must currently pay for iron ore, coke, coking coal and other raw materials used in their iron making processes.

Our operations also require substantial amounts of other raw materials, including various types of alloys, refractories, oxygen, natural gas and electricity, the price and availability of which are also subject to market conditions. Price increases (to the extent we are not able to pass such increases on to our customers) or the disruption of the supply of these products could adversely affect our results of operations.

***Our debt could adversely affect our cash flow available to fund our business needs and have other consequences adverse to our business.***

Our Long-term Debt is approximately \$300 million. See Item 7 “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition, Liquidity and Capital Resources—Impact of the distribution and separation from TXI.” Our debt could have important consequences. For example, it could:

- increase our vulnerability to general adverse economic and industry conditions; require us to dedicate a substantial portion of our cash flow from operations to service our debt, thereby reducing the availability of our cash flow to fund working capital, capital expenditures, investments and other general corporate purposes;
- limit our flexibility in planning for, or reacting to, changes in our business, the steel industry or the markets in which we operate;
- place us at a competitive disadvantage compared to our competitors that have less debt; and
- limit, among other things, our ability to borrow additional funds, even if necessary to maintain adequate liquidity.

The terms of the indentures governing our Senior Notes, our Credit Facility and our other debt agreements will allow us to issue and incur additional debt upon satisfaction of certain conditions. If new debt is added to current debt levels, the related risks described above could increase.

*We will require a significant amount of cash to service our debt. Our ability to generate cash depends on many factors beyond our control.*

Our ability to make payments on, or repay or refinance, our debt and to fund planned capital expenditures, depends largely upon the availability of financing through our bank credit facility and our future operating performance. Our future operating performance, to a certain extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. In addition, our ability to borrow funds in the future to make payments on our debt will depend on our satisfaction of the covenants in our Credit Facility, our Senior Notes and our other debt agreements, and other agreements we may enter into in the future.

Specifically, we will need to maintain certain financial ratios, including a leverage ratio and an interest expense coverage ratio. Although we generated \$157.1 million and \$78.1 million of net income for the years ended May 31, 2006 and 2005, we experienced net losses of \$5.3 million, \$64.1 million and \$13.2 million or fiscal years 2004, 2003 and 2002, respectively. We cannot be assured we will continue to be profitable or that our business will generate sufficient cash flow from operations or that future borrowings will be available to us under our bank credit facility or from other sources in an amount sufficient to enable us to pay our debt, or to fund our other liquidity needs. If we are unable to generate sufficient cash flow to meet our debt service requirements, we may have to renegotiate the terms of our debt or obtain additional financing.

We cannot be assured we will be able to refinance any of our debt, including our Credit Facility or our Senior Notes, or obtain additional financing on commercially reasonable terms or at all. If we were unable to obtain new financing under these circumstances, we would have to consider other options, such as:

- sales of certain assets to meet our debt service obligations;
- sales of equity; and
- negotiations with our lenders to restructure the applicable debt.

Our Credit Facility restricts, and the indentures governing the Senior Notes and the terms of any future debt may restrict, or market or business conditions may limit, our ability to do any of these things. If none of these options were available to us on reasonable terms, a default could occur under our debt agreements which could permit the lenders to accelerate any indebtedness outstanding under our debt agreements.

*The agreements governing our debt contain various covenants restricting our ability to prepay or repurchase our debt, otherwise limit our discretion in the operation of our business and could lead to acceleration of debt.*

Our financing agreements impose operating and financial restrictions on our activities. Our bank credit facility requires us to comply with or maintain certain financial tests and ratios, including a leverage ratio and an interest expense coverage ratio. Our Credit Facility also limits our ability to prepay or repurchase our Senior Notes in certain circumstances. Restrictions contained in these financing agreements also limit or prohibit our ability and the ability of certain of our subsidiaries to, among other things:

- make certain investments;
- incur additional debt or sell preferred stock;
- create liens;
- make dividend payments or other payments from subsidiaries to us;
- engage in consolidations and mergers or sell or transfer assets;
- engage in transactions with our affiliates; and
- sell stock in our subsidiaries.

Various risks and events beyond our control could affect our ability to comply with these covenants and maintain financial tests and ratios. If we cannot comply with the financial covenants in our bank credit facility, we may not be able to borrow under this facility. In addition, failure to comply with any of the covenants in our existing or future financing agreements could result in a default under those agreements and under other agreements containing cross-default provisions. A default would permit lenders to accelerate the maturity of the debt under these agreements and to foreclose upon any collateral securing that debt. In addition, lenders may be able to terminate any commitments they make to supply us with further funds. Under these circumstances, we might not have sufficient funds or other resources to satisfy all of our obligations. In addition, the limitations imposed by these agreements on our ability to incur additional debt and to take other actions might significantly impair our ability to obtain other financing. We may not be able to obtain waivers or amendments of our financing agreements, if necessary, at acceptable terms or at all.

*We may incur substantial expenditures to comply with environmental laws which may adversely affect our results of operations and harm our financial condition.*

We are subject to federal, state and local environmental laws and regulations concerning, among other matters, air emissions, furnace dust disposal and stormwater discharge. We believe we are in substantial compliance with applicable environmental laws and regulations. However, from time to time we receive claims from federal and state environmental regulatory agencies and entities asserting that we are or may be in violation of certain environmental laws and regulations. Based on our experience in dealing with such claims in the past and information currently available to us regarding any potential or outstanding claims, we believe that such claims will not have a material impact on our financial condition or results of operations. Despite our compliance and experience, it is possible we could be held liable for future charges which might be material but are not currently known or estimable. In addition, changes in federal or state laws, regulations or requirements or discovery of currently unknown conditions could require additional expenditures by us, interrupt production or hinder our ability to build new or expand production facilities.

Many of the raw materials, products and by-products associated with the operation of any industrial facility, including those for the production of steel, contain chemical elements or compounds that might be designated as hazardous. Our steel facilities generate, in the same manner as other similar steel plants in the industry, electric arc furnace ("EAF") dust that contains zinc, lead, chromium and cadmium. The EPA has designated this EAF dust, which is collected in baghouses, as hazardous waste. We have contracts with reclamation facilities in Mexico pursuant to which such facilities receive the EAF dust generated by us and recover the metals from the dust for reuse, thus rendering the dust non-hazardous. In addition, we routinely investigate alternative reclamation technologies and have implemented processes for diminishing the amount of EAF dust generated.

We purchase scrap steel from many sources. Much of the scrap is sorted and shredded at our plant sites. Although we screen incoming scrap for various contaminants, if we fail to detect radioactive or hazardous material, such materials could cause contamination of our equipment, land and products. We could incur significant costs to clean up the contamination and dispose of the contaminated material. The cost to clean up the contaminated material and the loss of revenue resulting from the lost production time could both be material. In addition, the "fluff" that remains after the steel and other valuable materials are removed from the scrap is deposited in landfills that we believe are operated by firms that properly dispose of the fluff. On occasion, we also recycle and dispose of hazardous wastes we generate in our plants, such as cleaning fluids, at hazardous waste recycling and disposal facilities. If a landfill or hazardous material recycler or disposal operator mismanages our fluff or other wastes in a way that creates an environmental hazard, we and all others who sent materials could become liable for cleanup costs, fines and other expenses many years after the disposal or recycling was completed.

We intend to comply with all legal requirements regarding the environment and health and safety matters, but since many of these requirements are subjective and therefore not quantifiable, are presently not determinable, or are likely to be affected by future legislation or rule making or regulatory interpretations by government agencies, it is not possible to accurately predict the aggregate future costs of compliance and their

effect on our operations, future net income or financial condition. Notwithstanding our intentions to comply with all legal requirements, if injury to persons or damage to property or contamination of the environment has been or is caused by the conduct of our business or hazardous substances or wastes used in, generated or disposed of by us, we may be liable for such injuries and damages, and be required to pay the cost of investigation and remediation of such contamination. The amount of such liability could be material, and we may incur material liability in connection with possible claims related to our operations and properties under environmental, health and safety laws.

*The requirements of complying with the Exchange Act and the Sarbanes-Oxley Act may strain our resources, and our internal control over financial reporting may not be sufficient to ensure timely and reliable external financial reports.*

We are subject to the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act") and the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act"). These requirements may place a strain on our systems and resources. The Exchange Act requires that we file annual, quarterly and current reports with respect to our business and financial condition. The Sarbanes-Oxley Act requires, among other things, that we maintain effective disclosure controls and procedures, corporate governance standards and internal control over financial reporting. Section 404 of the Sarbanes-Oxley Act requires that management document and test our internal control over financial reporting and provide management's conclusion in our Annual Report on Form 10-K for the fiscal year ending May 31, 2007, whether our internal control over financial reporting at May 31, 2007 is effective. To maintain and improve the effectiveness of our disclosure controls and procedures and internal control over financial reporting, significant resources and management oversight will be required and we may need to devote financial resources, additional time and personnel to legal, financial and accounting activities to ensure our ongoing compliance with public company reporting requirements. We cannot be assured that we will be able to implement any required changes to correct possible material weaknesses in internal control over financial reporting and sufficiently document and test the revised internal control procedures to make a positive conclusion as to the effectiveness of internal control over financial reporting by May 31, 2007.

*Unexpected equipment failures, catastrophic events and scheduled maintenance may lead to production curtailments or shutdowns.*

Due to the high fixed cost nature of our business, interruptions in our production capabilities may cause our productivity and results of operations to decline significantly during the affected period. Our manufacturing processes are dependent upon critical pieces of equipment, such as our steel furnaces, continuous casters and rolling equipment, as well as electrical equipment, such as transformers. This equipment may, on occasion, be out of service as a result of unanticipated failures or damaged during accidents. In addition to equipment failures, our facilities are also subject to the risk of catastrophic loss due to unanticipated events such as fires, explosions or violent weather conditions. We may in the future experience material plant shutdowns or periods of reduced production as a result of equipment failures or catastrophic events. We also have scheduled shut-downs every 12 to 24 months to refurbish our steel production facilities. Any interruption in production capability may require us to make significant capital expenditures to remedy problems. In addition lost production time could have a negative effect on our profitability and cash flows.

*Implementation of our growth strategy has certain risks.*

As part of our growth strategy, we may expand existing facilities, build additional plants, acquire other steel assets, enter into joint ventures or form strategic alliances that we believe will expand or complement our existing business. If any of these transactions occur, they will likely involve some or all of the following risks:

- the potential disruption of our ongoing business;
- the diversion of resources and management's time;
- the inability of management to maintain uniform standards, controls, procedures and policies;

- the difficulty of managing the operations of a larger company;
- the risk of becoming involved in labor, commercial or regulatory disputes or litigation related to the new enterprise;
- the risk of contractual or operational liability to joint venture participants or to third parties as a result of our participation;
- the difficulty of competing for acquisitions and other growth opportunities with companies having greater financial resources than us; and
- the difficulty of integrating the acquired operations and personnel into our existing business.

Pursuing our growth strategy may be required for us to remain competitive, but we may not be able to complete any such transactions or obtain financing, if necessary, for such transactions on favorable terms. Future transactions may not improve the competitive position and business prospects as anticipated, and could reduce sales or profit margins, and, therefore, earnings if they are not successful.

*If our products and methods and the products and methods we license infringe on the intellectual property rights of others, our ability to compete in the market may be harmed.*

We cannot be assured our products or methods do not infringe the patents or other intellectual property rights of third parties. Infringement and other intellectual property claims and proceedings brought against us, whether successful or not, could result in substantial costs and harm our reputation. Such claims and proceedings can also distract and divert management and key personnel from other tasks important to the success of our business. In addition, intellectual property litigation or claims could force us to do one or more of the following:

- cease selling our products or using our methods that incorporate the asserted intellectual property, which could adversely affect our revenue;
- pay substantial damages for past use of the asserted intellectual property; and
- obtain a license from the holder of the asserted intellectual property, which license may not be available on reasonable terms, if at all.

We are a party to a number of licenses giving us rights to third-party intellectual property that is useful to our business. Our success will depend in part on the ability of our licensors to obtain, maintain and enforce our licensed intellectual property. Without protection for the intellectual property we license, other companies might be able to offer substantially identical products for sale and use substantially similar methods, which could adversely affect our competitive business position and harm our business prospects.

*Our change-in-control provisions could make it more difficult for a third party to acquire us, and discourage a takeover, and may adversely affect our stockholders.*

Our certificate of incorporation and bylaws and the Delaware General Corporation Law contain provisions that may have the effect of making more difficult or delaying attempts by others to obtain control of us, even when these attempts may be in the best interests of stockholders. Delaware law also imposes conditions on certain business combination transactions with “interested stockholders.”

Prior to the spin-off, we adopted a preferred stock purchase rights plan to encourage anyone seeking to acquire us to negotiate with our board of directors prior to attempting a takeover. While the plan was designed to guard against coercive or unfair tactics to gain control of us, the rights have certain anti-takeover effects. The rights will cause substantial dilution to any person or group who attempts to acquire a significant amount of common stock without approval from our board of directors. As a result, the overall effect of the rights may be to render more difficult or discourage or delay any attempt to acquire us. Because we can redeem the rights, the rights will not interfere with a merger or other business combination approved by our board. See Item 5 “Market for the Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.”

We entered into a tax sharing and indemnification agreement with TXI under which we agreed that, among other things, we may not, except in certain specified transactions, redeem our equity securities (or those of certain of our subsidiaries) for two years following the spin-off. Notwithstanding these restrictions, we may take certain actions prohibited by these covenants if we provide TXI with an IRS ruling or an unqualified opinion of tax counsel, acceptable to TXI, to the effect that these actions will not affect the tax-free nature of the spin-off.

The credit agreement governing our Credit Facility and the indentures governing our Senior Notes contain provisions that may require us to repay our borrowings under the Credit Facility and repay holders of our Senior Notes if a change of control occurs.

These provisions and others that could be adopted in the future could deter unsolicited takeovers or delay or prevent changes in control or management of the Company, including transactions in which stockholders might otherwise receive a premium for their shares over then current market prices. These provisions may limit the ability of stockholders to approve transactions that they may deem to be in their best interests.

### **Risks Related to our Industry**

#### *Our business is sensitive to economic cycles.*

A significant percentage of our sales are attributable to the overall level of construction activity since demand for structural steel is derived primarily from non-residential construction. Construction activity in this segment is cyclical and is influenced by prevailing economic conditions, including interest rate levels, inflation, consumer spending habits and employment. The demand for steel products is also generally affected by macroeconomic fluctuations in the U.S. and global economies. Fluctuations in the value of the dollar can be expected to affect our business because a strong U.S. dollar makes imported steel products less expensive, resulting in more imports into the U.S. by foreign competitors.

Future economic downturns, stagnant economies or currency fluctuations could decrease the demand for our products or increase imports, which could have a material adverse effect on our results of operations by decreasing our volume of shipments, sales and profitability. Moreover, our industry is characterized by low backlogs, which means our results of operations are promptly affected by short term economic fluctuations.

#### *Excess global capacity and the availability of competitive substitute materials have, at times, resulted in intense competition and may, in the future, cause downward pressure on prices.*

The domestic and global steel industry has in the past been generally characterized by overcapacity, which can have a negative impact on domestic steel prices. Global overcapacity has sometimes resulted in high levels of steel imports into the United States, exerting downward pressure on domestic steel prices and resulting in, at times, a dramatic reduction in, or, in the case of many steel producers, the elimination of gross margins. In addition, in the case of certain product applications, we and other steel manufacturers compete with manufacturers of other materials, including plastic, aluminum, graphite composites, ceramics, glass, wood and concrete. Product substitution could also have a negative impact on demand for steel products and place downward pressure on prices.

#### *In recent years, imports of steel into the United States have adversely affected, and may again adversely affect, U.S. steel prices, which would impact our sales, margins and profitability.*

Excessive imports of steel into the United States have in recent years, and may again in the future, exerted downward pressure on U.S. steel prices and significantly reduce our sales, margins and profitability. U.S. steel producers compete with many foreign producers. Competition from foreign producers is typically strong, but it increases during some periods as a result of an excess of foreign steelmaking capacity, periodic weakening of the economies of certain foreign steelmaking countries, and a strong U.S. dollar relative to foreign currencies. Economic difficulties in these countries or a reduction in demand for steel produced by these countries, when

those events occur, result in lower local demand for steel products in these countries and tends to encourage greater steel exports to the United States at depressed prices. In addition, while the U.S. dollar is currently relatively weak compared to historical averages, any recovery or increase in the U.S. dollar exchange rate relative to other currencies would improve the competitive position of foreign producers by making the prices of foreign imports more attractive.

In addition, we believe the downward pressure on, and depressed levels of, U.S. steel prices in recent years have been, and may again in the future be, further exacerbated by imports of steel involving dumping and subsidy abuses by foreign steel producers. Some foreign steel producers are owned, controlled or subsidized by foreign governments. As a result, decisions by these producers with respect to their production, sales and pricing are often influenced to a greater degree by political and economic policy considerations than by prevailing market conditions or consideration of profit or loss. For example, between 1998 and 2001, when imports of structural and bar products increased dramatically, domestic steel producers, including us, were adversely affected by unfairly priced or "dumped" imported steel.

**ITEM 1B. UNRESOLVED STAFF COMMENTS.**

None

**ITEM 2. PROPERTIES.**

Our Midlothian, Texas steel plant is situated on approximately 1,711 acres that we own. The plant and other buildings occupy approximately 1,095,000 square feet. Our Texas plant has two electric arc furnaces with three continuous casters that feed billets to a bar mill, a medium structural mill and a large structural mill. Our Dinwiddie County, Virginia plant is situated on approximately 976 acres that we own. The plant and other buildings occupy approximately 789,000 square feet. Our Virginia plant has one electric arc furnace and in-line processing units consisting of two near-net shape casters and a sophisticated rolling mill.

**ITEM 3. LEGAL PROCEEDINGS.**

The information required by this item is included in the section of the Notes to Consolidated Financial Statements footnote entitled "Legal Proceedings and Contingent Liabilities" presented in Part II, Item 8 and incorporated herein by reference.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

None.

## PART II

### ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

#### Common Stock, Stockholders and Dividends.

The principal market for our common stock is the Nasdaq Global Select Market System. Our common stock is listed on the Nasdaq Global Select Market System under the symbol "CHAP." On July 12, 2006, our board of directors approved a stock split effected in the form of a 100% common stock dividend. The record date will be August 15, 2006, the distribution date will be September 1, 2006 and the ex-dividend date will be September 5, 2006. The par value of our common stock remains \$0.01 per share. The price of our common stock on July 3, 2006 was \$72.48. Our common stock began trading on a "when issued" basis on July 22, 2005, so no information regarding high and low sales prices for the prior quarterly periods is available.

2006	Quarter Ended			
	Aug. 31	Nov. 30	Feb. 28	May 31
Stock Prices				
High .....	\$23.00	\$27.50	\$46.71	\$73.37
Low .....	12.50	21.10	24.84	40.76

As of July 3, 2006, we had 2,033 common stockholders of record.

We paid a cash dividend of \$341.1 million to TXI on July 6, 2005 and did not declare any cash dividends in fiscal 2005 and 2004. We do not currently anticipate paying any cash dividends. The declaration and payment of dividends are subject to the discretion of our board of directors. Any future determination to pay dividends will depend on our results of operations, financial condition, capital requirements, contractual restrictions and other factors deemed relevant at the time by our board of directors. Our Credit Facility and our Senior Notes limit our ability to pay dividends. See "Risk Factors—Risks Related to Our Company."

#### Issuer Purchases of Equity Securities.

We did not repurchase any shares of our common stock during the quarter ended May 31, 2006.

#### Unregistered Issuances of Equity Securities.

When we were incorporated in February 2005, we issued 1,000 shares of our common stock to TXI. On June 25, 2005, we issued 22,727,000 shares of our common stock to TXI in connection with the preparations for the spin-off and in return for the various assets TXI contributed to us. On July 21, 2005, our board of directors approved a stock dividend of 75,867 shares of our common stock, payable on July 25, 2005 to TXI, our sole stockholder of record as of that date. The purpose of the stock dividend was to provide sufficient shares of our common stock to be issued to holders of TXI common stock in connection with our spin-off from TXI. All of the shares issued to TXI following our incorporation were issued in reliance on the exemption provided by Section 4(2) of the Securities Act of 1933, as amended, based upon the fact that TXI was our sole stockholder and the issuances did not involve a public offering of securities.

#### Stockholders Rights Plan.

On July 21, 2005, we adopted a stockholders rights plan (the "Rights Agreement"). Pursuant to the Rights Agreement, we declared a dividend of rights (the "Rights") to purchase, upon the occurrence of certain events, one one-thousandth of a share of the Series A Junior Participating Preferred Stock, par value \$0.01 per share ("Preferred Stock"), for each outstanding share of our common stock. Until the Rights become exercisable, all further issuances of common stock, including common stock issuable upon exercise of outstanding options, will

include issuances of Rights. The Rights will be exercisable at \$90.00 per one one-thousandth of a share of Preferred Stock. The Rights will expire on July 29, 2015 unless extended or unless the Rights are earlier redeemed or exchanged by us.

The Rights are not exercisable nor are they transferable apart from our common stock until the earlier of (a) the tenth day after such time as a person or group acquires beneficial ownership of 15% of our common stock or (b) the tenth business day (unless extended by our board of directors) after a person or group announces its intention to commence or commences a tender or exchange offer the consummation of which would result in beneficial ownership by a person or group of 15% or more of our common stock. The earlier of these dates is referred to as the "Distribution Date". As soon as practicable after the Distribution Date, separate right certificates will be issued and the Rights will become exercisable and transferable apart from our common stock.

The Preferred Stock issuable upon exercise of the Rights will be non-redeemable and rank junior to any other series of our preferred stock that is outstanding. Each whole share of Preferred Stock will be entitled to receive a quarterly preferential dividend of \$1.00 per share but will be entitled to receive, in the aggregate, a dividend of 1,000 times the dividend declared on the common stock. In the event of liquidation, the holders of the Preferred Stock will be entitled to receive a preferential liquidation payment equal to the greater of \$1,000 per share, plus accrued and unpaid dividends, or, in the aggregate, a liquidation payment equal to 1,000 times the payment made per share of our common stock. Each share of Preferred Stock will have 1,000 votes, voting together with the common stock. Finally, in the event of any merger, consolidation or other transaction in which shares of common stock are exchanged for or changed into other stock or securities, cash and/or other property, each share of Preferred Stock would be entitled to receive 1,000 times the amount received per share of common stock.

#### **ITEM 6. SELECTED FINANCIAL DATA.**

Set forth below is selected consolidated financial and other data for each of the five fiscal years in the period ended May 31, 2006. The consolidated balance sheet data as of May 31, 2006 and 2005 and consolidated statement of operations for each of the three fiscal years in the period ended May 31, 2006, have been derived from our audited consolidated financial statements included in Item 8. The consolidated balance sheet data as of May 31, 2004 and 2003 and consolidated statements of operations for the fiscal years ended May 31, 2003 and 2002 have been derived from our audited consolidated financial statements. The historical consolidated balance sheet data as of May 31, 2002 has been derived from our unaudited consolidated financial statements. For all periods prior to July 30, 2005, the consolidated financial statements reflect transactions with TXI and its affiliates on the basis determined by TXI. You should read the information presented below in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and related notes included in Item 8.

The historical financial data includes all costs of our steel business. For periods presented prior to July 30, 2005, these costs include the allocation of certain corporate expenses from TXI. We believe these allocations were made on a reasonable basis. The consolidated financial statements may not necessarily reflect our financial position, results of operations and cash flows in the future and the consolidated financial statements for periods prior to July 30, 2005 may not necessarily reflect what our financial position, results of operations or cash flows would have been if we had been an independent public company during the periods presented. See "Risk Factors—Risks Related to Our Spin-Off from TXI."

	Fiscal Years Ended May 31,				
	2006	2005	2004	2003	2002
	(in thousands, except per share)				
Statement of Operations Data:					
Net sales	\$1,466,729	\$1,116,376	\$ 905,324	\$ 645,991	\$ 685,228
Costs and expenses (income):					
Cost of products sold	1,161,173	925,766	842,228	673,597	640,034
Selling, general and administrative	46,652	28,730	30,173	23,913	30,482
Interest	32,015	47,275	49,597	51,027	50,581
Other income, net	(12,457)	(5,605)	(7,677)	(1,967)	(15,624)
	<u>1,227,383</u>	<u>996,166</u>	<u>914,321</u>	<u>746,570</u>	<u>705,473</u>
Income (loss) before income taxes and accounting change	239,346	120,210	(8,997)	(100,579)	(20,245)
Income taxes (benefit)	82,210	42,090	(3,199)	(36,517)	(7,011)
Income (loss) before accounting change	157,136	78,120	(5,798)	(64,062)	(13,234)
Cumulative effect of accounting change—net of income taxes	—	—	480	—	—
Net income (loss)	<u>\$ 157,136</u>	<u>\$ 78,120</u>	<u>\$ (5,318)</u>	<u>\$ (64,062)</u>	<u>\$ (13,234)</u>
Basic earnings (loss) per share:					
Income (loss) before accounting change	\$ 6.87	\$ 3.43	\$ (.25)	\$ (2.82)	\$ (.58)
Cumulative effect of accounting change	—	—	.02	—	—
Net income (loss)	<u>\$ 6.87</u>	<u>\$ 3.43</u>	<u>\$ (.23)</u>	<u>\$ (2.82)</u>	<u>\$ (.58)</u>
Diluted earnings (loss) per share:					
Income (loss) before accounting change	\$ 6.64	\$ 3.43	\$ (.25)	\$ (2.82)	\$ (.58)
Cumulative effect of accounting change	—	—	.02	—	—
Net income (loss)	<u>\$ 6.64</u>	<u>\$ 3.43</u>	<u>\$ (.23)</u>	<u>\$ (2.82)</u>	<u>\$ (.58)</u>
Average shares outstanding:					
Basic (1)	<u>22,878</u>	<u>22,804</u>	<u>22,804</u>	<u>22,804</u>	<u>22,804</u>
Diluted (1)	<u>23,673</u>	<u>22,804</u>	<u>22,804</u>	<u>22,804</u>	<u>22,804</u>
Balance Sheet Data (at end of period) (2)					
Cash and cash equivalents	\$ 42,583	\$ 9,287	\$ 8,575	\$ 3,328	\$ —
Short-term investments	164,000	—	—	—	—
Working capital	428,201	324,811	184,523	139,926	203,483
Property, plant and equipment—net	593,977	627,253	650,463	686,767	713,174
Total assets	1,229,522	1,152,242	1,035,925	986,430	1,078,316
Long-term debt	300,000	—	—	—	—
Long-term payable to Texas Industries, Inc.	—	543,246	543,246	543,246	543,246
Stockholders' equity	668,506	351,520	270,801	276,118	340,151
Other Financial Data:					
Units shipped (tons)					
Structural	1,916	1,426	1,637	1,464	1,498
Bar	415	369	449	360	383
Total units shipped	<u>2,331</u>	<u>1,795</u>	<u>2,086</u>	<u>1,824</u>	<u>1,881</u>

(1) Earnings (loss) per share information for all periods presented prior to July 30, 2005 has been computed based on the number of shares of our common stock issued to TXI as of July 29, 2005.

(2) In connection with our spin-off from TXI on July 29, 2005, we entered into a \$150 million, senior secured revolving credit facility, issued \$300 million of 10% senior unsecured notes and paid a dividend of \$341.1 million to TXI. See "Business-Recent Developments"

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

*You should read the following discussion in conjunction with the consolidated financial statements and the corresponding notes included elsewhere in Item 8. Certain statements contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. See "Forward-Looking Statements". Such statements are subject to risks, uncertainties and other factors, which could cause actual results to differ materially from future results expressed or implied by such forward-looking statements. See "Risk Factors."*

### Overview

We are a leading supplier of structural steel and steel bar products through a single business segment. We produce and sell structural steel, piling products, special bar quality products, merchant bar quality rounds, reinforcing bar and channels from facilities located in Texas and Virginia. Structural steel products include wide flange beams, channels, piling products and other shapes. Steel bar products include specialty bar products and, to a lesser extent, reinforcing bar. We sell to steel service centers and steel fabricators for use in the construction industry, as well as to cold finishers, forgers and original equipment manufacturers for use in the railroad, defense, automotive, manufactured housing and energy industries. Our products are marketed throughout the United States, Canada and Mexico, and to a limited extent in Europe. All of our long-lived assets are located in the United States.

Our sales prices closely track domestic steel industry sales prices and are market based. Domestic demand for structural steel is derived primarily from non-residential construction. Therefore, a significant percentage of our sales are attributable to the level of non-residential construction activity in the United States. The level of activity in non-residential construction is cyclical and is influenced by prevailing economic conditions, including interest rate levels, inflation, consumer spending habits and employment. In addition, we compete in a global steel industry and domestic prices are significantly influenced by global industry prices. The global steel industry is generally characterized by overcapacity, which in the past has resulted in high levels of steel imports into the United States, exerting downward pressure on domestic steel prices. However, in the recent past, world-wide steel and steel scrap demand has risen. Increased steel demand and the relatively weak U.S. dollar have helped curb imports into the United States. These domestic and global factors have combined to produce historically high selling prices.

Our business requires large amounts of capital investment, raw materials, energy, labor and maintenance, and our future success depends on continued access to these resources. At full capacity, our annual steel scrap usage would be 3.4 million tons, which would represent approximately 6% of the U.S. scrap market. We make predominately all steel scrap purchases on the open market where prices are subject to market forces beyond our control. A major portion of the shredded steel requirements of our Texas plant is produced by an on-site shredder operation primarily utilizing crushed auto bodies purchased on the open market. We believe our shredding operations give us a competitive advantage by providing usable scrap at reduced cost compared to similarly prepared scrap available on the open market. The geographical market that supplies the Texas plant provides some protection from sharply higher raw material prices caused in part by favorable global market conditions. Our Virginia plant began receiving scrap from our on-site, shredding facility (which is operated by an unrelated party) in the fourth quarter of fiscal year 2005. We believe there will be adequate sources of our principal raw materials to meet our near term needs, although probably at higher prices than has historically been the case.

Steel mini-mills consume large amounts of electricity and natural gas. The electric industry has been deregulated in Texas since January 2002. The Texas plant purchases electricity through a local retail electric provider using various long and short term supply arrangements. We have entered into agreements to purchase minimum amounts of electricity and natural gas for our Texas facility. As of May 31, 2006, our commitments under these agreements extend through October 2006 which will allow our production facility to operate without the threat of interruption caused by volatile energy prices during the summer months and the majority of the Gulf

Coast hurricane season. The Commonwealth of Virginia is in transition to a deregulated market for electricity. Electricity for the Virginia plant is purchased through the local utility under an interruptible supply contract with periodic adjustments for fuel costs. Natural gas is purchased from local gas marketers and delivered to our plants through local transportation agreements. Historically, we have not used financial instruments to mitigate price fluctuations on such purchases, however we may use such financial instruments when appropriate. We believe adequate supplies of electricity and natural gas are readily available, although some fluctuations in supply and cost will occur.

#### **Various Aspects of Spin-Off from TXI**

We became an independent public company on July 29, 2005, as a result of our spin-off from TXI. See "Business."

When we were a subsidiary of TXI, TXI utilized a centralized cash management program for all of its subsidiaries through which we received payments from TXI as a result of cash received from product sales or made payments to TXI or its subsidiaries for purchases of materials or services or for costs incurred on our behalf, including raw material procurement, payroll and capital expenditures. As a result of the spin-off, we are no longer part of this program.

The accompanying financial statements include all costs of our steel business. For periods prior to July 30, 2005, these costs include the allocation of certain corporate expenses from TXI. TXI's corporate expenses were allocated to us based on either the percentage of time employees incurred performing services for us or specifically identified costs incurred by TXI for us. Management believes the allocations were made on a reasonable basis. However, the consolidated financial statements may not necessarily reflect our financial position, results of operations and cash flows in the future. See "Risk Factors—Risks Related to Our Spin-Off from TXI."

TXI, through one of its subsidiaries, previously provided us with common carrier services, transporting finished product to our customers and backhauling materials and supplies for us. For periods prior to July 30, 2005, these costs have been included in cost of products sold in the consolidated statements of operations and were \$0.6 million in 2006, \$6.6 million in 2005 and \$5.9 million in 2004. We believe the rates charged to us for transportation services approximate the rates that would have been charged by third parties. For periods subsequent to July 29, 2005, we are utilizing assets transferred to us by TXI to operate our own common carrier service.

Since 1986, TXI included our operations in its United States consolidated federal income tax return. TXI also included us with it or certain of its subsidiaries in consolidated, combined or unitary income tax groups for state tax purposes as required by law. The provision (benefit) for deferred income taxes for the periods presented has been determined as if we had filed separate tax returns. TXI managed its tax position for the benefit of its entire portfolio of businesses and its tax strategies are not necessarily reflective of the tax strategies we will follow.

At various times, items of intercompany indebtedness were settled between and among us and our subsidiaries and TXI and its subsidiaries. These intercompany accounts were settled through offsets, contributions of such indebtedness to our capital and other non-cash transfers. TXI has contributed \$496.1 million to us and our subsidiaries' capital.

## Results of Operations

Fiscal Year 2006 Compared to Fiscal Year 2005.

	Fiscal Years Ended May 31,		Change	% Change
	2006	2005		
(in thousands, except per ton data)				
Net sales				
Structural mills	\$1,103,075	\$ 790,789	\$312,286	39.5%
Bar mill	239,886	238,934	952	0.4%
Other products	41,871	32,254	9,617	29.8%
Delivery fees	81,897	54,399	27,498	50.5%
Total	<u>\$1,466,729</u>	<u>\$1,116,376</u>	<u>\$350,353</u>	31.4%
Units shipped (tons)				
Structural	1,916	1,426	490	34.4%
Bar	415	369	46	12.5%
Total	<u>2,331</u>	<u>1,795</u>	<u>536</u>	29.9%
Average sales price per ton				
Structural	\$ 576	\$ 555	\$ 21	3.8%
Bar	578	647	(69)	(10.7)%
Total	576	574	2	0.3%
Net sales	\$1,466,729	\$1,116,376	\$350,353	31.4%
Costs and expenses (income)				
Cost of products sold	1,161,173	925,766	235,407	25.4%
Selling, general and administrative	46,652	28,730	17,922	62.4%
Interest	32,015	47,275	(15,260)	(32.3)%
Other income, net	(12,457)	(5,605)	(6,852)	122.2%
	<u>1,227,383</u>	<u>996,166</u>	<u>231,217</u>	23.2%
Income before income taxes	239,346	120,210	119,136	99.1%
Income taxes	82,210	42,090	40,120	95.3%
Net income	<u>\$ 157,136</u>	<u>\$ 78,120</u>	<u>\$ 79,016</u>	101.1%

*Net sales.* During 2006, our net sales increased \$350.4 million to a record level of \$1.5 billion. Shipments increased 29.9% to a level of 2.3 million tons, as domestic and international demand for structural products remained strong causing our levels of finished goods inventory to decline to historical lows as of May 31, 2006. Shipping volumes of bar products were 12.5% higher compared to the prior year period. The weak dollar and high transportation costs continue to be a deterrent to imports that currently account for approximately 10% of total domestic supply. Average selling prices for structural products increased \$21 from the prior year period also reflecting the strong demand. Average selling prices for bar products decreased 10.7% from the prior year period reflecting a lower percentage of special bar quality shipments. The increase in shipping volumes accounted for approximately \$307.3 million of increased net sales, while increased pricing for structural and bar products accounted for approximately \$6.0 million of increased net sales. Delivery fees increased by 50.5% due to the increase in shipments and higher fuel costs.

*Cost of products sold.* Cost of products sold including depreciation and amortization was \$1.2 billion, an increase of \$235.4 million from 2005 primarily due to the increase in shipments. Per ton scrap costs were comparable to the prior year period. Per ton energy cost was 23% higher than the prior year period while total per ton costs were \$18 lower due primarily to a 16% increase in production in the current year period.

*Selling, general and administrative.* Selling, general and administrative expense increased \$17.9 million from the prior year as a result of an increase in incentive compensation expense of \$12.5 million combined with generally higher costs in the current year period for employee wages and professional services incurred in connection with being a public company.

*Interest.* Interest expense of \$32.0 million decreased \$15.3 million from the prior year period and was reflective of changes in our capitalization structure described in Note 5 of the Consolidated Financial Statements. Interest was charged on the balance due TXI that primarily resulted from cash advances received for the construction of production facilities until our current capital structure was put in place in July 2005. Under our current debt structure, we anticipate interest expense to be virtually unchanged in 2007.

*Other income, net.* Other income, net increased by \$6.9 million to \$12.5 million due to higher miscellaneous sales and interest income in the current year period.

*Income taxes.* The provision for income taxes of \$82.2 million increased \$40.1 million from the prior year due to the increase in pretax results and a lower effective tax rate. On October 22, 2004, the American Jobs Creation Act of 2004 (the "Jobs Creation Act") became law. Among other provisions, the Jobs Creation Act allows a deduction for income from qualified domestic production activities, which will be phased in from 2005 through 2010. For financial reporting purposes, any deductions for qualified domestic production activities are accounted for as a special deduction rather than as a rate reduction. Accordingly, we recorded a deduction of \$6.1 million in 2006. In addition, we recorded a net state deferred tax liability of \$0.7 million in 2006 primarily due to a new tax law enacted in May 2006. Our current tax provision will be affected by this legislation commencing in 2007. We had an effective tax rate of 34.3% for the current period compared to 35.0% for the prior year period.

*Net income.* Net income more than doubled from \$78.1 million to \$157.3 million from the prior year period driven by the significant increase in net sales discussed above.

*Fiscal Year 2005 Compared to Fiscal Year 2004.*

	Fiscal Years Ended May 31,		Change	% Change
	2005	2004		
(in thousands, except per ton data)				
Net sales				
Structural mills	\$ 790,789	\$643,043	\$147,746	23.0%
Bar mill	238,934	177,967	60,967	34.3%
Other products	32,254	27,076	5,178	19.1%
Delivery fees	54,399	57,238	(2,839)	(5.0)%
Total	<u>\$1,116,376</u>	<u>\$905,324</u>	<u>\$211,052</u>	23.3%
Units shipped (tons)				
Structural	1,426	1,637	(211)	(12.9)%
Bar	369	449	(80)	(17.8)%
Total	<u>1,795</u>	<u>2,086</u>	<u>(291)</u>	(14.0)%
Average sales price per ton				
Structural	\$ 555	\$ 393	\$ 162	41.2%
Bar	647	396	251	63.4%
Total	574	394	180	45.7%
Net sales	\$1,116,376	\$905,324	\$211,052	23.3%
Costs and expenses (income)				
Cost of products sold	925,766	842,228	83,538	9.9%
Selling, general and administrative	28,730	30,173	(1,443)	(4.8)%
Interest	47,275	49,597	(2,322)	(4.7)%
Other income, net	(5,605)	(7,677)	2,072	(27.0)%
	<u>996,166</u>	<u>914,321</u>	<u>81,845</u>	9.0%
Income (loss) before income taxes and accounting change	120,210	(8,997)	129,207	N/M
Income taxes (benefit)	42,090	(3,199)	45,289	N/M
Income (loss) before accounting change	78,120	(5,798)	83,918	N/M
Cumulative effect of accounting change-net of income taxes	—	480	(480)	N/M
Net income (loss)	<u>\$ 78,120</u>	<u>\$ (5,318)</u>	<u>\$ 83,438</u>	N/M

N/M—Not Meaningful

*Net sales.* During 2005, our total net sales increased \$211.1 million to \$1.1 billion. The favorable market conditions primarily due to an increase in global demand resulted in an increase of 45.7% in the average sales price for our rolled product. Bar product average selling price was enhanced by a greater mix of higher margin special bar quality sales than the prior year. Shipping volumes for bar and structural products decreased in 2005 as selling prices stabilized and service center customers reduced their inventories compared to the prior year period. Increased pricing for structural and bar products accounted for approximately \$322.8 million of increased net sales, while the decrease in volumes accounted for approximately \$114.1 million of decreased net sales.

*Cost of products sold.* Cost of products sold in 2005 was \$925.8 million, including depreciation and amortization, an increase of \$83.5 million from the prior year. The increase was due primarily to 37.8% higher raw material unit costs as a result of the increase in global demand for our raw materials.

*Selling, general and administrative.* Selling, general and administrative expense in 2005 decreased \$1.4 million from the prior year as a decrease in bad debt expense of \$2.0 million was partially offset by a \$2.5 million increase in incentive compensation expense as a result of our higher profitability.

*Interest.* Interest expense decreased \$2.3 million to \$47.3 million in 2005, which was the interest charged on the balance due TX1 that primarily resulted from cash advances received for the construction of production facilities.

*Other income, net.* Other income, net in 2005 decreased \$2.1 million primarily due to \$4.2 million received from our litigation against certain graphite electrode suppliers in the prior year.

*Income taxes (benefit).* During 2005 our provision for income tax was \$42.1 million, compared to a benefit from income tax of \$3.2 million during 2004 due to improved pre-tax results. There was no material change in our effective tax rate from the prior year.

*Cumulative effect of accounting change—net of income taxes.* Effective June 1, 2003, we adopted Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations," which applies to legal obligations associated with the retirement of long-lived assets. We incur legal obligations for asset retirement as part of our normal operations related to land reclamation and Resource Conservation and Recovery Act closures. Application of the new rules resulted in a cumulative benefit of \$0.5 million, net of income taxes of \$0.3 million in 2004.

*Net income (loss).* Net income improved \$83.4 million in 2005 due to the factors discussed above.

### **Critical Accounting Policies**

The preparation of financial statements and accompanying notes in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported. Changes in the facts and circumstances could have a significant impact on the resulting financial statements. We believe the following critical accounting policies affect our more complex judgments and estimates.

*Inventories.* Inventories are stated at the lower of cost or market. Cost of inventories, other than supplies inventories, is determined using the last-in, first-out method of accounting. If the average cost method (which approximates current replacement cost) had been used, these inventory values would have been higher by \$51.5 million at May 31, 2006 and \$63.1 million at May 31, 2005. Supplies primarily consist of rolls and molds, which are used in the manufacturing process, and are carried at average cost. Management evaluates the current trend of selling prices and estimates market value based on expected near-term selling prices.

*Environmental liabilities.* We are subject to environmental laws and regulations established by federal, state and local authorities and make provision for the estimated costs related to compliance when it is probable that a reasonably estimable liability has been incurred.

*Legal contingencies.* We are defendants in lawsuits that arose in the normal course of business and make provision for the estimated loss from any claim or legal proceeding when it is probable that a reasonably estimable liability has been incurred.

*Long-lived assets.* Management reviews long-lived assets for impairment whenever changes in circumstances indicate that the carrying amount of the assets may not be recoverable and would record an impairment charge if necessary. Such evaluations compare the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset and are significantly impacted by estimates of future prices for our products, capital needs, economic trends and other factors.

*Goodwill.* We test goodwill for impairment at least annually. If the carrying amount of the goodwill exceeds its fair value, an impairment loss is recognized. In applying a fair-value-based test, estimates are made of the expected future cash flows to be derived from the applicable reporting unit. Similar to the review for impairment of other long-lived assets, the resulting fair value determination is significantly impacted by estimates of future prices for our products, capital needs, economic trends and other factors. The fair value of our goodwill exceeds its carrying value.

*New accounting pronouncements.* In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment". SFAS No. 123R is a revision of SFAS No. 123, "Accounting for Stock Based Compensation", and supersedes APB No. 25. Among other items, SFAS No. 123R eliminates the use of APB No. 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. We adopted SFAS No. 123R effective June 1, 2006 using the "modified prospective" method. Under the modified prospective method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS No. 123R for all share-based payments granted after that date, and based on the requirements of SFAS No. 123 for all unvested awards granted prior to the effective date of SFAS No. 123R. Financial information for periods prior to the date of adoption of SFAS No. 123R will not be restated. We will utilize the standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options and awards of equity instruments to employees and directors.

The adoption of SFAS No. 123R will have a significant effect on our future results of operations. However, it will not have an impact on our consolidated financial position. The entire impact of SFAS No. 123R on our results of operations cannot be predicted at this time, because it will depend on the number of equity awards granted in the future, as well as future financial measurements contained in the model used to value the awards. However, had we adopted the requirements of SFAS No. 123R in prior periods, the impact would have approximated the amounts disclosed in Note 2 in the Notes to Consolidated Financial Statements.

SFAS No. 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated, because they depend on, among other things, when employees exercise stock options. However, the amount of operating cash flows recognized in prior periods for such excess tax deductions, for 2006, 2005, and 2004 were not material.

In December 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4," which became effective for us beginning June 1, 2006. This standard clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted material should be expensed as incurred and not included in overhead. In addition, this standard requires that the allocation of fixed production overhead cost to inventory be based on the normal capacity of the production facilities. Based on current market conditions and historical plant performance, the new standard is not expected to have a material impact on our financial position and results of operations.

### **Financial Condition, Liquidity and Capital Resources**

Net working capital at May 31, 2006 increased \$103.4 million to \$428.2 million from May 31, 2005. Significant changes in the components of current assets included increases in cash and cash equivalents of \$33.3 million and short-term investments of \$164.0 million reflecting our higher net income in 2006. Accounts receivable-net increased \$32.3 million due to higher sales in the month of May 2006 compared to May 2005. Inventories declined \$86.4 million as a significant increase in shipments exceeded production levels in the current period. All net balances with TXI were contributed to our capital during 2006. Prepaid expenses decreased primarily due to a \$4.5 million decrease in unamortized shutdown costs, which are amortized over the benefited period, typically 12 months. The trade accounts payable decreased \$39.0 million in returning to a more normalized level of \$50.0 million. Accrued wages, taxes and other items increased \$34.5 million primarily due to increases in employee wages and benefits of \$14.0 million (due to increased employee incentive compensation), interest payable of \$11.4 million and income taxes payable of \$6.3 million. Interest and income taxes payable were previously settled through intercompany accounts with TXI.

Net working capital at May 31, 2005 increased \$140.3 million to \$324.8 million from May 31, 2004, reflecting a \$139.0 million increase in current assets and a \$1.3 million decrease in current liabilities. The increase in current assets was primarily due to an increase in inventories of \$69.1 million as a result of higher

volumes and higher raw material costs. The payable to TXI decreased \$76.2 million during 2005 as improved pre-tax results allowed us to reduce outstanding balances to TXI. Accounts receivable, net increased \$24.2 million due to higher sales in the month of May 2005 compared to the prior year period. Prepaid expenses increased primarily due to an increase in unamortized shutdown costs of \$4.9 million, which are amortized over the benefited period, typically 12 months.

In June 2005, we entered into our Credit Facility which provides up to \$150.0 million of available borrowings and we issued \$300.0 million aggregate principal amount of our Senior Notes. We used \$50.0 million of borrowings from our Credit Facility and the net proceeds from our Senior Notes to pay a cash dividend of \$341.1 million to TXI on July 6, 2005 in connection with the spin-off. We had no outstanding borrowings under the Credit Facility during the nine months ended May 31, 2006; however, \$1.7 million of the facility was utilized to support letters of credit. The amount borrowed under the Credit Facility will fluctuate based upon our cash flow and working capital needs.

In addition to cash and cash equivalents of \$42.6 million and short-term investments of \$164.0 million at May 31, 2006, our primary sources of liquidity are cash provided from operations and borrowings available under the Credit Facility. We fund working capital requirements and capital expenditures primarily with cash from operations. In addition, we lease certain mobile and other equipment used in our operations under operating leases that in the normal course of business are renewed or replaced by subsequent leases.

#### *Cash flows*

In periods prior to July 30, 2005, net cash provided by operating activities included the effects of TXI's centralized cash management program for all of its subsidiaries, through which we received advances from and made transfers to TXI depending on our cash requirements. These transactions were treated as amounts payable to and receivable from TXI.

In 2006, net cash provided by operating activities increased \$235.5 million to \$263.2 million compared to the prior year. An increase in cash provided by changes in inventories of \$155.5 million was due to higher shipping volumes in 2006 compared to our inventories which were increasing in 2005 in anticipation of increased demand. Net income and the related effect of deferred income taxes provided increased cash flows of \$46.2 million in 2006 compared to 2005. Cash provided by the change in accrued wages, taxes and other items increased \$32.4 million primarily due to increases in employee wages and benefits of \$14.0 million (due to increased employee incentive compensation), interest payable of \$11.4 million and income taxes payable of \$6.3 million. With anticipated levels of capital expenditures, we will incur approximately \$30 million of additional federal income tax payments in the next five years due to depreciation timing differences.

In 2005, net cash provided by operating activities increased \$8.4 million to \$27.7 million compared to the prior year. Net income and the related effect of deferred income taxes increased cash flows \$103.1 million, which was offset predominately by an increase in cash used for inventories of \$69.1 million due to higher raw material costs and volumes. The change in accounts receivable, trade accounts payable and amounts payable to and receivable from TXI reflected the termination of an agreement to sell trade receivables.

In 2004, net cash provided by operating activities decreased \$8.8 million to \$19.3 million primarily as a result of decreased net advances received from TXI, offset by higher net income due to increased pricing and the related effect of deferred income taxes. Changes in working capital items were primarily the result of higher steel prices that increased net receivables by \$37.5 million in addition to the termination of an agreement to sell trade receivables which resulted in a total change of \$101.2 million.

Net cash used by investing activities was \$181.3 million in 2006, \$27.0 million in 2005 and \$14.1 million in 2004. Purchases of available-for-sale securities used cash of \$3.162 billion and sales of available-for-sale securities provided cash of \$2.998 billion in 2006. Capital expenditures were \$16.4 million in 2006, \$26.6 million in 2005 and \$13.9 million in 2004. Capital expenditures for normal replacement and improvement of our existing equipment are currently estimated to be approximately \$25-\$30 million over the next 12 months.

Net cash provided (used) by financing activities was \$48.5 million in 2006 which consisted of long-term borrowings of \$350.0 million, debt retirements of \$50.0 million and debt issuance costs of \$9.5 million under our loan agreements described below. In conjunction with our spin-off, we paid a cash dividend to TXI of \$341.1 million in the current year period. Net cash provided by issuance of common stock for the exercise of our stock options was \$2.1 million in 2006.

*Impact of the distribution and separation from TXI*

On June 16, 2005, we entered into a senior secured revolving credit facility (the "Credit Facility") which provides up to \$150.0 million of available borrowings. The Credit Facility includes a \$25.0 million sub-limit for letters of credit of which \$1.7 million was outstanding at May 31, 2006. Any outstanding letters of credit are deducted from the borrowing availability under the Credit Facility. Amounts drawn under the Credit Facility bear interest either at the LIBOR rate plus a margin of 1.00% to 1.75%, or at a base rate (which will be the higher of the federal funds rate plus 0.5% and the prime rate) plus a margin of up to 1%. The interest rate margins are subject to adjustments based on our leverage ratio. The commitment fee calculated on the unused portion of the Credit Facility ranges from 0.25% to 0.5% per year based on our leverage ratio. The Credit Facility matures June 16, 2010 and may be terminated by us at any time. The Credit Facility is secured by security interests in all of our existing and future accounts and inventory, certain related personal property and in all of the equity interest in our present and future domestic subsidiaries and 66% of the equity interest in our present and future foreign subsidiaries. The Credit Facility contains covenants restricting, among other things, prepayment or redemption of our other debt, distributions, dividends, and repurchases of capital stock and other equity interests, acquisitions and investments, indebtedness, liens and affiliate transactions. We are required to comply with certain financial tests and to maintain certain financial ratios, such as leverage and interest coverage ratios. On July 6, 2005, we borrowed \$50.0 million under the Credit Facility, none of which was outstanding at May 31, 2006. We did not borrow any funds under the Credit Facility during the nine months ended May 31, 2006; however, \$1.7 million of the facility was utilized to support letters of credit. The amount borrowed under the Credit Facility will fluctuate based upon our cash flow and working capital needs.

In addition, on July 6, 2005, we issued \$300.0 million aggregate principal amount of 10% senior notes due July 15, 2013 (the "Senior Notes"). The Senior Notes are unsecured and will effectively be subordinated in right of payment to all of our existing and future senior secured debt, including borrowings under our Credit Facility. Interest is due semi-annually on January 15<sup>th</sup> and July 15<sup>th</sup>. The indenture governing the Senior Notes contains covenants limiting our ability and the ability of our subsidiaries to, among other things, incur additional indebtedness, pay dividends or make other distributions or repurchase or redeem stock, make investments, sell assets, incur liens, enter into agreements restricting our subsidiaries' ability to pay dividends, enter into transactions with affiliates and consolidate, merge or sell all or substantially all of our assets or the assets of our subsidiaries. As of May 31, 2006, we were in compliance with all loan covenants.

On December 2, 2005, we completed the offer to exchange our 10% senior notes due 2013, which are registered under the Securities Act of 1933, as amended, for the outstanding 10% Senior Notes due 2013 that were issued in a private offering on July 6, 2005. The terms of the registered notes are substantially identical to the Company's previously outstanding Senior Notes.

We used the net proceeds from our Credit Facility and Senior Notes to pay a cash dividend of \$341.1 million to TXI on July 6, 2005.

Any inter-company accounts to TXI that remained immediately prior to the distribution were contributed to our capital. As a result of these transactions, our interest expense decreased to \$32.0 million in 2006 compared to \$47.3 million in 2005.

The accompanying financial statements include all costs of our steel business. For all periods prior to July 30, 2005, these costs include the allocation of certain corporate expense from TXI. TXI's corporate expenses

have been allocated to us based on either the percentage of time employees incurred performing services for us or specifically identified costs incurred by TXI for us. Management believes the allocations were made on a reasonable basis. However, the consolidated financial statements may not necessarily reflect our financial position, results of operations and cash flows in the future.

We believe the net cash provided by our operating activities, supplemented as necessary with borrowings under the Credit Facility, and existing cash and cash equivalents and short-term investments will provide sufficient resources to meet our working capital requirements, debt service and other cash needs over the next year.

#### *Contractual obligations*

The following table summarizes our future payments under material contractual obligations to third parties at May 31, 2006.

	<u>Total</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010-2011</u>	<u>After 2011</u>
	(in thousands)					
Long-term debt .....	\$300,000	\$ —	\$ —	\$ —	\$ —	\$300,000
Interest on long-term debt .....	216,121	30,586	30,588	30,586	60,611	63,750
Processed gas supply contract purchase obligations .....	41,839	6,370	6,370	6,371	12,741	9,987
In-plant mill services purchase obligations ...	24,334	4,668	4,668	4,668	9,337	993
Short-term energy purchase obligations .....	30,869	30,869	—	—	—	—
Defined benefit plan .....	48,568	183	274	475	1,909	45,727
Asset retirement obligations .....	14,698	31	32	33	1,068	13,534
Operating lease obligations .....	1,990	405	76	61	124	1,324
<b>Total .....</b>	<b>\$678,419</b>	<b>\$73,112</b>	<b>\$42,008</b>	<b>\$42,194</b>	<b>\$85,790</b>	<b>\$435,315</b>

We have entered into an agreement to purchase a minimum monthly amount of processed gases at a base price adjusted quarterly based upon a percentage change in the producer price index. The gases are produced from a facility located at our Texas facility and owned and operated by an independent third-party. This agreement expires in August 2012. At May 31, 2006, the minimum monthly charge was approximately \$0.5 million. We entered into a similar agreement to purchase processed gases for the Virginia facility with the same third-party which expires in December 2014. The agreement specifies that we will purchase a minimum monthly amount of processed gases at a base price adjusted quarterly based upon a similar formula. At May 31, 2006, the minimum monthly charge was approximately \$0.1 million. We believe our minimum purchase requirements will be satisfied by our consumption of the products in the normal course of our business.

We have entered into an agreement to purchase a minimum monthly amount of mill services at our Texas facility. This agreement expires in December 2014. At May 31, 2006, the minimum monthly charge was approximately \$23,000. We have entered into a similar agreement to purchase a minimum monthly amount of mill services for the Virginia facility. This agreement expires in June 2011. At May 31, 2006, the minimum monthly charge was approximately \$0.4 million. We believe that our minimum purchase requirements will be satisfied by our consumption of the products in the normal course of our business.

We have entered into agreements to purchase minimum amounts of electricity and natural gas for our Texas facility. Total commitments under these agreements were \$5.6 million in 2006. As of May 31, 2006, our commitments under these agreements extend through October 2006 which will allow our production facility to operate without the threat of interruption caused by volatile energy prices during the summer months and the majority of the Gulf Coast hurricane season. We believe our purchase requirements will be satisfied by our consumption of these energy sources in the normal course of our business.

On July 21, 2005, our board of directors approved the Chaparral Steel Company financial security plan ("FSP") a non-qualified defined benefit plan providing death and retirement benefits to our executive and key managerial employees who are invited and elect to participate. The plan is contributory but not funded.

Our asset retirement obligations represent the estimated undiscounted costs for legal obligations associated with the retirement of long-lived assets. We lease certain mobile and other equipment, office space and other items, which in the normal course of business are renewed or replaced by subsequent leases. Total expense for such operating leases amounted to \$1.7 million in 2006, \$2.0 million in 2005 and \$2.0 million in 2004.

#### **Other Items**

*Off-balance sheet arrangements.* We have no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

*Environmental matters.* We are subject to federal, state and local environmental laws and regulations concerning, among other matters, air emissions, furnace dust disposal and wastewater discharge. We believe we are in substantial compliance with applicable environmental laws and regulations; however, from time to time we receive claims from federal and state environmental regulatory agencies and entities asserting that we are or may be in violation of certain environmental laws and regulations. Based on our experience in dealing with such claims in the past and the information currently available to us regarding any potential or outstanding claims, we believe that such claims will not have a material impact on our financial condition or results of operations. Despite our compliance and experience, it is possible that we could be held liable for future charges which might be material but are not currently known or estimable. In addition, changes in federal or state laws, regulations or requirements or discovery of currently unknown conditions could require additional expenditures by us.

*Inflation.* Inflation has not had a material effect on our results of operations during the three years in the period ended May 31, 2006.

### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

#### **Market Risk**

We have not entered into derivatives or other financial instruments for trading or speculative purposes.

As noted under Recent Developments, on July 6, 2005, we entered into a senior secured revolving credit facility (the "Credit Facility") which provides up to \$150 million of available borrowings. Amounts drawn under the Credit Facility bear interest either at the LIBOR rate plus a margin of 1.00% to 1.75%, or at a base rate (which will be the higher of the federal funds rate plus 0.50% and the prime rate) plus a margin of up to 1.00%. The interest rate margins are subject to adjustments based on our leverage ratio. Accordingly, fluctuations in interest rates will impact the interest we pay on borrowings under this Credit Facility. On July 6, 2005, we also issued \$300 million aggregate principal amount of fixed-rate 10% senior unsecured notes. Although fluctuations in interest rates will not impact the interest we pay on this debt, it would impact the fair value of this debt.

In the normal course of our business, we are exposed to market risk for price fluctuations related to the sale of steel products and to the purchase of commodities used in the steel production process, principally scrap steel, electricity and natural gas. We attempt to negotiate the best prices for our raw materials and energy requirements and to obtain prices for our steel products that match market price movements in response to supply and demand. We have implemented a raw material surcharge program, derived from a published scrap price index, designed to pass some of the increased costs associated with rising raw material prices through to customers.

Steel mini-mills consume large amounts of electricity and natural gas. The electric industry has been deregulated in Texas since January 2002. The Texas plant purchases electricity through a local retail electric

provider using various long and short term supply arrangements. The Commonwealth of Virginia is in transition to a deregulated market for electricity. Electricity for the Virginia plant is purchased through the local utility under an interruptible supply contract with periodic adjustments for fuel costs. Natural gas is purchased from local gas marketers and delivered to our plants through local transportation agreements. Historically, we have not used financial instruments to mitigate price fluctuations on such purchases; however, we may use such financial instruments when appropriate.

We have not engaged in formal hedging activities to mitigate risks associated with fluctuations in currency values, but we do periodically review the potential impact of this risk to ensure that the risk of significant potential losses is minimized.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**The Board of Directors and Stockholders  
Chaparral Steel Company**

We have audited the accompanying consolidated balance sheets of Chaparral Steel Company and subsidiaries (the Company) as of May 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended May 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Chaparral Steel Company and subsidiaries at May 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended May 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, in fiscal year 2004 the Company changed its method of accounting for asset retirement obligations.

/s/ Ernst & Young LLP

Dallas, Texas  
July 19, 2006

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

(In thousands, except share data)

	May 31,	
	<u>2006</u>	<u>2005</u>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents .....	\$ 42,583	\$ 9,287
Short-term investments .....	164,000	—
Accounts receivable—net .....	159,721	127,383
Inventories .....	159,803	246,223
Receivable from TXI .....	—	40,734
Prepaid expenses .....	7,465	11,097
<b>Total current assets .....</b>	<b><u>533,572</u></b>	<b><u>434,724</u></b>
Other assets:		
Goodwill .....	85,166	85,166
Investments and deferred charges .....	16,807	5,099
	<u>101,973</u>	<u>90,265</u>
Property, plant and equipment:		
Land and land improvements .....	96,926	93,937
Buildings .....	55,570	54,954
Machinery and equipment .....	1,032,697	1,025,475
Construction in process .....	28,867	28,074
	<u>1,214,060</u>	<u>1,202,440</u>
Less depreciation .....	620,083	575,187
	<u>593,977</u>	<u>627,253</u>
	<b><u>\$1,229,522</u></b>	<b><u>\$1,152,242</u></b>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Trade accounts payable .....	\$ 49,979	\$ 88,980
Accrued wages, taxes and other liabilities .....	55,392	20,933
<b>Total current liabilities .....</b>	<b><u>105,371</u></b>	<b><u>109,913</u></b>
Deferred income taxes and other credits .....	155,645	147,563
Long-term debt .....	300,000	—
Long-term payable to Texas Industries, Inc. ....	—	543,246
Stockholders' equity:		
Common stock, \$0.01 par value .....	231	228
Additional paid-in capital .....	707,804	206,818
Retained earnings (deficit) .....	(39,529)	144,474
	<u>668,506</u>	<u>351,520</u>
	<b><u>\$1,229,522</u></b>	<b><u>\$1,152,242</u></b>

See notes to consolidated financial statements.

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except per share)

	Year Ended May 31,		
	2006	2005	2004
Net sales .....	\$1,466,729	\$1,116,376	\$ 905,324
Costs and expenses (income):			
Cost of products sold .....	1,161,173	925,766	842,228
Selling, general and administrative .....	46,652	28,730	30,173
Interest .....	32,015	47,275	49,597
Other income, net .....	(12,457)	(5,605)	(7,677)
	<u>1,227,383</u>	<u>996,166</u>	<u>914,321</u>
Income (loss) before income taxes and accounting change .....	239,346	120,210	(8,997)
Income taxes (benefit) .....	82,210	42,090	(3,199)
Income (loss) before accounting change .....	157,136	78,120	(5,798)
Cumulative effect of accounting change—net of income taxes .....	—	—	480
Net income (loss) .....	<u>\$ 157,136</u>	<u>\$ 78,120</u>	<u>\$ (5,318)</u>
Basic earnings (loss) per share:			
Income (loss) before accounting change .....	\$ 6.87	\$ 3.43	\$ (.25)
Cumulative effect of accounting change .....	—	—	.02
Net income (loss) .....	<u>\$ 6.87</u>	<u>\$ 3.43</u>	<u>\$ (.23)</u>
Diluted earnings (loss) per share:			
Income (loss) before accounting change .....	\$ 6.64	\$ 3.43	\$ (.25)
Cumulative effect of accounting change .....	—	—	.02
Net income (loss) .....	<u>\$ 6.64</u>	<u>\$ 3.43</u>	<u>\$ (.23)</u>
Average shares outstanding:			
Basic .....	<u>22,878</u>	<u>22,804</u>	<u>22,804</u>
Diluted .....	<u>23,673</u>	<u>22,804</u>	<u>22,804</u>

See notes to consolidated financial statements.

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	Year Ended May 31.		
	2006	2005	2004
Operating activities:			
Net income (loss) .....	\$ 157,136	\$ 78,120	\$ (5,318)
Adjustments to reconcile net income (loss) to net cash provided by operating activities			
Cumulative effect of accounting change .....	—	—	(480)
Depreciation .....	50,116	48,881	49,599
Deferred income taxes .....	741	33,572	13,865
Other—net .....	4,595	3,397	345
Changes in operating assets and liabilities			
Accounts receivable .....	(32,338)	(24,211)	(101,187)
Inventories .....	86,420	(69,063)	2,766
Prepaid expenses .....	3,914	(4,290)	8,138
Accounts payable .....	(39,001)	33,920	1,252
Accrued wages, taxes and other .....	35,912	3,548	4,108
Other credits .....	5,943	40	1,352
Receivable from or payable to TXI .....	(10,286)	(76,227)	44,875
Net cash provided by operating activities .....	<u>263,152</u>	<u>27,687</u>	<u>19,315</u>
Investing activities:			
Capital expenditures .....	(16,424)	(26,581)	(13,875)
Purchases of short-term investments .....	(3,162,385)	—	—
Sales of short-term investments .....	2,998,385	—	—
Other—net .....	(914)	(395)	(193)
Net cash used by investing activities .....	<u>(181,338)</u>	<u>(26,976)</u>	<u>(14,068)</u>
Financing activities:			
Long-term debt .....	350,000	—	—
Debt retirements .....	(50,000)	—	—
Debt issuance costs .....	(9,500)	—	—
Dividend to Texas Industries, Inc. ....	(341,139)	—	—
Issuance of common stock .....	2,121	1	—
Net cash provided (used) by financing activities .....	<u>(48,518)</u>	<u>1</u>	<u>—</u>
Increase in cash and cash equivalents .....	33,296	712	5,247
Cash and cash equivalents at beginning of period .....	9,287	8,575	3,328
Cash and cash equivalents at end of period .....	<u>\$ 42,583</u>	<u>\$ 9,287</u>	<u>\$ 8,575</u>

See notes to consolidated financial statements.

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
(In thousands)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Total Stockholders' Equity
May 31, 2003 .....	\$ —	\$ —	\$204,446	\$ 71,672	\$ 276,118
Net loss .....	—	—	—	(5,318)	(5,318)
Tax benefit from exercise of stock options .....	—	—	1	—	1
May 31, 2004 .....	—	—	204,447	66,354	270,801
Net income .....	—	—	—	78,120	78,120
Tax benefit from exercise of stock options .....	—	—	2,598	—	2,598
Issuance of common stock to parent .....	—	228	(227)	—	1
May 31, 2005 .....	—	228	206,818	144,474	351,520
Net income .....	—	—	—	157,136	157,136
Contribution by Texas Industries, Inc. ....	—	—	496,096	—	496,096
Dividend paid to Texas Industries, Inc. ....	—	—	—	(341,139)	(341,139)
Restricted stock amortization .....	—	—	406	—	406
Tax benefit from exercise of stock options .....	—	—	2,337	—	2,337
Issuance of common stock for options .....	—	3	2,147	—	2,150
May 31, 2006 .....	<u>\$ —</u>	<u>\$ 231</u>	<u>\$707,804</u>	<u>\$ (39,529)</u>	<u>\$ 668,506</u>

See notes to consolidated financial statements.

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Description of Business and Basis of Presentation**

Chaparral Steel Company and its subsidiaries (the "Company") is a leading supplier of structural steel and steel bar products through a single business segment. The Company produces and sells structural steel, piling products, special bar quality products, merchant bar quality rounds, reinforcing bar and channels from facilities located in Texas and Virginia. Structural steel products include wide flange beams, channels, piling products and other shapes. Steel bar products include specialty bar products and, to a lesser extent, reinforcing bar. The Company sells to steel service centers and steel fabricators for use in the construction industry, as well as to cold finishers, forgers and original equipment manufacturers for use in the railroad, defense, automotive, manufactured housing and energy industries. The Company's products are marketed throughout the United States, Canada and Mexico, and to a limited extent in Europe. All of the Company's long-lived assets are located in the United States.

On December 15, 2004, Texas Industries, Inc. and its subsidiaries ("TXI") announced a plan to spin-off its steel business to TXI stockholders. On July 29, 2005, the spin-off was completed in the form of a pro-rata, tax-free dividend to TXI stockholder's of one share of the Company's common stock for each share of TXI stock owned on July 20, 2005. See Note 13 "Spin-off from TXI".

For all periods prior to the spin-off, the Company's costs include the allocation of certain corporate expenses from TXI. TXI's corporate expenses have been allocated to the Company based on either the percentage of time employees incurred performing services for the company or specifically identified costs incurred by TXI for the Company. Management believes that the allocations were made on a reasonable basis. However, the consolidated financial statements may not necessarily reflect the financial position, results of operations and cash flows of the Company in the future, nor is it practical for management to estimate what the financial position, results of operations or cash flows would have been if the Company had been an independent, public company for the historical periods presented. See Note 12 for additional information.

**2. Summary of Significant Accounting Policies**

*Principles of Consolidation.* The consolidated financial statements include the accounts of Chaparral Steel Company and all subsidiaries.

*Estimates.* The preparation of financial statements and accompanying notes in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported. Actual results could differ from those estimates.

*Fair Value of Financial Instruments.* The estimated fair value of each class of financial instruments as of May 31, 2006 and May 31, 2005 approximates its carrying value except for the Senior Notes having a fixed interest rate at May 31, 2006. The fair value of the Senior Notes at May 31, 2006, estimated based on quoted market prices, was \$334.5 million compared to the carrying amount of \$300.0 million.

*Cash Equivalents.* Investments with maturities of less than 90 days when purchased are classified as cash equivalents and consist primarily of money market funds and investment grade commercial paper issued by major corporations and financial institutions.

*Short-term investments.* Short-term investments consist of Auction Rate Securities ("ARS"). At May 31, 2006, these ARS have remaining stated maturities which range from 14 to 34 years, but have their interest rates reset at predetermined intervals, typically less than 30 days, through an auction process. The Company invests in high credit quality instruments of political subdivisions of states with an active resale market to ensure liquidity and the ability to readily convert these investments into cash to fund current operations or satisfy other cash

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

requirements as needed. Accordingly, the Company classified all these securities as available-for-sale and as current assets in the accompanying balance sheet as of May 31, 2006. The ARS are stated at cost which approximates fair value based on market quotes. Net unrealized gains and losses, net of deferred taxes, have not been significant. The Company limits the amount of credit exposure to any one issuer. The Company expects that the majority of its short-term investments will be sold within one year, regardless of legal maturity date. Purchases and sales activity of ARS are presented as cash flows from investing activities in the consolidated statements of cash flows.

*Receivables.* Management evaluates the ability to collect accounts receivable based on a combination of factors. A reserve for doubtful accounts is maintained based on historical default rates and current economic trends. The reserve is increased if it is anticipated that a specific customer will be unable to make required payments. Concentrations of credit risk with respect to accounts receivable are limited due to the large number of customers in our customer base and their dispersion across geographical areas. No single customer represented more than 10% of the Company's total consolidated revenues in fiscal year 2006.

*Environmental Liabilities.* The Company is subject to environmental laws and regulations established by federal, state and local authorities and makes provision for the estimated costs related to compliance when it is probable that a reasonably estimable liability has been incurred.

*Legal Contingencies.* The Company and its subsidiaries are defendants in lawsuits which arose in the normal course of business, and make provision for the estimated loss from any claim or legal proceeding when it is probable that a reasonably estimable liability has been incurred.

*Long-lived Assets.* Management reviews long-lived assets for impairment whenever changes in circumstances indicate that the carrying amount of the assets may not be recoverable and would record an impairment charge if necessary. Such evaluations compare the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset and are significantly impacted by estimates of future prices for the Company's products, capital needs, economic trends and other factors. All of the Company's long-lived assets are located in the United States.

Property, plant and equipment is recorded at cost. Provisions for depreciation are computed generally using the straight-line method. The Company assigns each fixed asset a useful life generally ranging from 5 to 7 years for mobile and other equipment, 10 to 20 years for machinery and equipment and 20 to 40 years for buildings and land improvements. Maintenance and repairs are charged to expense as incurred. Costs incurred for scheduled shut-downs to refurbish the facilities are amortized over the benefited period, typically 12 months. Such deferred amounts are included in prepaid expenses on the consolidated balance sheets and amounted to \$3.4 million at May 31, 2006 and \$7.9 million at May 31, 2005.

*Goodwill.* Management tests goodwill for impairment at least annually. If the carrying amount of the goodwill exceeds its fair value, an impairment loss is recognized. In applying a fair-value-based test, estimates are made of the expected future cash flows to be derived from the applicable reporting unit. Similar to the review for impairment of other long-lived assets, the resulting fair value determination is significantly impacted by estimates of future prices for the Company's products, capital needs, economic trends and other factors. At May 31, 2006 and 2005, the fair value of the Company's goodwill on the balance sheet exceeded its carrying value.

*Investments and Deferred Charges.* Investments are composed primarily of life insurance contracts that may be used to fund certain Company benefit agreements. The contracts, recorded at their net cash surrender value, totaled \$8.3 million at May 31, 2006 and \$5.1 million at May 31, 2005. Deferred charges are composed primarily of debt issuance costs that totaled \$8.5 million at May 31, 2006 and none at May 31, 2005. The costs are associated with various debt issues and amortized over the term of the related debt.

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

*Other Credits.* Other credits of \$13.8 million at May 31, 2006 and \$7.4 million at May 31, 2005 are composed primarily of liabilities related to the Company's retirement plans, asset retirement obligations and deferred compensation agreements.

*Asset Retirement Obligations.* Effective June 1, 2003, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement Obligations", which applies to legal obligations associated with the retirement of long-lived assets.

SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The fair value of the liability is added to the carrying amount of the associated asset and this additional carrying amount is depreciated over the life of the asset. The liability is accreted at the end of each period through a charge to operating expense. If the obligation is settled for other than the carrying amount of the liability, the Company will recognize a gain or loss on settlement.

The Company incurs legal obligations for asset retirement as part of its normal operations related to the Resource Conservation and Recovery Act closures. Prior to the adoption of SFAS No. 143, the Company generally accrued for land reclamation obligations as incurred. Determining the amount of any asset retirement liability requires estimating the future cost of contracting with third parties to perform the obligation. The estimate is significantly impacted by, among other considerations, management's assumptions regarding the scope of the work required, labor costs, inflation rates, market-risk premiums and closure dates. The initial application of the new rules resulted in a pretax cumulative credit of \$0.7 million.

Changes in asset retirement obligations for the year ended May 31, 2006 and May 31, 2005 are as follows (in thousands):

	May 31, 2006	May 31, 2005
Balance at beginning of period .....	\$ 566	\$ 537
Accretion expense .....	96	60
Settlements .....	(49)	(31)
Revisions .....	427	—
Balance at end of period .....	<u>\$1,040</u>	<u>\$ 566</u>

*Net Sales.* The Company sells product to a highly diversified customer base representing various steel consuming markets. A significant portion of the Company's sales are to steel service centers, fabricators and processors. These customers typically act as intermediaries between steel producers and various end-user manufacturers that require further processing or inventory programs. The Company recognizes revenue when the goods are shipped and title and risk of loss transfer to the customer (FOB shipping point). The Company includes delivery fees in the amount it bills customers to the extent needed to recover the Company's cost of freight and delivery. The following table summarizes the Company's net sales by product line. Other products revenue is generated from the Company's metals separation operation.

	Year Ended May 31,		
	2006	2005	2004
	(in thousands)		
Net sales			
Structural mills .....	\$1,103,075	\$ 790,789	\$ 643,043
Bar mill .....	239,886	238,934	177,967
Other products .....	41,871	32,254	27,076
Delivery fees .....	81,897	54,399	57,238
	<u>\$1,466,729</u>	<u>\$1,116,376</u>	<u>\$ 905,324</u>

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Sales to customers located outside of the United States represented 11.4%, 12.7% and 11.7% of the Company's net sales in 2006, 2005, 2004, respectively. These customers were primarily located in Canada and Mexico, with no individual country accounting for more than 10% of the Company's net sales in any of the periods presented.

*Other Income.* Other income primarily includes miscellaneous sales and interest income.

*Income Taxes.* The Company uses the liability method of recognizing and classifying deferred income taxes. The Company and its subsidiaries will be included in the consolidated income tax returns of TXI for periods prior to the spin-off and will file stand alone returns for subsequent periods. However, the provision for income taxes for the periods presented has been determined as if the Company had filed separate tax returns. The Company provides valuation allowances to reduce deferred tax assets to amounts that will more likely than not be realized.

*Earnings (loss) per share (EPS).* For periods subsequent to the spin-off, Basic EPS is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted EPS adjusts net income and the outstanding shares for the dilutive effect of stock options and other equity-based awards. For periods prior to the spin-off, EPS has been computed based on the number of shares of the Company's common stock issued to TXI as of July 29, 2005. See Note 13, "Spin-off from TXI". During 2006, the Company issued 269,590 shares of common stock as a result of the exercise of stock options and 31,000 shares of common stock as a result of non-employee director restricted stock awards.

	<u>Year ended May 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(In thousands except per share)		
Basic and diluted earnings (loss)			
Income (loss) before accounting change .....	\$157,136	\$78,120	\$ (5,798)
Cumulative effect of accounting change .....	—	—	480
Basic and diluted net income (loss) .....	<u>\$157,136</u>	<u>\$78,120</u>	<u>\$ (5,318)</u>
Shares			
Weighted-average shares outstanding .....	<u>22,878</u>	<u>22,804</u>	<u>22,804</u>
Basic weighted-average shares .....	22,878	22,804	22,804
Dilutive stock option and other equity-based awards .....	795	—	—
Diluted weighted-average shares .....	<u>23,673</u>	<u>22,804</u>	<u>22,804</u>
Basic earnings (loss) per share			
Income (loss) before accounting change .....	\$ 6.87	\$ 3.43	\$ (0.25)
Cumulative effect of accounting change .....	—	—	0.02
Net income (loss) .....	<u>\$ 6.87</u>	<u>\$ 3.43</u>	<u>\$ (0.23)</u>
Diluted earnings (loss) per share			
Income (loss) before accounting change .....	\$ 6.64	\$ 3.43	\$ (0.25)
Cumulative effect of accounting change .....	—	—	0.02
Net income (loss) .....	<u>\$ 6.64</u>	<u>\$ 3.43</u>	<u>\$ (0.23)</u>

*Stock-based Compensation.* The Company's employees and non-employee directors participate in stock compensation plans. The plans provide for the granting of incentive and non-qualified stock options, restricted

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

stock and other equity-based incentive awards for officers, key employees and non-employee directors. Prior to the spin-off, the Company's employees and certain non-employee directors participated in TXI's stock compensation plans.

The Company accounts for employee stock options using the intrinsic value method of accounting prescribed by APB Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees," as allowed by SFAS No. 123, "Accounting for Stock-Based Compensation". Generally, no expense is recognized related to the Company's stock options because each option's exercise price is set at the stock's fair market value on the date the option is granted.

In accordance with SFAS No. 123, the Company discloses the compensation cost based on the estimated fair value at the date of grant recognizing compensation expense ratably over the vesting period. For those plan participants of the Company, the fair value of each option grant was estimated on the date of grant for purposes of the pro forma disclosures using the Black-Scholes option-pricing model and assumptions applicable to the underlying common stock. In 2006, the fair value of options granted to the Company's employees ranged from \$8.42 to \$15.92 based on assumptions for dividend yield of 0.0%, volatility factors ranging from .385 to .461, risk-free interest rates ranging from 4.0% to 4.5% and expected life in years of 6.5. In 2005, the weighted-average fair value of TXI options granted to the Company's employees was \$23.86 based on weighted average assumptions for dividend yield of .50%, volatility factor of .345, risk-free interest rate of 3.89% and expected life in years of 6.4. TXI options granted to Company employees were 73,000 in 2005. No options were granted to the Company's employees in 2004.

Therefore, had compensation expense for stock options held by the Company's employee participants been recognized based upon the fair value for awards granted, the Company's net income (loss) would have been reduced to the following pro forma amounts:

	Year Ended May 31,		
	2006	2005	2004
	(in thousands, except per share)		
Net income (loss)			
As reported .....	\$157,136	\$78,120	\$(5,318)
Stock-based compensation included in the determination of net income			
(loss) reported, net of tax .....	454	11	17
Fair value of stock-based compensation, net of tax .....	(1,271)	(20)	(1,686)
Pro forma .....	<u>\$156,319</u>	<u>\$78,111</u>	<u>\$(6,987)</u>
Net earning per share-as reported			
Basic .....	<u>\$ 6.87</u>	<u>\$ 3.43</u>	<u>\$ (.23)</u>
Diluted .....	<u>\$ 6.64</u>	<u>\$ 3.43</u>	<u>\$ (.23)</u>
Net earning per share-pro forma			
Basic .....	<u>\$ 6.83</u>	<u>\$ 3.43</u>	<u>\$ (.31)</u>
Diluted .....	<u>\$ 6.60</u>	<u>\$ 3.43</u>	<u>\$ (.31)</u>

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment". SFAS No. 123R is a revision of SFAS No. 123, "Accounting for Stock Based Compensation", and supersedes APB No. 25. Among other items, SFAS No. 123R eliminates the use of APB No. 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of services received in exchange for awards of equity instruments,

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

based on the grant date fair value of those awards, in the financial statements. The Company adopted SFAS No. 123R effective June 1, 2006 using the "modified prospective" method. Under the modified prospective method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS No. 123R for all share-based payments granted after that date, and based on the requirements of SFAS No. 123 for all unvested awards granted prior to the effective date of SFAS No. 123R. Financial information for periods prior to the date of adoption of SFAS No. 123R will not be restated. The Company will utilize the standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options and awards of equity instruments to employees and directors.

The adoption of SFAS No. 123R will have a significant effect on the Company's future results of operations. However, it will not have an impact on the Company's consolidated financial position. The entire impact of SFAS No. 123R on the Company's results of operations cannot be predicted at this time, because it will depend on the number of equity awards granted in the future, as well as future financial measurements contained in the model used to value the awards. However, had the Company adopted the requirements of SFAS No. 123R in prior periods, the impact would have approximated the amounts disclosed above.

SFAS No. 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated, because they depend on, among other things, when employees exercise stock options. However, the amount of operating cash flows recognized in prior periods for such excess tax deductions, for 2006, 2005, and 2004 were not material.

**3. Working Capital**

Working capital totaled \$428.2 million at May 31, 2006 and \$324.8 million at May 31, 2005.

Short-term investments were \$164.0 million at May 31, 2006 and none at May 31, 2005 and consisted of Auction Rate Securities all of which had stated maturities of over 10 years but have their interest rates reset at predetermined intervals, typically less than 30 days, through an auction process.

Accounts receivable are presented net of allowances for doubtful receivables of \$1.8 million at May 31, 2006 and 2005. Provisions (recoveries) for bad debts charged (credited) to expense were (\$0.2) million in 2006, \$0.9 million in 2005 and \$2.6 million in 2004. Uncollectible accounts written off amounted to \$0.2 million in 2006, \$0.6 million in 2005 and \$1.7 million in 2004.

Prior to June 6, 2003, TXI had an agreement with a financial institution to sell, on a revolving basis, an interest in a defined pool of trade receivables. The maximum amount outstanding varied based upon the level of eligible receivables. The Company sold its qualifying receivables to TXI at a discount and received an interest bearing note in exchange. The Company's receivables sold to TXI totaled \$63.7 million at May 31, 2003. On June 6, 2003, TXI entered into an agreement with a financial institution whereby the entire outstanding interest in the defined pool of trade receivables previously sold was repurchased and the agreement to sell receivables to TXI was terminated. The repurchase was reflected as an increase in accounts receivable. Sales of receivables to TXI were reflected as reductions of accounts receivable. As collections reduced previously sold interests, new accounts receivable were customarily sold to TXI. The Company retained collection and administration responsibilities for the receivables sold to TXI.

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Inventories consist of:

	May 31,	
	2006	2005
	(in thousands)	
Finished products .....	\$ 52,373	\$107,475
Work in process .....	15,348	22,021
Raw materials .....	16,952	33,904
Supplies .....	75,130	82,823
	\$159,803	\$246,223

Inventories, excluding supplies, are stated at cost (not in excess of market) using the last-in, first-out (“LIFO”) method that results in better matching of costs and revenues. If the average cost method (which approximates current replacement cost) had been used, these inventory values would have been higher by \$51.5 million at May 31, 2006 and \$63.1 million at May 31, 2005. During 2006, certain inventory quantities were reduced, which resulted in a liquidation of LIFO inventory layers carried at lower costs. The effect of the liquidation was to decrease cost of products sold by \$11.2 million in 2006. Supplies primarily consist of rolls and molds, which are used in the manufacturing processes, and are carried at average cost.

In December 2004, the FASB issued SFAS No. 151, “Inventory Costs, an amendment of ARB No. 43, Chapter 4,” which became effective for the Company beginning June 1, 2006. This standard clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted material should be expensed as incurred and not included in overhead. In addition, this standard requires that the allocation of fixed production overhead cost to inventory be based on the normal capacity of the production facilities. Based on current market conditions and historical plant performance, the new standard is not expected to have a material impact on the Company’s financial position and results of operations.

Accrued wages, taxes and other liabilities consist of:

	May 31,	
	2006	2005
	(in thousands)	
Employee wages and benefits .....	\$26,354	\$12,389
Current portion of deferred income taxes .....	—	572
Property taxes .....	3,135	3,156
Current income taxes payable .....	6,695	412
Interest payable .....	11,431	—
Other liabilities .....	7,777	4,404
	\$55,392	\$20,933

**4. Commitments**

The Company has entered into an agreement to purchase a minimum monthly amount of processed gases at a base price adjusted quarterly based upon a percentage change in the producer price index. The gases are produced from a facility located at the Company’s Texas facility and owned and operated by an independent third-party. This agreement expires in August 2012. At May 31, 2006, the minimum monthly charge was approximately \$0.5 million. The Company entered into a similar agreement to purchase processed gases for its Virginia facility with the same third-party which expires in December 2014. The agreement specifies that the



**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

credit are deducted from the borrowing availability under the Credit Facility. Amounts drawn under the Credit Facility bear interest either at the LIBOR rate plus a margin of 1.00% to 1.75%, or at a base rate (which will be the higher of the federal funds rate plus 0.5% and the prime rate) plus a margin of up to 1%. The interest rate margins are subject to adjustments based on the Company's leverage ratio. The commitment fee calculated on the unused portion of the Credit Facility ranges from 0.25% to 0.5% per year based on the Company's leverage ratio. The Credit Facility matures June 16, 2010 and may be terminated by the Company at any time. The Credit Facility is secured by security interests in all of the Company's existing and future accounts and inventory, certain related personal property and in all of the equity interest in the Company's present and future domestic subsidiaries and 66% of the equity interest in the Company's present and future foreign subsidiaries. The Credit Facility contains covenants restricting, among other things, prepayment or redemption of the Company's other debt, distributions, dividends, and repurchases of capital stock and other equity interests, acquisitions and investments, indebtedness, liens and affiliate transactions. The Company is required to comply with certain financial tests and to maintain certain financial ratios, such as leverage and interest coverage ratios. On July 6, 2005, the Company borrowed \$50.0 million under the Credit Facility, none of which was outstanding at August 31, 2005. The Company did not borrow any funds under the Credit Facility during the nine months ended May 31, 2006; however, \$1.7 million of the facility was utilized to support letters of credit. The amount borrowed under the Credit Facility will fluctuate based upon the Company's cash flow and working capital needs.

In addition, on July 6, 2005, the Company issued \$300.0 million aggregate principal amount of 10% senior notes due July 15, 2013 in a private offering. On December 2, 2005, the Company completed the offer to exchange senior notes due 2013 (the "Senior Notes"), which are registered under the Securities Act of 1933, as amended, for the outstanding 10% senior notes due 2013 that were issued in a private offering. The terms of the registered notes are substantially identical to the Company's previously outstanding senior notes. The Senior Notes are unsecured and will effectively be subordinated in right of payment to all of the Company's existing and future senior secured debt, including borrowings under the Company's Credit Facility. The indenture governing the Senior Notes contains covenants limiting the Company's ability and the ability of the Company's subsidiaries to, among other things, incur additional indebtedness, pay dividends or make other distributions or repurchase or redeem stock, make investments, sell assets, incur liens, enter into agreements restricting the Company's subsidiaries' ability to pay dividends, enter into transactions with affiliates and consolidate, merge or sell all or substantially all of the Company's assets or the assets of its subsidiaries. As of May 31, 2006, the Company was in compliance with all loan covenants.

The Company used the net proceeds from the Credit Facility and 10% senior notes to pay a cash dividend of \$341.1 million to TXI on July 6, 2005.

The amount of interest paid was \$19.4 million in 2006, \$47.3 million in 2005 and \$50.0 million in 2004. No interest was capitalized in 2006, 2005 or 2004.

**6. Stockholders' Equity**

Common stock consists of:

	May 31,	
	2006	2005
	(in thousands)	
Shares authorized .....	100,000	100,000
Shares outstanding .....	23,104	22,804

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Preferred stock consists of 10,000,000 authorized shares, \$.01 par value, none of which have been issued.

On July 21, 2005, the Company adopted a stockholders rights plan (the "Rights Agreement"). Pursuant to the Rights Agreement, the Company declared a dividend of rights (the "Rights") to purchase, upon the occurrence of certain events, one one-thousandth of a share of the Series A Junior Participating Preferred Stock, par value \$0.01 per share ("Preferred Stock"), for each outstanding share of common stock of the Company. Until the Rights become exercisable, all further issuances of common stock, including common stock issuable upon exercise of outstanding options, will include issuances of Rights. The Rights will be exercisable at \$90.00 per one one-thousandth of a share of Preferred Stock. The Rights will expire on July 29, 2015 unless extended or unless the Rights are earlier redeemed or exchanged by the Company.

The Rights are not exercisable nor are they transferable apart from the common stock until the earlier of (a) the tenth day after such time as a person or group acquires beneficial ownership of 15% of the Common Stock of the Company or (b) the tenth business day (unless extended by the Company's board of directors) after a person or group announces its intention to commence or commences a tender or exchange offer the consummation of which would result in beneficial ownership by a person or group of 15% or more of the common stock. The earlier of these dates is referred to as the "Distribution Date". As soon as practicable after the Distribution Date, separate right certificates will be issued and the Rights will become exercisable and transferable apart from the common stock.

The Preferred Stock issuable upon exercise of the Rights will be non-redeemable and rank junior to any other series of the Company's preferred stock that is outstanding. Each whole share of Preferred Stock will be entitled to receive a quarterly preferential dividend of \$1.00 per share but will be entitled to receive, in the aggregate, a dividend of 1,000 times the dividend declared on the Common Stock. In the event of liquidation, the holders of the Preferred Stock will be entitled to receive a preferential liquidation payment equal to the greater of \$1,000 per share, plus accrued and unpaid dividends, or, in the aggregate, a liquidation payment equal to 1,000 times the payment made per share of Common Stock. Each share of Preferred Stock will have 1,000 votes, voting together with the Common Stock. Finally, in the event of any merger, consolidation or other transaction in which shares of Common Stock are exchanged for or changed into other stock or securities, cash and/or other property, each share of Preferred Stock would be entitled to receive 1,000 times the amount received per share of Common Stock.

**7. Stock Compensation Plans**

Prior to the spin-off, certain of the Company's employees participated in TXI stock option plans which provided that non-qualified and incentive stock options to purchase TXI's common stock could be granted to officers and key employees at an exercise price no less than market price on the date of grant. Outstanding options became exercisable in installments beginning one year after date of grant and expire ten years from the date of grant. TXI options totaling 95,900 and 612,076 were exercisable by Company employees and directors as of May 31, 2005 and 2004 at a weighted-average option price of \$33.23 and \$32.45, respectively.

TXI options that were vested at the distribution date of July 29, 2005 and held by individuals who became or were retained as employees of the Company in connection with the spin-off were cancelled and replaced with the new TXI stock options. The exercise price of each new TXI option was based upon the respective market values of the two companies at the time the spin-off was completed so that the aggregate exercise price of the new options, as well as the ratio of the per-share fair market value of the shares to the per-share exercise price of the new TXI options, were the same as the cancelled TXI options. All other terms of the new TXI options remained the same as the cancelled TXI options.

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

On July 21, 2005, the Company's board of directors and on July 22, 2005, TXI as the sole stockholder of the Company approved the Company's Amended and Restated 2005 Omnibus Equity Compensation Plan which provides for grants of stock-based awards, including non-qualified and incentive stock options, restricted stock, restricted stock units, performance shares, and performance units to non-employee directors, officers and key employees of the Company. A maximum of 4,000,000 shares of the Company's common stock is available for issuance to participants under this plan.

TXI options that were unvested at the date of distribution and held by individuals who became or were retained as employees of the Company in connection with the spin-off were cancelled and replaced with options to purchase shares of the Company's common stock. The exercise price of each new option issued by the Company was based upon the respective market values of the two companies at the time the spin-off was completed so that the aggregate exercise price of the new options, as well as the ratio of the per-share fair market value of the shares to the per-share exercise price of the new options, remained the same as the cancelled TXI options. All other terms of the new Company options, were the same as the cancelled TXI options. Following the adjustment, there were 1,181,212 options outstanding to purchase shares of the Company's common stock at a weighted-average option price of \$8.39 per share. On January 13, 2006, certain options originally issued pursuant to TXI's 1993 Stock Option Plan were amended to conform the "change of control" provisions in such options with the terms of other options issued by the Company.

During 2006, officers and key employees were awarded options to purchase 613,713 shares of common stock. The options were granted at the market price of the common stock on the respective dates of grant, which ranged from \$18.40 to \$30.36. The term of the options is ten years and the options vest in equal annual installments over five years.

A summary of option transactions related to the Company's employees for the three years ended May 31, 2006, follows:

	Shares Under Option	Weighted- Average Option Price
TXI options outstanding at May 31, 2003 .....	996,136	\$ 29.86
Exercised .....	(26,550)	19.44
Canceled .....	(20,000)	31.19
TXI options outstanding at May 31, 2004 .....	949,586	30.13
Granted .....	73,000	60.27
Exercised .....	(624,466)	31.53
Canceled .....	(4,400)	34.78
TXI options outstanding at May 31, 2005 .....	393,720	33.43
Exercised .....	(31,000)	29.95
Canceled .....	(67,500)	34.42
Unvested TXI options outstanding at July 29, 2005 .....	295,220	33.57
Adjustment in connection with the spin-off from TXI .....	885,992	
Company options converted from TXI outstanding at July 29, 2005 .....	1,181,212	8.39
Granted .....	613,713	20.16
Exercised .....	(269,590)	(7.97)
Stock appreciation right converted .....	16,006	6.61
Canceled .....	(6,200)	(10.65)
Company options outstanding at May 31, 2006 .....	1,535,141	\$ 13.14

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Company options totaling 171,441 were exercisable as of May 31, 2006 at a weighted-average option price of \$7.18. Outstanding options expire on various dates through January 12, 2016.

The following table summarizes information about Company stock options held by the Company's employees outstanding as of May 31, 2006.

	Range of Exercise Prices		
	<u>\$5.35 - \$9.13</u>	<u>\$12.09 - \$18.40</u>	<u>\$20.245 - \$30.36</u>
Options outstanding:			
Shares outstanding .....	676,652	644,939	213,550
Weighted-average remaining life in years .....	6.35	8.95	9.32
Weighted-average exercise price .....	\$ 6.08	\$ 17.14	\$ 23.44
Options exercisable:			
Shares exercisable .....	154,712	16,729	—
Weighted-average exercise price .....	\$ 6.31	\$ 15.29	\$ —

In addition, during 2006, the Company's board of directors granted 31,000 shares of restricted stock to the non-employee directors pursuant to the Company's Amended and Restated 2005 Omnibus Equity Compensation Plan. These awards are consistent with the compensation package for non-employee directors previously approved on July 21, 2005. The Company recorded compensation expense of \$0.4 million related to these grants based on their vesting periods in 2006. Vesting is contingent upon the restricted stockholder remaining a director of the Company until the specified annual meeting of stockholders. Any shares of restricted stock awarded to a director which have not vested will be forfeited on the resignation or removal of the director. As of May 31, 2006, no shares of restricted stock were vested.

As of May 31, 2006, the aggregate intrinsic value (the difference in the market price of \$61.43 of the Company's common stock and the exercise price to be paid by the optionee) of stock options outstanding was \$74.1 million. The aggregate intrinsic value of exercisable stock options at that date was \$9.3 million. During 2006, the total intrinsic value of options exercised (the difference in the market price of the Company's common stock at the exercise date and the price paid by the optionee to exercise the option) was \$11.2 million.

As of May 31, 2006, the total future compensation cost related to previous grants of stock options to be recognized in the statement of operations following the adoption of FAS 123R was \$5.3 million while \$0.6 million remained to be recognized related to previous grants of restricted stock. The Company currently expects to recognize stock compensation expense of \$2.1 million, \$1.6 million, \$1.1 million, \$0.9 million and \$0.2 million in 2007, 2008, 2009, 2010 and 2011, respectively related to these grants.

**8. Income Taxes**

The provisions (benefit) for income taxes are composed of:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
		(in thousands)	
Current .....	\$81,469	\$ 8,518	\$(17,064)
Deferred .....	741	33,572	13,865
	<u>\$82,210</u>	<u>\$42,090</u>	<u>\$ (3,199)</u>

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Reconciliation from income taxes at the federal statutory rate to the preceding provisions (benefit) follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(in thousands)		
Taxes at statutory rate .....	\$83,771	\$42,074	\$(3,150)
Manufacturers deduction .....	(2,147)	—	—
State income taxes .....	938	8	(421)
Nontaxable interest .....	(674)	—	—
Other—net .....	322	8	372
	<u>\$82,210</u>	<u>\$42,090</u>	<u>\$(3,199)</u>

The components of the net deferred tax liability at May 31 are summarized below.

	<u>2006</u>	<u>2005</u>
	(in thousands)	
Deferred tax assets:		
Deferred compensation .....	\$ 5,220	\$ 2,446
Accrued expenses not currently tax deductible .....	2,812	2,626
Total deferred tax assets .....	8,032	5,072
Deferred tax liabilities:		
Property, plant and equipment .....	144,660	141,328
Inventory costs .....	4,197	4,484
Other .....	729	—
Total deferred tax liabilities .....	149,586	145,812
Net deferred tax liability .....	141,554	140,740
Current deferred tax (asset) liability .....	(254)	572
Long-term deferred tax liability .....	<u>\$141,808</u>	<u>\$140,168</u>

The Company made federal income tax payments of \$75.2 million in 2006, \$5.9 million in 2005 and received federal income tax reimbursements of \$16.8 million in 2004. All federal income tax obligations that arise for the periods prior to the spin-off will be settled with TXI. As of May 31, 2006, the Company has \$688.7 million in Virginia state net operating loss carryforwards that begin to expire in 2020. The Company also has Virginia state credits to offset future income tax liabilities of \$41.9 million that begin to expire in 2018 and \$10 million of credits that do not expire. The Company had net Virginia state deferred tax assets of \$47.4 million at May 31, 2006 and \$51.9 million at May 31, 2005. Management believes it is more likely than not that this net state deferred tax asset will be unrealized. Therefore, a valuation allowance has been recorded to fully reserve the amount of the net state deferred tax assets.

On October 22, 2004, the American Jobs Creation Act of 2004 (the "Jobs Creation Act"), became effective. Among other provisions, the Jobs Creation Act allows a deduction for income from qualified domestic production activities, which will be phased in from 2005 through 2010. For financial reporting purposes, any deduction for qualified domestic production activities is accounted for as a special deduction rather than as a rate reduction. Accordingly, the Company recorded a deduction of \$6.1 million in 2006. In addition, the Company recorded a net state deferred tax liability of \$0.7 million in 2006 primarily due to a new tax law enacted in May 2006. The Company's current tax provision will be affected by this legislation commencing in fiscal 2007.

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**9. Legal Proceedings and Contingent Liabilities**

The Company is subject to federal, state and local environmental laws and regulations concerning, among other matters, air emissions, furnace dust disposal and wastewater discharge. The Company believes it is in substantial compliance with applicable environmental laws and regulations; however, from time to time the Company receives claims from federal and state environmental regulatory agencies and entities asserting that the Company is or may be in violation of certain environmental laws and regulations. Based on its experience in dealing with such claims in the past and the information currently available to it regarding any potential or outstanding claims, the Company believes that such claims will not have a material impact on its consolidated financial condition or results of operations. Despite the Company's compliance and experience, it is possible that the Company could be held liable for future charges, which might be material but are not currently known or estimable. In addition, changes in federal and state laws, regulations and requirements or discovery of currently unknown conditions could require additional expenditures by the Company.

The Company and subsidiaries are defendants in lawsuits which arose in the normal course of business. In management's judgment (based on the opinion of counsel) the ultimate liability, if any, from such legal proceedings will not have a material effect on the consolidated financial position or results of operations of the Company.

In November 1998, the Company filed an action in the District Court of Ellis County, Texas against certain graphite electrode suppliers seeking damages for illegal restraints of trade in the sale of graphite electrodes. The Company obtained a settlement of \$4.2 million in 2004 and does not anticipate any material future settlements.

In connection with the Company's spin-off from TXI, the Company entered into a separation and distribution agreement and a tax sharing and indemnification agreement with TXI. In these agreements, the Company has agreed to indemnify TXI and its related parties against, among other things, any liabilities arising out of the businesses, assets or liabilities transferred to the Company and any taxes imposed on TXI in connection with the spin-off that result from the Company's breach of its covenants in the tax sharing and indemnification agreement. TXI has agreed to indemnify the Company and its related parties against, among other things, any liabilities arising out of the businesses, assets or liabilities retained by TXI and any taxes imposed on the Company in connection with the spin-off that result from TXI's breach of its covenants in the tax sharing and indemnification agreement.

The Company and TXI have made certain covenants to each other in connection with the spin-off that prohibit the Company and TXI from taking certain actions. Pursuant to these covenants: (1) the Company and TXI will, for a minimum of two years after the distribution date, continue the active conduct of the steel or cement business, respectively; (2) neither the Company nor TXI will repurchase its stock for two years following the distribution date of the spin-off except in certain circumstances permitted by the IRS; (3) neither the Company nor TXI will take any actions inconsistent with the representations made in the separation and distribution agreement or in connection with the issuance by tax counsel of its legal opinion with respect to the spin-off; and (4) neither the Company nor TXI will take any other action that would result in or fail to take any action necessary to prevent any tax being imposed on the spin-off. Each of the Company and TXI may take actions inconsistent with these covenants if it obtains an unqualified opinion of counsel or a private letter ruling from the IRS that such actions will not cause the spin-off to become taxable.

**10. Retirement Plans**

The Company's employees participate in a defined contribution retirement plan. Prior to January 1, 2006, the Company contributed 2% of each employee's eligible compensation and a variable contribution based on a predetermined formula established annually. After December 31, 2005, the Company will contribute 100% of

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

eligible contributions of up to 3% of employee compensation, and 50% of eligible contributions of the next 2% of employee compensation as defined by the plan. The amount of retirement expense charged to costs and expenses for this plan was \$2.9 million in 2006, \$2.5 million in 2005 and \$1.7 million in 2004. It is the Company's policy to fund the plan to the extent of charges to income.

On July 21, 2005, the Company's board of directors approved the Chaparral Steel Company financial security plan ("FSP") a non-qualified defined benefit plan providing death and retirement benefits to the Company's executive and key managerial employees who are invited and elect to participate. The plan is contributory but not funded. Participants elect the amount of their base salary that is covered by the plan. Costs and associated assets and liabilities related to the Company's employee participation are included in the financial information contained herein. Amounts payable to participants are to be paid exclusively from the general assets of the Company and are otherwise unsecured. Life insurance contracts have been purchased that may be used to fund the FSP payments. These insurance contracts, recorded at their net cash surrender value, totaled \$8.3 million at May 31, 2006 and \$5.1 million at May 31, 2005, and are included in investments on the consolidated balance sheets. The amount of FSP benefit expense and the projected FSP benefit obligation are determined using assumptions as of the end of each fiscal year. The weighted-average discount rate used was 6% in the current period. Actuarial gains or losses are recognized when incurred, and therefore, the end of year benefit obligation is the same as the accrued benefit costs recognized in the balance sheet. Prior to the spin-off, the Company's executive and key managerial employees who were invited and elected to do so, participated in a series of TXI financial security plans which had terms and conditions similar to those of the FSP adopted by the Company.

The estimated future benefit payments for each of the five succeeding years are \$0.2 million, \$0.3 million, \$0.5 million, \$0.9 million and \$1.0 million and for the five-year period thereafter an aggregate of \$5.9 million.

The amount of FSP benefit expense was as follows:

	Year Ended May 31,		
	2006	2005	2004
	(in thousands)		
Service cost .....	\$ 884	\$ 822	\$ 603
Interest cost .....	553	365	449
Amortization of costs .....	105	17	17
Recognized actuarial loss (gain) .....	—	566	806
Participant deferrals .....	(265)	(231)	(206)
	\$1,277	\$1,539	\$1,669

The following provides a reconciliation of the FSP benefit obligation.

	Year Ended May 31,	
	2006	2005
	(in thousands)	
Change in projected benefit obligation		
Benefit obligation at beginning of period .....	\$ 6,988	\$ 7,316
Service cost .....	884	822
Interest cost .....	553	365
Amortization of costs .....	105	17
Recognized actuarial loss .....	—	566
Transfer to TXI .....	—	(1,915)
Benefits paid .....	(183)	(183)
Benefit obligation at end of period .....	\$ 8,347	\$ 6,988

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**11. Incentive Plans**

All personnel employed by the Company as of May 31 and not subject to production-based incentive awards share in the pretax income of the Company for the year then ended based on predetermined formulas. The duration of the plan is one year. Certain executives are additionally covered under three-year plans with respect to the fiscal years ending May 31, 2006, 2007 and 2008. New plans will be subject to annual approval by the Company's board of directors. Incentive compensation related to these plans is included in selling, general and administrative expense and was \$16.7 million in 2006, \$4.2 million in 2005 and \$1.7 million in 2004.

**12. Transactions with TXI and affiliates**

Prior to the spin-off, TXI utilized a centralized cash management program for all of its subsidiaries, through which the Company received payments from TXI as a result of cash received from product sales or made payments to TXI or its subsidiaries for purchases of materials or services or for costs incurred on its behalf, including raw material procurement, payroll and capital expenditures. The current receivable from TXI also contained transactions with TXI under an inter-company tax sharing policy. Prior to the spin-off, TXI through one of its subsidiaries provided the Company with common carrier services, transporting finished product to the Company's customers and backhauling materials and supplies for the Company. These costs have been included in cost of products sold in the consolidated statements of operations and were \$0.6 million in 2006, \$6.6 million in 2005 and \$5.9 million in 2004. The Company believes that the rates charged to it for transportation services approximate the rates that would be charged by third parties. Following the spin-off, the Company has utilized assets transferred to it by TXI to operate its own common carrier service. Prior to the spin-off, TXI also allocated certain corporate expenses related primarily to shared services and facilities. Management believes that the allocations were made on a reasonable basis.

The long-term payable to Texas Industries, Inc. consisted of advances made by TXI to the Company for the construction of production facilities. Prior to the spin-off, the Company received or paid interest on its balances with TXI and its subsidiaries at a rate 8%. This rate does not necessarily represent the rate that the Company would have been able to obtain on loans from unaffiliated third parties.

In connection with the Company's spin-off from TXI (Note 13), the remaining inter-company accounts with TXI were converted to the capital of the Company and its subsidiaries. The Company's relationship with TXI is now governed by a separation and distribution agreement and the ancillary agreements described in that agreement. The terms of the agreements are more fully described in Note 9 "Legal Proceedings and Contingent Liabilities".

**13. Spin-off from TXI**

On December 14, 2004, TXI's board of directors adopted a plan to spin-off its steel operations, which was completed on July 29, 2005. In anticipation of the spin-off, the TXI and the Company entered into the following transactions:

On February 22, 2005, TXI formed a new, wholly-owned subsidiary, Chaparral Steel Company (the "Company"), to serve as the holding company for its steel business. The Company was initially capitalized for \$1,000 and issued 1,000 shares of its common stock, at \$0.01 par value per share, to TXI. On June 7, 2005, the Company's authorized capital stock was increased to 10,000,000 shares of preferred stock, \$.01 par value per share, and 100,000,000 shares of common stock, \$.01 par value per share.

On June 25, 2005, TXI transferred to the Company all of the stock of its subsidiaries that were engaged in its steel business, consisting of Chaparral Steel Investments Inc. and its subsidiaries and Chaparral (Virginia) Inc.

## CHAPARRAL STEEL COMPANY AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In addition, the Company issued 22,802,867 additional shares of the Company's common stock to TXI. These transactions have been accounted for as a reorganization of entities under common control. As a result, the assets and liabilities transferred to the Company were recorded at historical cost. In connection with these transactions, on July 6, 2005, TXI also contributed or transferred to the Company real estate and transportation assets used in the steel business. The Company assumed all liabilities arising out of the steel business and the transferred assets.

On June 16, 2005, the Company entered into a senior secured revolving credit facility which provides up to \$150.0 million of available borrowings and on July 6, 2005, the Company borrowed \$50.0 million under the credit facility. In addition, on July 6, 2005, the Company issued \$300.0 million aggregate principal amount of 10% senior notes due July 15, 2013. The terms of these debt instruments are more fully described in Note 5 "Long-term Debt".

The Company used the net proceeds from its senior secured revolving credit facility and 10% senior notes to pay a cash dividend of \$341.1 million to TXI.

At various times intercompany indebtedness were settled between and among the Company and its subsidiaries and TXI and its subsidiaries. These intercompany accounts were settled through offsets, contributions of such indebtedness to the capital of the debtor subsidiaries and other non-cash transfers. TXI has contributed \$496.1 million to the capital of the Company and its subsidiaries.

On July 21, 2005, the Company adopted the Rights Agreement Pursuant to the Rights Agreement, the Company declared a dividend of rights to purchase, upon the occurrence of certain events, one one-thousandth of a share of the Series A Junior Participating Preferred Stock, par value \$0.01 per share, for each outstanding share of common stock of the Company. The terms of the agreement are more fully described in Note 6 "Stockholders' Equity".

On July 29, 2005, the Company became an independent, public company. Although pursuant to the Company's separation and distribution agreement with TXI and certain ancillary agreements, TXI has agreed to indemnify the Company against certain liabilities and the Company has agreed to indemnify TXI against certain liabilities, TXI has no further ownership interest in the Company, and the Company has no ownership interest in TXI. In addition, the Company is not a guarantor of any of TXI's indebtedness nor is TXI a guarantor of any of the Company's indebtedness. The Company's relationship with TXI is now governed by the separation and distribution agreement and the ancillary agreements described in that agreement. The terms of the agreements are more fully described in Note 9 "Legal Proceedings and Contingent Liabilities".

#### 14. Condensed Consolidating Financial Information

On July 6, 2005, Chaparral Steel Company (the "Parent Company") issued \$300.0 million principal amount of its 10% senior notes due July 15, 2013. All of the Parent Company's consolidated domestic subsidiaries have guaranteed the 10% senior notes. The guarantees are full and unconditional and are joint and several. There are no significant restrictions on the Parent Company's ability to obtain funds from any of the guarantor subsidiaries in the form of a dividend or loan. Additionally, there are no significant restrictions on a guarantor subsidiary's ability to obtain funds from the Parent Company or its direct or indirect subsidiaries. For periods prior to the quarter ended August 31, 2005, the Parent Company had no significant assets or operations independent of its investment in its subsidiaries.

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

The following condensed consolidating balance sheet as of May 31, 2006, and the condensed consolidating statement of operations and cash flows for the year then ended are provided for the Parent Company and all guarantor subsidiaries. The information has been presented as if the Parent Company accounted for its ownership of the guarantor subsidiaries using the equity method of accounting.

<u>In thousands</u>	<u>Chaparral Steel Company</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminating Entries</u>	<u>Consolidated</u>
<i>Condensed consolidating balance sheet as of May 31, 2006</i>					
Cash and cash equivalents .....	\$ 35,939	\$ 6,644	\$ —	\$ —	\$ 42,583
Short-term investments .....	164,000	—	—	—	164,000
Accounts receivable-net .....	—	159,721	—	—	159,721
Intercompany receivables .....	—	251,985	—	(251,985)	—
Inventories .....	—	159,803	—	—	159,803
Prepaid expenses .....	173	7,292	—	—	7,465
Total current assets .....	200,112	585,445	—	(251,985)	533,572
Goodwill .....	—	85,166	—	—	85,166
Investments and deferred charges .....	16,807	—	—	—	16,807
Investments in subsidiaries .....	1,026,771	—	—	(1,026,771)	—
Property, plant and equipment—net .....	—	593,977	—	—	593,977
Total assets .....	<u>\$1,243,690</u>	<u>\$1,264,588</u>	<u>\$ —</u>	<u>\$(1,278,756)</u>	<u>\$1,229,522</u>
Trade accounts payable .....	\$ 179	\$ 49,800	\$ —	\$ —	\$ 49,979
Intercompany payables .....	251,985	—	—	(251,985)	—
Accrued wages, taxes and other liabilities .....	17,620	37,772	—	—	55,392
Total current liabilities .....	269,784	87,572	—	(251,985)	105,371
Deferred income taxes and other credits ...	5,400	150,245	—	—	155,645
Long-term debt .....	300,000	—	—	—	300,000
Stockholders' equity .....	668,506	1,026,771	—	(1,026,771)	668,506
Total liabilities and stockholders' equity .....	<u>\$1,243,690</u>	<u>\$1,264,588</u>	<u>\$ —</u>	<u>\$(1,278,756)</u>	<u>\$1,229,522</u>

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

<u>In thousands</u>	<u>Chaparral Steel Company</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminating Entries</u>	<u>Consolidated</u>
<i>Condensed consolidating statement of operations for the year ended May 31, 2006</i>					
Net sales .....	\$ —	\$1,466,729	\$ —	\$ —	\$ 1,466,729
Costs and expenses (income)					
Cost of products sold .....	—	1,161,173	—	—	1,161,173
Selling, general and administrative .....	2,034	44,618	—	—	46,652
Interest, net .....	29,169	2,846	—	—	32,015
Other income .....	(3,441)	(9,016)	—	—	(12,457)
	<u>27,762</u>	<u>1,199,621</u>	<u>—</u>	<u>—</u>	<u>1,227,383</u>
Income (loss) before income taxes .....	(27,762)	267,108	—	—	239,346
Income taxes (benefit) .....	(10,227)	92,437	—	—	82,210
	<u>(17,535)</u>	<u>174,671</u>	<u>—</u>	<u>—</u>	<u>157,136</u>
Equity in earnings (loss) of subsidiaries .....	174,671	—	—	(174,671)	—
Net income (loss) .....	<u>\$ 157,136</u>	<u>\$ 174,671</u>	<u>\$ —</u>	<u>\$(174,671)</u>	<u>\$ 157,136</u>
<i>Condensed consolidating statement of cash flows for the year ended May 31, 2006</i>					
Net cash provided by operating activities ..	\$ 72	\$ 263,080	\$ —	\$ —	\$ 263,152
Investing activities					
Capital expenditures .....	—	(16,424)	—	—	(16,424)
Purchases of short-term investments ..	(3,162,385)	—	—	—	(3,162,385)
Purchases of short-term investments ..	2,998,385	—	—	—	2,998,385
Intercompany advances .....	248,817	(248,817)	—	—	—
Other-net .....	(433)	(481)	—	—	(914)
Net cash provided (used) by investing activities .....	84,384	(265,722)	—	—	(181,338)
Financing activities					
Long-term borrowings .....	350,000	—	—	—	350,000
Debt issuance costs .....	(9,500)	—	—	—	(9,500)
Debt retirements .....	(50,000)	—	—	—	(50,000)
Issuance of common stock .....	2,121	—	—	—	2,121
Dividend paid to TXI .....	(341,139)	—	—	—	(341,139)
Net cash used by financing activities .....	<u>(48,518)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(48,518)</u>
Increase (decrease) in cash and cash equivalents .....	35,938	(2,642)	—	—	33,296
Cash and cash equivalents at beginning of period .....	1	9,286	—	—	9,287
Cash and cash equivalents at end of period .....	<u>\$ 35,939</u>	<u>\$ 6,644</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 42,583</u>

**CHAPARRAL STEEL COMPANY AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**15. Quarterly Financial Information (Unaudited)**

<u>2006</u>	<u>Aug. 31</u>	<u>Nov. 30</u>	<u>Feb. 28</u>	<u>May 31</u>
	(in thousands, except per share)			
Net sales .....	\$338,405	\$348,130	\$374,649	\$405,545
Gross profit .....	41,211	64,883	95,399	104,063
Operating profit .....	35,074	59,490	82,052	94,745
Net income .....	17,751	34,003	49,244	56,138
Per share				
Basic earnings				
Net income .....	<u>\$ 0.78</u>	<u>\$ 1.49</u>	<u>\$ 2.15</u>	<u>\$ 2.44</u>
Dilutive earnings:				
Net income .....	<u>\$ 0.77</u>	<u>\$ 1.44</u>	<u>\$ 2.06</u>	<u>\$ 2.33</u>
<u>2005</u>	<u>Aug. 31</u>	<u>Nov. 30</u>	<u>Feb. 28</u>	<u>May 31</u>
	(in thousands, except per share)			
Net sales .....	\$290,781	\$249,119	\$259,119	\$317,357
Gross profit .....	62,466	49,269	39,308	39,567
Operating profit .....	55,201	44,307	34,127	33,850
Net income .....	28,122	21,014	14,247	14,737
Per share				
Basic earnings				
Net income .....	<u>\$ 1.23</u>	<u>\$ 0.92</u>	<u>\$ 0.62</u>	<u>\$ 0.65</u>
Dilutive earnings				
Net income .....	<u>\$ 1.23</u>	<u>\$ 0.92</u>	<u>\$ 0.62</u>	<u>\$ 0.65</u>

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.**

None.

**ITEM 9A. CONTROLS AND PROCEDURES.**

Our management, including the principal executive officer and principal financial officer, maintains our disclosure controls and procedures (as defined in Rule 13a-15(e) and the Securities Exchange Act of 1934) and has evaluated the effectiveness of our disclosure controls and procedures as of May 31, 2006. Based on such evaluation, the principal executive officer and principal financial officer have concluded that as of May 31, 2006, such disclosure controls and procedures are effective for the purpose of ensuring that material information required to be in the reports that we submit, file, furnish or otherwise provide to the SEC is made known to them by others on a timely basis and is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. There have not been any changes in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f) of the Securities Exchange Act of 1934) during the quarter ended May 31, 2006 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

In connection with our spin-off from TXI on July 29, 2005, responsibility for all of our corporate accounting, finance and internal audit functions was transferred from personnel at TXI to our personnel. We have created our own, or engaged third parties to provide these functions to replace those previously performed by TXI. These changes, although significant, are not likely to materially affect our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION.**

None.

## PART III

### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information with respect to our directors which is contained under the caption "Election of Directors" in our Proxy Statement for our 2006 Annual Meeting of Stockholders, is incorporated herein by reference to such Proxy Statement. The information with respect to our executive officers which is contained under the caption "Executive Officers" in our Proxy Statement for our 2006 Annual Meeting of Stockholders, is incorporated herein by reference to such Proxy Statement. The information with respect to our audit committee and our audit committee financial experts contained under the caption "Corporate Governance" in our Proxy Statement for our 2006 Annual Meeting of Stockholders, is incorporated herein by reference to such Proxy Statement. The information with respect to Section 16(a) beneficial ownership reporting compliance contained under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in our Proxy Statement for our 2006 Annual Meeting of Stockholders, is incorporated herein by reference to such Proxy Statement.

#### Code of Business Conduct and Ethics

We have adopted a corporate Ethical Business Conduct Policy (the "Code of Conduct") that applies to all of our directors and employees. The Code of Conduct is intended to promote:

- honest and ethical conduct;
- avoidance of conflicts of interest;
- full, fair, accurate, timely, and understandable disclosure in the reports and documents that we file with, or submit to, the SEC, and in all other public communications we make;
- compliance with all governmental laws, rules, and regulations;
- prompt internal reporting of violations of the Code of Conduct; and
- accountability for adherence to the Code of Conduct.

The Code of Conduct is a product of our commitment to honesty. We have also adopted an additional Code of Ethics applicable to our Chief Executive Officer and senior financial officers which, in addition to Code of Conduct, provides specific policies to promote full, fair, accurate, timely, and understandable disclosure in the reports and documents that we file with, or submit to, the SEC, and in all of our other public communications. You may access the Code of Conduct and the Code of Ethics on the Investor Relations-Corporate Governance page of our website at [www.chapusa.com](http://www.chapusa.com). In addition, copies of the Code of Conduct and the Code of Ethics may be obtained free of charge, upon written request to our Corporate Secretary at Chaparral Steel Company, 300 Ward Road, Midlothian, Texas 76065. Any amendments to the Code of Conduct or Code of Ethics and any waivers that are required to be disclosed by the rules of the SEC and the Nasdaq Stock Market, Inc. will be posted on our corporate website.

### ITEM 11. EXECUTIVE COMPENSATION.

The information contained under the captions "Executive Officer and Non-Employee Director Compensation," "Compensation Committee Interlocks and Insider Participation" and "Stock Performance", in our Proxy Statement for our 2006 Annual Meeting of Stockholders is incorporated herein by reference to such Proxy Statement.

### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

The information concerning (a) the beneficial ownership of our common stock by investors who own 5% or more of our common stock, our directors, nominees for election as a director, our chief executive officer, our

four most highly compensated executive officers (other than our chief executive officer), and all of our executive officers and directors as a group, that is contained under the captions "Security Ownership of Certain Beneficial Owners" and "Security Ownership of Management" in our Proxy Statement for the 2006 Annual Meeting of Stockholders, is incorporated herein by reference to such Proxy Statement.

**Equity Compensation Plan Information.**

The following table provides information regarding the number of shares of our common stock that may be issued on exercise of outstanding stock options under our Amended and Restated 2005 Omnibus Equity Compensation Plan (the "Plan") as of July 3, 2006.

<u>Plan Category</u>	<u>(A)</u> Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights	<u>(B)</u> Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	<u>(C)</u> Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (A))
Equity Compensation Plans			
Approved by Stockholders . . . . .	1,623,166	\$13.15	2,104,844
Equity Compensation Plans Not			
Approved by Stockholders . . . . .	n/a	n/a	n/a
Total . . . . .	1,623,166	\$13.15	2,104,844

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.**

None.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.**

The information with respect to our principal accountant's fees and services contained under the caption "Independent Auditors" in our Proxy Statement for the 2006 Annual Meeting of Stockholders is incorporated herein by reference to such Proxy Statement.

**PART IV**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.**

(a) The following documents are filed as a part of this report:

(1) Financial Statements and Schedules

Report of Independent Registered Public Accounting Firm .....	35
Consolidated Balance Sheets as of May 31, 2006 and May 31, 2005 .....	36
Consolidated Statements of Operations for the Years Ended May 31, 2006, May 31, 2005 and May 31, 2004 .....	37
Consolidated Statements of Cash Flows for the Years Ended May 31, 2006, May 31, 2005 and May 31, 2004 .....	38
Consolidated Statements of Stockholders' Equity for the Years Ended May 31, 2006, May 31, 2005 and May 31, 2004 .....	39
Notes to Consolidated Financial Statements .....	40

(2) Financial Statement Schedules

Financial statement schedules have been omitted because they are not applicable or the information required therein is included elsewhere in our financial statements or notes thereto.

(3) Listing of Exhibits

Articles of Incorporation and Bylaws.

- 3.1 Amended and Restated Certificate of Incorporation of Chaparral Steel Company.
- 3.2 Bylaws of Chaparral Steel Company.
- 3.3 Certificate of Designations of Series A Participating Preferred Stock, filed with the Secretary of State of Delaware on July 21, 2005.

Instruments defining the rights of security holders, including indentures.

- 4.1 Reference is made to Exhibit 3.1, Exhibit 3.2 and Exhibit 3.3.
- 4.2 Registration Rights Agreement, dated July 6, 2005, between Chaparral Steel Company, its domestic subsidiaries, Banc of America Securities LLC, UBS Securities LLC, SunTrust Capital Markets, Inc., Wells Fargo Securities, LLC, and Comerica Securities, Inc.
- 4.3 Form of Notation of Guarantee.
- 4.4 Form of Chaparral Steel Company's 10% Senior Note due 2013.
- 4.5 Indenture, dated July 6, 2005, among Chaparral Steel Company, certain of its domestic subsidiaries and Wells Fargo Bank, National Association, as Trustee.
- 4.6 Rights Agreement, effective as of July 29, 2005, between Chaparral Steel Company and Mellon Investor Services LLC, as rights agent.

Material Contracts.

- 10.1 Purchase Agreement, dated June 29, 2005, among Chaparral Steel Company, Banc of America Securities LLC, UBS Securities LLC, SunTrust Capital Markets, Inc., Wells Fargo Securities, LLC and Comerica Securities, Inc.
- 10.2 Credit Agreement, dated June 16, 2005, among Chaparral Steel Company, Bank of America, N.A., as administrative agent, letter of credit issuer, swing line lender and lender, UBS Securities LLC, as syndication agent, General Electric Capital Corporation, Wells Fargo Bank, National Association, and SunTrust Bank, as co-documentation agents and as lenders, and UBS Loan Finance LLC and Comerica Bank, as lenders.

- 10.3 Security Agreement, dated July 6, 2005, made by Chaparral Steel Company, certain of its domestic subsidiaries, and Bank of America, N.A. as administrative agent.
- 10.4 Separation and Distribution Agreement, dated July 6, 2005, between Texas Industries, Inc. and Chaparral Steel Company.
- 10.5 Amendment No. 1 to Separation and Distribution Agreement between Chaparral Steel Company and Texas Industries, Inc., dated July 27, 2005.
- 10.6 Tax Sharing and Indemnification Agreement, dated July 6, 2005, between Texas Industries, Inc. and Chaparral Steel Company.
- 10.7 Chaparral Steel Company Amended and Restated 2005 Omnibus Equity Compensation Plan. \*
- 10.8 Chaparral Steel Company Financial Security Plan. \*
- 10.9 Employment Agreement, effective as of January 13, 2006, between Chaparral Steel Company and Tommy A. Valenta. \*
- 10.10 Form of Incentive and Nonqualified Stock Option Agreement under the Chaparral Steel Company Amended and Restated 2005 Omnibus Equity Compensation Plan issued by Chaparral Steel Company in replacement of Texas Industries, Inc. options originally granted to Texas Industries, Inc. employees under the Texas Industries, Inc. 1993 Stock Option Plan and the related form of Amendment (Change of Control) to Stock Option Agreement. \*
- 10.11 Form of Incentive and Nonqualified Stock Option Agreement under the Chaparral Steel Company Amended and Restated 2005 Omnibus Equity Compensation Plan issued by Chaparral Steel Company in replacement of Texas Industries, Inc. options originally granted to Texas Industries, Inc. employees under the Texas Industries, Inc. 2004 Omnibus Equity Compensation Plan. \*
- 10.12 Form of Nonqualified Stock Option Agreement under the Chaparral Steel Company Amended and Restated 2005 Omnibus Equity Compensation Plan issued by Chaparral Steel Company in replacement of Texas Industries, Inc. options originally granted to Texas Industries, Inc. non-employee directors under the Texas Industries, Inc. 1993 Stock Option Plan and the related form of Amendment (Change of Control) to Stock Option Agreement. \*
- 10.13 Form of Nonqualified Stock Option Agreement under the Chaparral Steel Company Amended and Restated 2005 Omnibus Equity Compensation Plan issued by Chaparral Steel Company in replacement of Texas Industries, Inc. options originally granted to Texas Industries, Inc. non-employee directors under the Texas Industries, Inc. 2004 Omnibus Equity Compensation Plan. \*
- 10.14 Form of Stock Option Agreement for employees under the Chaparral Steel Company Amended and Restated 2005 Omnibus Equity Compensation Plan. \*
- 10.15 Form of Deferred Compensation Agreement for non-employee directors under the Chaparral Steel Company Amended and Restated 2005 Omnibus Equity Compensation Plan. \*
- 10.16 Form of Restricted Stock Agreement for non-employee directors under the Chaparral Steel Company Amended and Restated 2005 Omnibus Equity Compensation Plan. \*
- 10.17 Form of Texas Industries, Inc. Common Stock Award Plan and Award Letters for Tommy A. Valenta and William H. Dickert assumed by Chaparral Steel Company. \*
- 10.19 Three Year Cash Incentive Plan of Chaparral Steel Company for the three fiscal years ending May 31, 2007. \*
- 10.20 Three Year Cash Incentive Plan of Chaparral Steel Company for the three fiscal years ending May 31, 2008. \*

- 10.21 Three Year Incentive Plan Participant Designation Agreement. \*
- 10.23 Form of Amended and Restated Change of Control/Severance Agreement entered into with the officers of Chaparral Steel Company (other than the Chief Executive Officer) effective as of April 11, 2006. \*

Statements re computation of ratios.

- 12.1 Computation of Ratio of Earnings to Fixed Charges.

Code of Ethics.

- 14.1 Ethical Business Conduct Policy.
- 14.2 Code of Ethics for the CEO and Senior Financial Officers.

Subsidiaries of the Registrant.

- 21.1 Subsidiaries of Chaparral Steel Company.

Consents of Experts and Counsel.

- 23.1 Consent of Independent Registered Public Accounting Firm.

Rule 13a-14(a)/15d-14(a) Certifications.

- 31.1 Certification pursuant to Rule 13a-14(a)/15d-14(a) (Chief Executive Officer).
- 31.2 Certification pursuant to Rule 13a-14(a)/15d-14(a) (Chief Financial Officer).

Section 1350 Certifications.

- 32.1 Section 1350 Certifications (Chief Executive Officer).
- 32.2 Section 1350 Certifications (Chief Financial Officer).

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\* Management contract or compensatory plan

## 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.

Date: July 21, 2006

**CHAPARRAL STEEL COMPANY**  
(Registrant)

*/s/* TOMMY A. VALENTA

Tommy A. Valenta  
Director, Chief Executive Officer and President  
(Principal 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.

Date: July 21, 2006

*/s/* JAMES M. HOAK, JR.

James M. Hoak, Jr.  
Director, Chairman of the Board

Date: July 21, 2006

*/s/* TOMMY A. VALENTA

Tommy A. Valenta  
Director, Chief Executive Officer and President  
(Principal Executive Officer)

Date: July 21, 2006

*/s/* J. CELTYN HUGHES

J. Celytn Hughes  
Vice President and Chief Financial Officer  
(Principal Financial Officer)

Date: July 21, 2006

*/s/* M. KEVIN LINCII

M. Kevin Lynch  
Vice President and Controller  
(Principal Accounting Officer)

Date: July 21, 2006

*/s/* EUGENIO CLARIOND

Eugenio Clariond  
Director

Date: July 21, 2006

*/s/* RONALD J. GAFFORD

Ronald J. Gafford  
Director

Date: July 21, 2006

*/s/* JOSEPH M. GRANT

Joseph M. Grant  
Director

Date: July 21, 2006

*/s/* JOSEPH D. MAHAFFEY

Joseph D. Mahaffey  
Director

Date: July 21, 2006

*/s/* IAN WACHTMEISTER

Ian Wachtmeister  
Director

Date: July 21, 2006

*/s/* ELIZABETH C. WILLIAMS

Elizabeth C. Williams  
Director

**Certification Pursuant to Rule 13a-14(a)/15d-14(a)**  
**(Chief Executive Officer)**

**CERTIFICATION BY CHIEF EXECUTIVE OFFICER**

I, Tommy A. Valenta, certify that:

I have reviewed this annual report on Form 10-K of Chaparral Steel Company;

1. Based on my knowledge, this 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 report;
2. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
3. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
  - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
4. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; 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 over financial reporting.

Date: July 24, 2006

/s/ Tommy A. Valenta

Tommy A. Valenta  
Chief Executive Officer

**Certification Pursuant to Rule 13a-14(a)/15d-14(a)**  
**(Chief Financial Officer)**

**CERTIFICATION BY CHIEF FINANCIAL OFFICER**

I, J. Celtyn Hughes certify that:

I have reviewed this annual report on Form 10-K of Chaparral Steel Company;

1. Based on my knowledge, this 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 report;

2. Based on my knowledge, the financial statements, and other financial information included in this 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 report;

3. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

- a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
- b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
- c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

4. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; 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 over financial reporting.

Date: July 24, 2006

/s/ J. Celtyn Hughes

J. Celtyn Hughes  
Chief Financial Officer

**Section 1350 Certification  
(Chief Executive Officer)**

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Chaparral Steel Company (the "Company") on Form 10-K for the fiscal year ended May 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Tommy A. Valenta, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (i) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (ii) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: July 24, 2006

/s/ Tommy A. Valenta

Tommy A. Valenta  
Chief Executive Officer

**Certification Pursuant to Section 906 of the Sarbanes-Oxley Act  
(Chief Financial Officer)**

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Chaparral Steel Company (the "Company") on Form 10-K for the fiscal year ended May 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, J. Celtyn Hughes, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (i) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (ii) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: July 24, 2006

/s/ J. Celtyn Hughes

J. Celtyn Hughes  
Chief Financial Officer

**Management****Tommy A. Valenta**

President & Chief Executive Officer

**William H. Dickert**

Vice President  
Chief Operating Officer

**J. Celyn Hughes**

Vice President  
Chief Financial Officer

**Cary D. Baetz**

Vice President & Treasurer

**Timothy J. Bourcier**

Vice President  
Operations

**Daniel W. Brock**

Vice President  
Human Resources

**Robert E. Crawford, Jr.**

Vice President  
Secretary & General Counsel

**Richard T. Jaffre**

Vice President  
Raw Materials

**M. Kevin Linch**

Vice President  
Controller

**Von R. Mundy**

Vice President  
Logistics & Procurement

**Joe E. Prusa**

Vice President  
Tax & Audit

**Robert J. Simcoe**

Vice President  
Virginia Plant Manager

**Corporate Office**

300 Ward Road  
Midlothian, Texas 76065  
(972) 775-8241  
www.chapusa.com

**Board of Directors****James M. Hoak, Jr.**

Chairman of the Board,  
Chaparral Steel Company

Chairman and a Principal,  
Hoak Capital Corporation

**Tommy A. Valenta**

President and Chief Executive Officer,  
Chaparral Steel Company

**Eugenio Clariond**

Chairman of the Board and Chief Executive Officer,  
Grupo IMSA, S.A. of Monterrey, Mexico

**Ronald J. Gafford**

President and Chief Executive Officer,  
Austin Industries, Inc.

**Joseph M. Grant**

Chairman and Chief Executive Officer,  
Texas Capital Bancshares Inc.

**Joseph D. Mahaffey**

Private Investor

**Ian Wachtmeister**

Chief Executive Officer and Chairman,  
The Empire, AB of Stockholm, Sweden

**Elizabeth C. Williams**

Treasurer,  
Southern Methodist University

**Transfer Agent**

Stockholders of record who wish to change the ownership or address of stock, report lost, stolen or destroyed certificates, or who have questions about their accounts, please contact:

Mellon Investor Services, LLC  
480 Washington Blvd., 27th floor  
Jersey City, NJ 07310  
866-683-2966

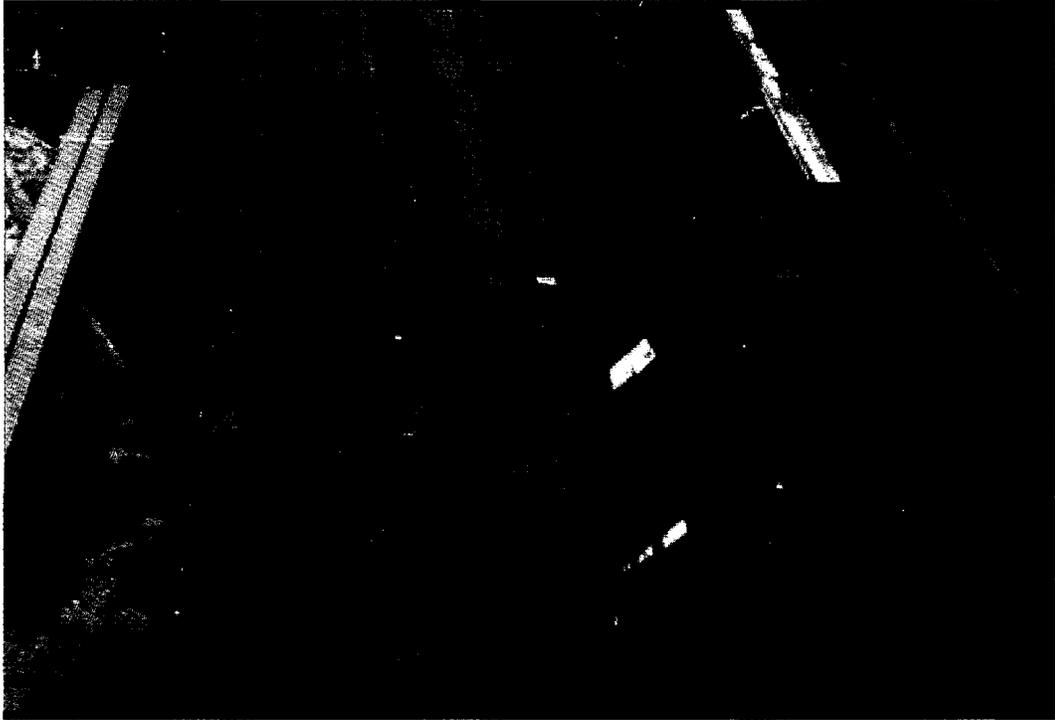
Chaparral Steel is traded on the NASDAQ under the symbol CHAP.

**Investor Information****Cary D. Baetz**

Vice President & Treasurer  
(972) 779-1032  
cbaetz@chapusa.com

**Annual Meeting**

Chaparral Steel Company's 2006 Annual Meeting of Stockholders will be held Tuesday, August 29, at the Hotel Crescent Court in Dallas, Texas.



**CHAPARRAL**  
**[WWW.CHAPUSA.COM](http://WWW.CHAPUSA.COM)**

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NEW ORLEANS A SAFER PLACE TO LIVE.*

