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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended July 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 1-5725

**QUANEX CORPORATION**

(Exact name of registrant as specified in its charter)

**DELAWARE**  
(State or other jurisdiction of  
incorporation or organization)

**38-1872178**  
(I.R.S. Employer  
Identification No.)

**1900 West Loop South, Suite 1500, Houston, Texas 77027**  
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: **(713) 961-4600**

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

Indicate by check mark whether the registrant 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

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

<b>Class</b>	<b>Outstanding at August 25, 2006</b>
Common Stock, par value \$0.50 per share	36,964,588

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

QUANEX CORPORATION  
CONSOLIDATED BALANCE SHEETS  
(Unaudited)

	July 31, 2006	October 31, 2005
	(In thousands except share data)	
<b>ASSETS</b>		
Current assets:		
Cash and equivalents	\$ 61,151	\$ 49,681
Accounts and notes receivable, net of allowance of \$4,657 and \$7,609	184,413	152,072
Inventories	156,424	133,003
Deferred income taxes	10,212	12,864
Other current assets	6,396	4,669
Current assets of discontinued operations	—	5,504
Total current assets	418,596	357,793
Property, plant and equipment, net	437,500	423,942
Goodwill	196,349	196,341
Cash surrender value insurance policies, net	24,733	24,927
Intangible assets, net	77,053	82,360
Other assets	9,814	9,002
Assets of discontinued operations	—	5,846
Total assets	<u>\$ 1,164,045</u>	<u>\$ 1,100,211</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 164,522	\$ 129,152
Accrued liabilities	57,657	73,616
Income taxes payable	9,220	14,465
Current maturities of long-term debt	2,727	2,459
Current liabilities of discontinued operations	—	4,208
Total current liabilities	234,126	223,900
Long-term debt	130,680	133,462
Deferred pension credits	—	8,158
Deferred postretirement welfare benefits	7,296	7,519
Deferred income taxes	62,224	58,836
Non-current environmental reserves	5,911	6,732
Other liabilities	2,508	2,742
Liabilities of discontinued operations	—	2,120
Total liabilities	442,745	443,469
Stockholders' equity:		
Preferred stock, no par value, shares authorized 1,000,000; issued and outstanding none	—	—
Common stock, \$0.50 par value, shares authorized 50,000,000; issued 38,319,959 and 38,198,199	19,155	19,092
Additional paid-in-capital	207,225	198,333
Retained earnings	546,396	445,670
Unearned compensation	—	(1,388)
Accumulated other comprehensive loss	(3,172)	(3,217)
	769,604	658,490
Less treasury stock, at cost, 1,225,042 and 0 shares	(46,556)	—
Less common stock held by Rabbi Trust, 130,329 shares	(1,748)	(1,748)
Total stockholders' equity	721,300	656,742
Total liabilities and stockholders' equity	<u>\$ 1,164,045</u>	<u>\$ 1,100,211</u>

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

**QUANEX CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
	(In thousands, except per share amounts)			
<b>Net sales</b>	\$ 553,047	\$ 492,559	\$ 1,504,852	\$ 1,485,737
Cost and expenses:				
Cost of sales (exclusive of items shown separately below)	442,789	373,323	1,191,414	1,141,897
Selling, general and administrative expense	23,963	26,938	68,776	73,869
Depreciation and amortization	17,268	16,077	52,566	47,844
<b>Operating income</b>	69,027	76,221	192,096	222,127
Interest expense	(1,234)	(2,463)	(3,689)	(7,758)
Other, net	2,296	(743)	2,763	(2,082)
Income from continuing operations before income taxes	70,089	73,015	191,170	212,287
Income tax expense	(25,186)	(28,110)	(69,986)	(81,734)
<b>Income from continuing operations</b>	44,903	44,905	121,184	130,553
Income (loss) from discontinued operations, net of taxes	(20)	27	(115)	(2,039)
Gain (loss) on sale of discontinued operations, net of taxes	250	(217)	(61)	(4,579)
<b>Net income</b>	<u>\$ 45,133</u>	<u>\$ 44,715</u>	<u>\$ 121,008</u>	<u>\$ 123,935</u>
<b>Basic earnings per common share:</b>				
Earnings from continuing operations	\$ 1.20	\$ 1.19	\$ 3.21	\$ 3.46
Income (loss) from discontinued operations	\$ —	\$ (0.01)	\$ (0.01)	\$ (0.17)
Basic earnings per share	<u>\$ 1.20</u>	<u>\$ 1.18</u>	<u>\$ 3.20</u>	<u>\$ 3.29</u>
<b>Diluted earnings per common share:</b>				
Earnings from continuing operations	\$ 1.14	\$ 1.14	\$ 3.05	\$ 3.33
Income (loss) from discontinued operations	\$ —	\$ (0.01)	\$ —	\$ (0.16)
Diluted earnings per share	<u>\$ 1.14</u>	<u>\$ 1.13</u>	<u>\$ 3.05</u>	<u>\$ 3.17</u>
<b>Weighted-average common shares outstanding:</b>				
Basic	37,531	37,857	37,785	37,700
Diluted	39,857	39,945	40,190	39,591
Cash dividends per share	\$ 0.1200	\$ 0.0900	\$ 0.3433	\$ 0.2700

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

**QUANEX CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOW**  
**(Unaudited)**

	Nine Months Ended July 31,	
	2006	2005
	(In thousands)	
<b>Operating activities:</b>		
Net income	\$ 121,008	\$ 123,935
Loss (income) from discontinued operations	176	6,618
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	53,045	48,283
Deferred income taxes	6,040	3,150
Stock-based compensation	3,883	590
Changes in assets and liabilities, net of effects from acquisitions and dispositions:		
(Increase) decrease in accounts and notes receivable	(32,335)	16,162
(Increase) decrease in inventory	(23,396)	(6,040)
Increase (decrease) in accounts payable	35,370	(40,730)
Increase (decrease) in accrued liabilities	(12,846)	(847)
Increase (decrease) in income taxes payable	(5,253)	11,491
Increase (decrease) in deferred pension and postretirement benefits	(11,942)	1,544
Other, net	(4,024)	(1,275)
Cash provided by (used for) operating activities from continuing operations	129,726	162,881
Cash provided by (used for) operating activities from discontinued operations	(762)	(2,147)
Cash provided by (used for) operating activities	<u>128,964</u>	<u>160,734</u>
<b>Investing activities:</b>		
Acquisitions, net of cash acquired	—	(200,519)
Proceeds from sale of discontinued operations	5,683	11,592
Capital expenditures, net of retirements	(60,964)	(35,297)
Retired executive life insurance proceeds	461	—
Other, net	275	674
Cash provided by (used for) investing activities from continuing operations	(54,545)	(223,550)
Cash provided by (used for) investing activities from discontinued operations	(14)	(362)
Cash provided by (used for) investing activities	<u>(54,559)</u>	<u>(223,912)</u>
<b>Financing activities:</b>		
Bank borrowings (repayments), net	(2,514)	29,865
Common stock dividends paid	(13,165)	(10,351)
Issuance of common stock from option exercises, including related tax benefits	11,112	10,328
Purchase of treasury stock	(58,326)	—
Other, net	—	568
Cash provided by (used for) financing activities from continuing operations	(62,893)	30,410
Cash provided by (used for) financing activities from discontinued operations	(56)	(158)
Cash provided by (used for) financing activities	<u>(62,949)</u>	<u>30,252</u>
Effect of exchange rate changes on cash equivalents	14	10
Increase (decrease) in cash and equivalents	11,470	(32,916)
Cash and equivalents at beginning of period	49,681	41,743
Cash and equivalents at end of period	<u>\$ 61,151</u>	<u>\$ 8,827</u>
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	\$ 4,020	\$ 7,959
Cash paid during the period for income taxes	\$ 64,493	\$ 58,914
Cash received during the period for income tax refunds	\$ —	\$ 171

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

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

<u>Nine months ended July 31, 2006</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Treasury Stock &amp; Other</u>	<u>Total Stockholders' Equity</u>
	(In thousands, except per share amounts)					
Balance at October 31, 2005	\$ 19,092	\$ 198,333	\$ 445,670	\$ (3,217)	\$ (3,136)	\$ 656,742
Net income			121,008			121,008
Common dividends (\$0.34 per share)			(13,165)			(13,165)
Treasury shares purchased, at cost					(58,326)	(58,326)
Reclassification of unearned compensation for restricted stock		(1,388)			1,388	—
Stock option and restricted stock activity, including related tax benefit	63	10,280	(7,117)		11,770	14,996
Other				45		45
Balance at July 31, 2006	<u>\$ 19,155</u>	<u>\$ 207,225</u>	<u>\$ 546,396</u>	<u>\$ (3,172)</u>	<u>\$ (48,304)</u>	<u>\$ 721,300</u>

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

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation**

The interim unaudited consolidated financial statements of Quanex Corporation and its subsidiaries (Quanex or the Company) include all adjustments, which, in the opinion of management, are necessary for a fair presentation of the Company's financial position and results of operations. All such adjustments are of a normal recurring nature. These financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X.

In March 2006, the Company effected a three-for-two stock split in the form of a 50% stock dividend. All prior periods presented have been adjusted on a retroactive basis after giving effect to such stock split.

In January 2006, the Company sold Temroc Metals, Inc. (Temroc) and in the first quarter of 2005, the Company sold its Piper Impact business. Accordingly, the assets and liabilities of Temroc and Piper Impact are reported as discontinued operations in the Consolidated Balance Sheets presented, and their operating results are reported as discontinued operations in the Consolidated Statements of Income and Consolidated Statements of Cash Flow (see Note 14).

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and notes thereto included in the Quanex Corporation Form 10-K filed with the U.S. Securities and Exchange Commission for the year ended October 31, 2005.

**2. New Accounting Pronouncements**

*Stock-Based Compensation*

On November 1, 2005, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), "*Share-Based Payment*" (SFAS 123R) issued by the Financial Accounting Standards Board (FASB) in December 2004. SFAS 123R requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in the consolidated financial statements. Prior to November 1, 2005, under the disclosure only provisions of SFAS No. 123, "*Accounting for Stock-Based Compensation*" (SFAS 123), the Company applied Accounting Principles Board (APB) Opinion No. 25, "*Accounting for Stock Issued to Employees*" (APB 25), and related Interpretations in accounting for its stock option plans. Accordingly, prior to fiscal 2006, the Company recognized zero stock-based compensation expense in its income statement for non-qualified stock options, as the exercise price was equal to the closing market price of the Company's stock on the date of grant. However, the Company did recognize stock-based compensation expense for its restricted stock plans as discussed in Note 15, Restricted Stock and Stock Option Plans, of the Notes to the Consolidated Financial Statements in its Annual Report on Form 10-K for the fiscal year ended October 31, 2005. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123R. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R.



**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

The Company elected the modified prospective transition method as permitted by the adoption of SFAS 123R. Under this transition method, stock-based compensation expense beginning as of November 1, 2005 includes (i) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of October 31, 2005, based on the grant-date fair value estimated in accordance with the original proforma provisions of SFAS 123; and (ii) compensation expense for all stock-based compensation awards granted subsequent to October 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Prior to the adoption of SFAS 123R, unearned compensation was shown as a reduction of stockholders' equity. The November 1, 2005 unearned compensation balance of \$1.4 million was reclassified against additional paid-in-capital upon adoption of SFAS 123R. In fiscal 2006 and future periods, common stock par value will be recorded when the restricted stock is issued and additional paid-in-capital will be increased as the restricted stock compensation cost is recognized for financial reporting purposes. In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R.

The Company recognizes compensation expense on a straight-line basis over the requisite service period of the award. As stock-based compensation expense recognized in the income statement beginning November 1, 2005 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, when necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. In the Company's proforma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred. Prior to the implementation of SFAS 123R, the Company computed stock-based compensation cost for employees eligible to retire over the standard vesting period of the grants. Upon adoption of SFAS 123R, the Company amortizes new option grants to such retirement-eligible employees immediately upon grant, consistent with the retirement vesting acceleration provisions of these grants. For employees near retirement age, the Company amortizes such grants over the period from the grant date to the retirement date if such period is shorter than the standard vesting schedule.

The following is the effect of adopting SFAS 123R as of November 1, 2005 (in thousands except per share amounts):

	<b>Three Months Ended July 31, 2006</b>	<b>Nine Months Ended July 31, 2006</b>
Decrease in operating income and income from continuing operations	\$ 744	\$ 3,104
Related deferred income tax benefit	(275)	(1,148)
Decrease in net income	<u>\$ 469</u>	<u>\$ 1,956</u>
Decrease in basic earnings per common share	\$ (0.01)	\$ (0.05)
Decrease in diluted earnings per common share	\$ (0.01)	\$ (0.05)

The amounts above relate to the impact of recognizing compensation expense for stock options only, as compensation expense related to restricted stock was recognized by the Company before implementation of SFAS 123R under previous accounting standards.

In accordance with SFAS 123R, the consolidated statements of cash flow report the excess tax benefits from the stock-based compensation as financing cash inflows. For the three and nine months ended July 31, 2006, \$0.3 million and \$4.7 million, respectively, of excess tax benefits were reported as financing cash inflows.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Under SFAS 123R, the Company continues to use the Black-Scholes-Merton option-pricing model to estimate the fair value of its stock options. However, the Company has applied the expanded guidance under SFAS 123R and SAB 107 for the development of the assumptions used as inputs for the Black-Scholes-Merton option pricing model for grants beginning November 1, 2005. The Company's fair value determination of stock-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company's expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behavior. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company's employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management's opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company's employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123R and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

On November 10, 2005, the FASB issued FASB Staff Position No. SFAS 123(R)-3, "*Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*" (FSP 123R-3). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123R. The Company has until November 2006 to make a one-time election to adopt the transition method described in FSP 123R-3. The Company is currently evaluating FSP 123R-3; however, the one-time election is not expected to affect operating income or net income.

See Note 11 for additional stock-based compensation disclosures.

*Other*

In July 2006, the FASB issued Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes*" (FIN 48) which is effective for fiscal years beginning after December 15, 2006 (as of November 1, 2007 for the Company) and is an interpretation of FASB Statement No. 109, "*Accounting for Income Taxes*". FIN 48 prescribes a recognition threshold and measurement attribute for recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition and expanded disclosure requirements. The Company is currently assessing the impact, if any, that the adoption of FIN 48 will have on the Company's financial statements.

In May 2005, the FASB issued SFAS No. 154, "*Accounting Changes and Error Corrections*" (SFAS 154), which replaces Accounting Principles Board Opinion No. 20, "*Accounting Changes*" and FASB Statement No. 3, "*Reporting Accounting Changes in Interim Financial Statements*". SFAS 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005 (the Company's fiscal 2007) and requires retrospective application to prior period financial statements of voluntary changes in accounting principles, unless it is impractical to determine either the period-specific effects or the cumulative effect of the change. The impact of SFAS 154 will depend on the nature and extent of voluntary accounting changes or error corrections, if any, after the effective date, but the Company does not expect SFAS 154 to have a material impact on its consolidated financial statements.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

In March 2005, the FASB issued Interpretation No. 47, “*Accounting for Conditional Asset Retirement Obligations*” (FIN 47) which is effective no later than the end of fiscal years ending after December 15, 2005 (as of October 31, 2006 for the Company) and is an interpretation of FASB Statement No. 143, “*Accounting for Asset Retirement Obligations*”. FIN 47 requires recognition of a liability for the fair value of a conditional asset retirement obligation when incurred if the fair value of the liability can be reasonably estimated. The Company does not expect the adoption of FIN 47 to have a material impact on its consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 153, “*Exchanges of Nonmonetary Assets, an Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions*” (SFAS 153), as part of its short-term international convergence project with the International Accounting Standards Board (IASB). Under SFAS 153, nonmonetary exchanges are required to be accounted for at fair value, recognizing any gains or losses, if their fair value is determinable within reasonable limits and the transaction has commercial substance. SFAS 153 is effective for the Company for nonmonetary asset exchanges beginning November 1, 2005. The adoption of SFAS 153 did not have a material impact on the consolidated financial position, results of operations or cash flows.

In October 2004, the President signed into law the American Jobs Creation Act (the AJC Act). The AJC Act allows for a federal income tax deduction for a percentage of income earned from certain domestic production activities. The Company’s U.S. production activities qualify for the deduction. Based on the effective date of this provision of the AJC Act, the Company is eligible for this deduction beginning in fiscal 2006. Additionally, in December 2004, the FASB issued FASB Staff Position 109-1, “*Application of FASB Statement No. 109, Accounting for Income Taxes (SFAS 109), to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004*” (FSP 109-1). FSP 109-1, which was effective upon issuance, requires the Company to treat the tax deduction as a special deduction instead of a change in tax rate that would have impacted the existing deferred tax balances. The Company has estimated that this special deduction will reduce the Company’s effective tax rate in fiscal 2006 by approximately 1%.

In November 2004, the FASB issued SFAS No. 151, “*Inventory Costs, an Amendment of ARB No. 43, Chapter 4*” (SFAS 151), which adopts wording from the IASB’s International Accounting Standard, “*Inventories*,” in an effort to improve the comparability of cross-border financial reporting. The new standard indicates that abnormal freight, handling costs and wasted materials are required to be treated as current period charges rather than as a portion of inventory costs. Additionally, the standard clarifies that fixed production overhead should be allocated based on the normal capacity of a production facility. SFAS 151 is effective for the Company for inventory costs incurred beginning as of November 1, 2005. The adoption of SFAS 151 did not have a material impact on the consolidated financial position, results of operations or cash flows.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**3. Acquired Intangible Assets**

Intangible assets consist of the following (in thousands):

	As of July 31, 2006		As of October 31, 2005	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Non-compete agreements	\$ 264	\$ 237	\$ 313	\$ 247
Patents	25,877	6,751	25,877	4,149
Trademarks and trade names	37,930	3,282	37,930	2,013
Customer relationships	23,691	3,064	23,691	1,893
Other intangibles	1,201	776	1,201	550
<b>Total</b>	<b>\$ 88,963</b>	<b>\$ 14,110</b>	<b>\$ 89,012</b>	<b>\$ 8,852</b>
Unamortized intangible assets:				
Trade name	\$ 2,200		\$ 2,200	

The aggregate amortization expense for the three and nine month periods ended July 31, 2006 was \$1.8 million and \$5.3 million, respectively. The aggregate amortization expense for the three and nine month periods ended July 31, 2005 was \$1.8 million and \$4.9 million, respectively. Estimated amortization expense for the next five years, based upon the amortization of pre-existing intangibles follows (in thousands):

Fiscal Years Ending October 31,	Estimated Amortization
2006 (remaining three months)	\$ 1,769
2007	7,033
2008	5,757
2009	3,873
2010	\$ 3,792

**4. Inventories**

Inventories consist of the following:

	July 31 2006	October 31, 2005
	(In thousands)	
Raw materials	\$ 44,479	\$ 32,696
Finished goods and work in process	95,656	86,077
	140,135	118,773
Supplies and other	16,289	14,230
<b>Total</b>	<b>\$ 156,424</b>	<b>\$ 133,003</b>

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

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

	<b>July 31 2006</b>	<b>October 31, 2005</b>
	<b>(In thousands)</b>	
LIFO	\$ 70,531	\$ 62,820
FIFO	85,893	70,183
Total	\$ 156,424	\$ 133,003

An actual valuation of inventory under the last in, first out (LIFO) method can be made only at the end of each year based on the inventory costs and levels at that time. Accordingly, interim LIFO calculations must be based on management's estimates of expected year-end inventory costs and levels. Because these are subject to many factors beyond management's control, interim results are subject to the final year-end LIFO inventory valuation which could significantly differ from interim estimates. To estimate the effect of LIFO on interim periods, the Company performs a projection of the year-end LIFO reserve and considers expected year-end inventory pricing and expected inventory levels. Depending on this projection, the Company may record an interim allocation of the projected year-end LIFO calculation. With respect to inventories valued using the LIFO method, replacement cost exceeded the LIFO value by approximately \$40.3 million and \$34.3 million as of July 31, 2006 and October 31, 2005, respectively.

**5. Earnings Per Share**

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

	<b>For the Three Months Ended</b>					
	<b>July 31, 2006</b>			<b>July 31, 2005</b>		
	<b>Income (Numerator)</b>	<b>Shares (Denominator)</b>	<b>Per- Share Amount</b>	<b>Income (Numerator)</b>	<b>Shares (Denominator)</b>	<b>Per- Share Amount</b>
Basic earnings per share	\$ 44,903	37,531	\$ 1.20	\$ 44,905	37,857	\$ 1.19
Effect of dilutive securities						
Common stock equivalents arising from settlement of contingent convertible debentures	493	1,776		480	1,360	
Common stock equivalents arising from stock options	—	354		—	581	
Restricted stock		66		—	15	
Common stock held by rabbi trust		130		—	132	
Diluted earnings per share	\$ 45,396	39,857	\$ 1.14	\$ 45,385	39,945	\$ 1.14

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

	For the Nine Months Ended					
	July 31, 2006			July 31, 2005		
	Income (Numerator)	Shares (Denominator)	Per- Share Amount	Income (Numerator)	Shares (Denominator)	Per- Share Amount
Basic earnings per share	\$ 121,184	37,785	\$ 3.21	\$ 130,553	37,700	\$ 3.46
Effect of dilutive securities						
Common stock equivalents arising from settlement of contingent convertible debentures	1,477	1,785		1,441	1,141	
Common stock equivalents arising from stock options		433		—	603	
Restricted stock		57		—	15	
Common stock held by rabbi trust		130		—	132	
Diluted earnings per share	\$ 122,661	40,190	\$ 3.05	\$ 131,994	39,591	\$ 3.33

The computation of diluted earnings per share excludes outstanding options in periods where inclusion of such options would be anti-dilutive in the periods presented. Options to purchase 0.2 million shares of common stock were outstanding as of July 31, 2006 but were not included in the computation of diluted earnings per share for the three and nine months ended July 31, 2006 as the options' exercise price was greater than the average market price of the common stock during those periods.

On January 26, 2005, the Company announced that it had irrevocably elected to settle the principal amount of its 2.50% Convertible Senior Debentures due 2034 (the Debentures) in cash when they become convertible and are surrendered by the holders thereof. The Company retains its option to satisfy any excess conversion obligation (stock price in excess of conversion price) with either shares, cash or a combination of shares and cash. As a result of the Company's election, diluted earnings per share include only the amount of shares it would take to satisfy the excess conversion obligation, assuming that all of the Debentures were surrendered. For calculation purposes, the average closing price of the Company's common stock for each of the periods presented is used as the basis for determining dilution.

**6. Comprehensive Income**

Comprehensive income comprises of net income and all other non-owner changes in equity, including realized and unrealized gains and losses on derivatives, minimum pension liability adjustments and foreign currency translation adjustments. Comprehensive income for the three and nine months ended July 31, 2006 and 2005 was as follows:

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
	(In thousands)			
Comprehensive income:				
Net income	\$ 45,133	\$ 44,715	\$ 121,008	\$ 123,935
Foreign currency translation adjustment	(14)	21	45	(2)
Total comprehensive income, net of taxes	\$ 45,119	\$ 44,736	\$ 121,053	\$ 123,933

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**7. Long-term Debt**

Long-term debt consists of the following:

	<b>July 31, 2006</b>	<b>October 31, 2005</b>
	<b>(In thousands)</b>	
“Bank Agreement” Revolver	\$ —	\$ —
2.50% Convertible Senior Debentures due 2034	125,000	125,000
City of Richmond, Kentucky Industrial Building Revenue Bonds	5,000	7,175
City of Huntington, Indiana Economic Development Revenue Bonds principle due 2010	1,665	1,665
Scott County, Iowa Industrial Waste Recycling Revenue Bonds	1,600	1,800
Capital lease obligations and other	142	281
	<u>\$ 133,407</u>	<u>\$ 135,921</u>
Less maturities due within one year included in current liabilities	2,727	2,459
	<u>\$ 130,680</u>	<u>\$ 133,462</u>

Approximately 95% and 93% of the total debt had a fixed interest rate at July 31, 2006 and October 31, 2005, respectively. See Interest Rate Risk section in Item 3 Quantitative and Qualitative Disclosures about Market Risk of this Form 10-Q for additional discussion.

*Bank Agreement*

The Company’s \$310.0 million Revolving Credit Agreement (Bank Agreement) is secured by all Company assets, excluding land and buildings. The Bank Agreement expires February 28, 2007 and provides for up to \$25.0 million for standby letters of credit, limited to the undrawn amount available under the Bank Agreement. All borrowings under the Bank Agreement bear interest, at the option of the Company, at either (a) the prime rate or federal funds rate plus one percent, whichever is higher, or (b) a Eurodollar based rate.

The Bank Agreement requires maintenance of certain financial ratios and maintenance of a minimum consolidated tangible net worth. As of July 31, 2006, the Company was in compliance with all current Bank Agreement covenants. The Company had no borrowings under the Bank Agreement as of July 31, 2006 and October 31, 2005. The aggregate availability under the Bank Agreement was \$296.0 million at July 31, 2006, which is net of \$14.0 million of outstanding letters of credit.

The Company anticipates executing a new five-year unsecured bank agreement prior to the end of calendar 2006. The new facility is expected to be increased to approximately \$350.0 million and is expected to bear interest at LIBOR based on a combined leverage and ratings grid.

*Convertible Senior Debentures*

On May 5, 2004, the Company issued \$125.0 million of the Debentures in a private placement offering. The Debentures were subsequently registered in October 2004 pursuant to the registration rights agreement entered into in connection with the offering. In June 2006, the Company filed a post-effective amendment to deregister all unsold securities under the registration statement as the Company’s obligation to maintain the effectiveness of such registration statement has expired; the post-effective amendment has not yet been declared effective. The net proceeds from the offering, totaling approximately \$122.0 million, were used to repay a portion of the amounts outstanding under the Bank

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Agreement. The Debentures are general unsecured senior obligations, ranking equally in right of payment with all existing and future unsecured senior indebtedness, and senior in right of payment to any existing and future subordinated indebtedness. The Debentures are effectively subordinated to all senior secured indebtedness and all indebtedness and liabilities of subsidiaries, including trade creditors.

The Debentures are only convertible under certain circumstances, including: (i) during any fiscal quarter if the closing price of the Company's common stock for at least 20 trading days in the 30 trading-day period ending on the last trading day of the previous fiscal quarter is more than 120% of the conversion price per share of the Company's common stock on such last trading day; (ii) if the Company calls the Debentures for redemption; or (iii) upon the occurrence of certain corporate transactions, as defined. Upon conversion, the Company has the right to deliver common stock, cash or a combination of cash and common stock. The Company may redeem some or all of the Debentures for cash any time on or after May 15, 2011 at the Debentures' full principal amount plus accrued and unpaid interest, if any. Holders of the Debentures may require the Company to purchase, in cash, all or a portion of the Debentures on May 15, 2011, 2014, 2019, 2024 and 2029, or upon a fundamental change, as defined, at the Debentures' full principal amount plus accrued and unpaid interest, if any.

The Debentures are convertible into shares of Quanex common stock, upon the occurrence of certain events, at an adjusted conversion rate of 39.2978 shares of common stock per \$1,000 principal amount of notes. This conversion rate is equivalent to an adjusted conversion price of \$25.45 per share of common stock, subject to adjustment in some events such as a common stock dividend or an increase in the cash dividend. Adjustments to the conversion rate are made when the cumulative adjustments exceed 1% of the conversion rate. In January 2005, the Company announced that it had irrevocably elected to settle the principal amount of the Debentures in cash when they become convertible and are surrendered by the holders thereof. The Company retains its option to satisfy any excess conversion obligation (stock price in excess of conversion price) with either shares, cash or a combination of shares and cash. Based on the provisions of EITF Issue No. 01-6 "*The Meaning of Indexed to a Company's Own Stock*" and EITF Issue No. 00-19, "*Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock*", the conversion feature of the Debenture is not subject to the provisions of SFAS No. 133, "*Accounting for Derivative Instruments and Hedging Activities*" (SFAS 133) and accordingly has not been bifurcated and accounted for separately as a derivative under SFAS 133.

Effective May 1, 2005, the Debentures became convertible and continue to be convertible through the quarter ending October 31, 2006. For each quarter in this period, the convertibility was triggered when the closing price of the Company's common stock exceeded the contingent conversion threshold price of approximately \$30.54 for at least 20 of the last 30 trading days of the previous fiscal quarter.



**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**8. Pension Plans and Other Postretirement Benefits**

The components of net pension and other postretirement benefit cost are as follows:

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
	(In thousands)			
<b>Pension Benefits:</b>				
Service cost	\$ 1,302	\$ 1,496	\$ 3,641	\$ 3,208
Interest cost	1,135	918	3,055	2,634
Expected return on plan assets	(1,393)	(1,216)	(3,327)	(2,651)
Amortization of unrecognized transition asset	26	29	—	(36)
Amortization of unrecognized prior service cost	44	32	150	145
Amortization of unrecognized net loss	222	286	720	684
Net periodic pension cost	<u>\$ 1,336</u>	<u>\$ 1,545</u>	<u>\$ 4,239</u>	<u>\$ 3,984</u>

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
	(In thousands)			
<b>Postretirement Benefits:</b>				
Service cost	\$ 3	\$ 3	\$ 54	\$ 74
Interest cost	22	65	286	366
Net amortization and deferral	(5)	60	(40)	(51)
Net periodic postretirement benefit cost	<u>\$ 20</u>	<u>\$ 128</u>	<u>\$ 300</u>	<u>\$ 389</u>

During the three and nine months ended July 31, 2006, the Company contributed \$15.0 million and \$16.0 million, respectively, to its defined benefit plans. The \$16.0 million contribution includes \$13.9 million of voluntary contributions in addition to \$2.1 million of minimum required contributions.

**9. Industry Segment Information**

Quanex manages the Company as a market-focused enterprise which utilizes its resources for two target markets where its products are sold: the Vehicular Products segment and the Building Products segment. These markets are driven by distinct economic indicators; domestic light vehicle builds and heavy duty truck builds primarily drive the Vehicular Products segment while housing starts and remodeling expenditures primarily drive the Building Products segment. The Vehicular Products segment includes engineered steel bar manufacturing, steel bar and tube heat-treating services, and steel bar and tube corrosion and wear resistant finishing services. The Building Products segment produces mill finished and coated aluminum sheet and various window and door products for the building products markets. Corporate and other includes corporate office charges and assets, intersegment eliminations and consolidated LIFO inventory adjustments.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
(In thousands)				
<b>Net Sales</b>				
Vehicular products	\$ 259,836	\$ 233,687	\$ 724,006	\$ 786,943
Building products(1)	293,211	258,872	780,846	698,794
Consolidated	<u>\$ 553,047</u>	<u>\$ 492,559</u>	<u>\$ 1,504,852</u>	<u>\$ 1,485,737</u>
<b>Operating Income (Loss)</b>				
Vehicular products	\$ 40,297	\$ 47,932	\$ 113,968	\$ 153,943
Building products(1)	41,639	42,804	103,411	96,267
Corporate & other	(12,909)	(14,515)	(25,283)	(28,083)
Consolidated	<u>\$ 69,027</u>	<u>\$ 76,221</u>	<u>\$ 192,096</u>	<u>\$ 222,127</u>
(In thousands)				
<b>Identifiable Assets</b>				
Vehicular products			\$ 465,105	\$ 425,536
Building products(1)			645,799	618,112
Corporate & other			53,141	45,213
Discontinued operations(2)			—	11,350
Consolidated			<u>\$ 1,164,045</u>	<u>\$ 1,100,211</u>
<b>Goodwill</b>				
Vehicular products			\$ —	\$ —
Building products(1)			196,349	196,341
Consolidated			<u>\$ 196,349</u>	<u>\$ 196,341</u>

(1) Fiscal 2005 includes Mikron as of December 9, 2004.

(2) Temroc and Piper Impact are included in discontinued operations for all periods presented.

#### 10. Stock Repurchase Program and Treasury Stock

On August 26, 2004, the Company's Board of Directors approved an increase in the number of authorized shares in the Company's existing stock buyback program, up to 2.25 million shares; and on August 24, 2006 the Board of Directors approved an additional increase of 2.0 million shares to the existing program. The Company records treasury stock purchases under the cost method whereby the entire cost of the acquired stock is recorded as treasury stock. The Company uses a moving average method on the subsequent reissuance of shares, and any resulting proceeds in excess of cost are credited to additional paid in capital while any deficiency is charged to retained earnings. The Company purchased 1,573,950 treasury shares for \$58.3 million during the nine months ended July 31, 2006. As of July 31, 2006, the number of shares in treasury was reduced to 1,225,042 resulting primarily from stock option exercises. There were no treasury shares purchased during fiscal 2005. As of July 31, 2006, the remaining shares authorized for repurchase in the program was 676,050. After considering the approval of additional shares in the program in August 2006, the remaining shares authorized for repurchase was increased to 2,676,050.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**11. Stock-Based Compensation**

In the first quarter of fiscal 2006, the Company adopted SFAS 123R which required the Company to measure all employee stock-based compensation awards using a fair value method and record such expense in the consolidated financial statements beginning as of November 1, 2005. See Note 2 for impact of the adoption.

The Company has restricted stock and stock option plans which provide for the granting of common shares or stock options to key employees and non-employee directors. The Company's practice is to grant options and restricted stock to directors on October 31<sup>st</sup> of each year, with an additional grant of options to each director on the date of his or her first anniversary of service. Additionally, the Company's practice is to grant options and restricted stock to employees at the Company's December board meeting and occasionally to key employees on their respective date of hire. The exercise price of the option awards is equal to the closing market price on these pre-determined dates. The following table shows a summary of information with respect to stock option and restricted stock compensation for 2006 and restricted stock compensation for 2005, which are included in the consolidated statements of income for those respective periods:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>July 31,</b>		<b>July 31,</b>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	<b>(In thousands)</b>			
Total pretax stock-based compensation expense included in net income	\$ 1,086	\$ 328	\$ 3,883	\$ 590
Income tax benefit related to stock-based compensation included in net income	\$ 402	\$ 126	\$ 1,437	\$ 228

The Company has not capitalized any stock-based compensation cost as part of inventory or fixed assets during the three or nine months ended July 31, 2006 and 2005. Cash received from option exercises for the nine months ended July 31, 2006 and 2005 was \$6.4 million and \$6.3 million, respectively. The actual tax benefit realized for the tax deductions from option exercises and lapses on restricted stock totaled \$4.7 million and \$4.1 million for the nine months ended July 31, 2006 and 2005, respectively.

The Company generally issues shares from treasury, if available, to satisfy stock option exercises. If there are no shares in treasury, the Company issues additional shares of common stock.

*Restricted Stock Plans*

Under the Company's restricted stock plans, common stock may be awarded to key employees, officers and non-employee directors. The recipient is entitled to all of the rights of a shareholder, except that during the forfeiture period the shares are nontransferable. The awards vest over a specified time period, but typically either immediately vest or cliff vest over a three-year period with service as the vesting condition. Upon issuance of stock under the plan, fair value is measured by the grant date price of the Company's shares. This fair value is then expensed over the restricted period with a corresponding increase to additional paid-in-capital. A summary of non-vested restricted shares at July 31, 2006, and changes during the nine months ended July 31, 2006, is presented below:

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

	Shares	Weighted- Average Grant- Date Fair Value Per Share
Nonvested at October 31, 2005	115,650	\$ 22.31
Granted	33,885	40.50
Vested	(6,750)	17.60
Forfeited	(18,000)	20.87
Nonvested at July 31, 2006	<u>124,785</u>	<u>\$ 27.71</u>

The weighted-average grant-date fair value of restricted stock granted during the nine months ended July 31, 2006 and 2005 was \$40.50 and \$26.61, respectively. The total fair value of restricted stock vested during the nine months ended July 31, 2006 and 2005 was \$0.1 million and \$0.2 million, respectively. Total unrecognized compensation cost related to unamortized restricted stock awards was \$1.6 million as of July 31, 2006. That cost is expected to be recognized over a weighted-average period of 1.7 years.

*Valuation of Stock Options under SFAS 123R*

Under SFAS 123R, the Company continues to use the Black-Scholes-Merton option-pricing model to estimate the fair value of its stock options. However, the Company has applied the expanded guidance under SFAS 123R and SAB 107 for the development of its assumptions used as inputs for the Black-Scholes-Merton option pricing model for grants beginning November 1, 2005. Expected volatility is determined using historical volatilities based on historical stock prices for a period that matches the expected term. The expected volatility assumption is adjusted if future volatility is expected to vary from historical experience. The expected term of options represents the period of time that options granted are expected to be outstanding and falls between the option's vesting and contractual expiration dates. The expected term assumption is developed by using historical exercise data adjusted as appropriate for future expectations. Separate groups of employees that have similar historical exercise behavior are considered separately. Accordingly, the expected term range given below results from certain groups of employees exhibiting different behavior. The risk-free rate is based on the yield at the date of grant of a zero-coupon U.S. Treasury bond whose maturity period equals the option's expected term. The fair value of each option was estimated on the date of grant. The following is a summary of valuation assumptions for grants during the nine months ended July 31, 2006 and 2005:

<b>Valuation assumptions</b>	<b>Grants During the Nine Months Ended July 31,</b>	
	<b>2006 (SFAS 123R)</b>	<b>2005 (SFAS 123)</b>
Weighted-average expected volatility	35.00%	35.38%
Expected term (in years)	4.8-5.2	5.0
Risk-free interest rate	4.45%	3.49%
Expected dividend yield over expected term	2.00%	1.53%

The weighted-average grant-date fair value of options granted during the nine months ended July 31, 2006 and 2005 was \$12.78 and \$8.42, respectively. The increase in per share fair value of the options was primarily related to the increase in the Company's stock price on the date of grant from an average price of approximately \$27 per share for grants during the nine months ended fiscal 2005 to \$41 per share for the same period of 2006.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

*Proforma Effect Prior to the Adoption of SFAS 123R*

The following table presents the proforma effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation prior to the adoption of SFAS 123R during the three and nine month period ending July 31, 2005 (in thousands except per share amounts).

	<b>Three Months Ended July 31, 2005</b>	<b>Nine Months Ended July 31, 2005</b>
Net income, as reported	\$ 44,715	\$ 123,935
Add: Restricted stock compensation, net of forfeitures included in reported net income, net of tax	202	363
Deduct: Total stock-based employee compensation (restricted stock amortization and stock option expense determined under SFAS 123 fair value based method), net of related tax effects	(744)	(1,886)
Pro forma net income	<u>\$ 44,173</u>	<u>\$ 122,412</u>
<b>Earnings per common share:</b>		
Basic as reported	\$ 1.18	\$ 3.29
Basic pro forma	\$ 1.17	\$ 3.25
Diluted as reported	\$ 1.13	\$ 3.17
Diluted pro forma	\$ 1.12	\$ 3.13

Disclosures for the three and nine months ended July 31, 2006 are not presented as the amounts are recognized in the consolidated financial statements.

*2006 Omnibus Incentive Plan*

At the Company's annual meeting in February 2006, the Company's stockholders approved the Quanex Corporation 2006 Omnibus Incentive Plan (the 2006 Plan). The 2006 Plan provides for the granting of stock options, stock appreciation rights, restricted stock, restricted stock units, performance stock awards, performance unit awards, annual incentive awards, other stock-based awards and cash-based awards. The 2006 Plan is administered by the Compensation Committee of the Board and allows for immediate, graded or cliff vesting options, but options must be exercised no later than ten years from the date of grant. The aggregate number of shares of common stock authorized for grant under the 2006 Plan is 2,625,000. Any officer, key employee and / or non-employee director of the Company or any of its affiliates is eligible for awards under the 2006 Plan. The initial awards granted under the 2006 Plan were during the third fiscal quarter of 2006; these awards provided for three-year vesting with service as the vesting condition.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

A summary of stock option activity under the 2006 Plan during the nine months ended July 31, 2006 is presented below:

	Shares	Weighted- Average Exercise Price Per Share	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (000's)
Outstanding at October 31, 2005	—	—		
Granted	23,250	\$ 37.13		
Exercised	—	—		
Cancelled	(2,000)	39.32		
Expired	—	—		
Outstanding at July 31, 2006	<u>21,250</u>	<u>\$ 36.93</u>	9.9	\$ 0
Exercisable at July 31, 2006	<u>—</u>	<u>—</u>		—

A summary of the nonvested stock option shares under the 2006 Plan during the nine months ended July 31, 2006 is presented below:

	Shares	Weighted- Average Grant- Date Fair Value Per Share
Nonvested at October 31, 2005	—	—
Granted	23,250	\$ 11.96
Vested	—	—
Forfeited	(2,000)	\$ 12.97
Nonvested at July 31, 2006	<u>21,250</u>	<u>\$ 11.86</u>

Total unrecognized compensation cost related to stock options granted under this plan was \$0.2 million as of July 31, 2006. That cost is expected to be recognized over a weighted-average period of 2.5 years.

*Key Employee and Non-Employee Director Stock Option Plans*

The Company's 1996 Employee Stock Option and Restricted Stock Plan (the 1996 Plan) and 1997 Key Employee Stock Plan (the 1997 Plan) provide for the granting of options to employees and non-employee directors of up to an aggregate of 6,637,500 common shares. Unless otherwise provided by the Board of Directors at the time of grant, options become exercisable in one-third increments maturing cumulatively on each of the first through third anniversaries of the date of grant and must be exercised no later than ten years from the date of grant. There were 1,994,312 shares available for granting of options at October 31, 2005. The 1996 Plan expired as of December 31, 2005, and the 1997 Plan was terminated effective December 31, 2005.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

A summary of stock option activity under the 1996 Plan and the 1997 Plan during the nine months ended July 31, 2006 is presented below:

	<u>Shares</u>	<u>Weighted- Average Exercise Price Per Share</u>	<u>Weighted- Average Remaining Contractual Term (in years)</u>	<u>Aggregate Intrinsic Value (000's)</u>
Outstanding at October 31, 2005	1,453,772	\$ 19.05		
Granted	230,250	40.95		
Exercised	(420,497)	14.27		
Cancelled	(46,717)	23.66		
Expired	—	—		
Outstanding at July 31, 2006	<u>1,216,808</u>	<u>\$ 24.66</u>	7.4	\$ 14,147
Exercisable at July 31, 2006	<u>574,759</u>	<u>\$ 18.66</u>	6.8	\$ 10,130

The total intrinsic value of options (the amount by which the market price of the stock on the date of exercise exceeded the exercise price of the option) exercised during the nine months ended July 31, 2006 and 2005 was \$11.5 million and \$11.2 million, respectively.

A summary of the nonvested stock option shares under the 1996 Plan and the 1997 Plan during the nine months ended July 31, 2006 is presented below:

	<u>Shares</u>	<u>Weighted- Average Grant- Date Fair Value Per Share</u>
Nonvested at October 31, 2005	914,552	\$ 7.54
Granted	230,250	12.86
Vested	(457,585)	7.32
Forfeited	(45,168)	7.92
Nonvested at July 31, 2006	<u>642,049</u>	<u>\$ 9.57</u>

Total unrecognized compensation cost related to stock options granted under these plans was \$3.0 million as of July 31, 2006. That cost is expected to be recognized over a weighted-average period of 1.3 years. The total fair value of shares vested during the nine months ended July 31, 2006 and 2005 was \$3.4 million and \$2.2 million, respectively.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

*Non-Employee Director Plans*

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

1989 Non-Employee Directors Stock Option Plan

The Company's 1989 Non-Employee Directors Stock Option Plan provides for the granting of stock options to non-employee Directors to purchase up to an aggregate of 472,500 shares of common stock. Options become exercisable at any time commencing six months after the grant and must be exercised no later than ten years from the date of grant. No option may be granted under the plan after December 5, 1999.

A summary of stock option activity under this plan during the nine months ended July 31, 2006 is presented below:

	Shares	Weighted- Average Exercise Price Per Share	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (000's)
Outstanding at October 31, 2005	48,750	\$ 11.24		
Granted	—	—		
Exercised	(29,250)	10.85		
Cancelled/Expired	—	—		
Outstanding at July 31, 2006	<u>19,500</u>	<u>\$ 11.83</u>	1.3	\$ 477
Exercisable at July 31, 2006	<u>19,500</u>	<u>\$ 11.83</u>	1.3	\$ 477

The total intrinsic value of options exercised during the nine months ended July 31, 2006 and 2005 was \$1.0 million and \$0.3 million, respectively.

All stock option shares under this plan were vested as of the beginning of the reporting period. Accordingly, there is no unrecognized compensation cost related to stock options granted under this plan.

1997 Non-Employee Director Stock Option Plan

The Company's 1997 Non-Employee Director Stock Option Plan provided for the granting of stock options to non-employee Directors to purchase up to an aggregate of 900,000 shares of common stock. Options granted under this plan generally became exercisable immediately or became exercisable in one-third increments maturing cumulatively on each of the first through third anniversaries of the date of grant. Options generally must be exercised no later than ten years from the date of grant. On December 5, 2002, the Company elected to terminate future grants of options under this plan.



**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

A summary of stock option activity under this plan during the nine months ended July 31, 2006 is presented below:

	<u>Shares</u>	<u>Weighted- Average Exercise Price Per Share</u>	<u>Weighted- Average Remaining Contractual Term (in years)</u>	<u>Aggregate Intrinsic Value (000's)</u>
Outstanding at October 31, 2005	74,250	\$ 13.00		
Granted	—	—		
Exercised	(6,750)	10.62		
Cancelled/Expired	—	—		
Outstanding at July 31, 2006	<u>67,500</u>	<u>\$ 13.24</u>	5.4	\$ 1,556
Exercisable at July 31, 2006	<u>67,500</u>	<u>\$ 13.24</u>	5.4	\$ 1,556

The total intrinsic value of options exercised during the nine months ended July 31, 2006 and 2005 was \$0.2 million and \$0.4 million, respectively.

All stock options under this plan were vested as of October 31, 2005. Accordingly, there is no unrecognized compensation cost related to stock options granted under this plan. The total fair value of shares vested during the nine months ended July 31, 2005 was \$30 thousand.

## 12. Income Taxes

The provision for income taxes is determined by applying an estimated annual effective income tax rate to income before income taxes. The rate is based on the most recent annualized forecast of pretax income, permanent book versus tax differences, and tax credits. It also includes the effect of any valuation allowance expected to be necessary during the year. The Company's estimated annual effective tax rate decreased to 36.6% in fiscal 2006 primarily due to the domestic manufacturing income deduction allowed by the passage of the AJC Act and an overall reduction in effective state tax rates. The Company became eligible for the special manufacturing deduction beginning in fiscal 2006 and has estimated that this special deduction will reduce the Company's effective tax rate in fiscal 2006 by approximately 1%.

In August 2006, the Internal Revenue Service began an audit of the tax year ending 2004. In addition, the Company has a case in Tax Court regarding the disallowance of a capital loss realized in 1997 and 1998. During fiscal 2004, the Company made a tax payment of \$10.0 million related to the case to stop the running of the interest outstanding. Adequate provision has been made for this contingency and the Company believes the outcome of the case will not have a material adverse impact on its financial position or results of operations. See Note 13 for further explanation.

## 13. Contingencies

### *Environmental*

Quanex is subject to extensive laws and regulations concerning the discharge of materials into the environment and the remediation of chemical contamination. To satisfy such requirements, Quanex must make capital and other expenditures on an ongoing basis. The Company accrues its best estimates of its remediation obligations and adjusts such accruals as further information and circumstances develop.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Those estimates may change substantially depending on information about the nature and extent of contamination, appropriate remediation technologies, and regulatory approvals. In accruing for environmental remediation liabilities, costs of future expenditures are not discounted to their present value, unless the amount and timing of the expenditures are fixed or reliably determinable. When environmental laws might be deemed to impose joint and several liability for the costs of responding to contamination, the Company accrues its allocable share of liability taking into account the number of parties participating, their ability to pay their shares, the volumes and nature of the wastes involved, the nature of anticipated response actions, and the nature of the Company's alleged connections. The cost of environmental matters has not had a material adverse effect on Quanex's operations or financial condition in the past, and management is not aware of any existing conditions that it currently believes are likely to have a material adverse effect on Quanex's operations, financial condition or cash flows.

During the third quarter of 2005, the United States Department of Justice filed a complaint against the Company for recovery of cleanup costs incurred at the "Jepscor" Superfund site in Dixon, Illinois. The United States Environmental Protection Agency indicated that it had incurred approximately \$2.6 million to remove processing residue and other materials from that former metal recovery plant. Of the Jepscor site's former owners, operators, and many customers, the government asserted liability for cleanup only against the Company. During the fourth fiscal quarter of 2005, the Company and the Department of Justice reached a tentative agreement to settle this matter. In May 2006, the parties successfully finalized that settlement, pursuant to which the Company paid \$1.0 million of the government's cleanup costs. Such amount had been reserved for during fiscal 2005.

Total remediation reserves, at July 31, 2006, for Quanex's current plants, former operating locations, and disposal facilities were approximately \$6.9 million, down \$2.0 million from the reserve at October 31, 2005. This reduction is comprised of the cash paid for the Jepscor settlement discussed above, cash spent on remediation efforts previously reserved for as well as an updated estimate in an existing reserve for one of the Company's plants. Of the current remediation reserve, approximately \$1.8 million represents administrative costs; the balance represents estimated costs for investigation, studies, cleanup, and treatment. On the balance sheet as of July 31, 2006, \$5.9 million of the remediation reserve is included in non-current liabilities with the remainder in accrued liabilities (current).

Approximately 63% of the total remediation reserve is currently allocated to cleanup work related to Piper Impact. During the first quarter of 2005, the Company sold the operating assets of the Piper Impact business, including its only active plant on Barkley Drive in New Albany, Mississippi. In the fourth fiscal quarter of 2005, the Company sold the location on Highway 15 in New Albany where Piper Impact previously had operated a plant (the Highway 15 location), but as part of the sale retained environmental liability for pre-closing contamination there. At present, the largest component of the Piper Impact remediation reserve is for remediation of soil and groundwater contamination from prior operators of the Highway 15 location. The Company voluntarily implemented a state-approved remedial action plan there that includes natural attenuation together with a groundwater collection and treatment system. The Company continues to monitor conditions at the site and to evaluate performance of that remedy.

Included in the current reserve is the estimated cost of operating the existing groundwater remediation system at the Highway 15 location over the next 20 years, which was discounted to a net present value using an interest rate of 3.0%. The Company has estimated the annual cost of operating the existing system to be approximately \$0.2 million and has assumed that the existing system will continue to be effective.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

The final remediation costs and the timing of the expenditures at the Highway 15 location and other sites will depend upon such factors as the nature and extent of contamination, the cleanup technologies employed, and regulatory concurrences. While actual remediation costs therefore may be more or less than amounts accrued, the Company believes it has established adequate reserves for all probable and reasonably estimable remediation liabilities. It is not possible at this point to reasonably estimate the amount of any obligation for remediation in excess of current accruals because of uncertainties as to the extent of environmental impact, cleanup technologies, and concurrence of governmental authorities. The Company currently expects to pay the accrued remediation reserve through at least fiscal 2025, although some of the same factors discussed earlier could accelerate or extend the timing.

For fiscal 2006, the Company estimates expenses at its facilities will be approximately \$4.2 million for continuing environmental compliance. In addition, the Company estimates that capital expenditures for environmental compliance in fiscal 2006 will be approximately \$0.8 million. Future expenditures relating to environmental matters will necessarily depend upon the application to Quanex and its facilities of future regulations and government decisions. Quanex will continue to have expenditures in connection with environmental matters beyond fiscal 2006, but it is not possible at this time to reasonably estimate the amount of those expenditures except as discussed above. Based upon its analysis and experience to date, Quanex does not believe that its compliance with the Clean Air Act or other environmental requirements will have a material adverse effect on its operations or financial condition.

*Tax Liability*

As reported in its annual report on Form 10-K for the year ended October 31, 2005, the Company is currently involved in a case in Tax Court regarding the disallowance of a capital loss realized in 1997 and 1998. During 2004, the Company made a tax payment of \$10.0 million related to the case to curtail the accumulation of interest on the disputed amounts. The Company has reserves for income tax contingencies primarily associated with this case as of July 31, 2006 and October 31, 2005 of \$13.2 million and \$12.3 million, respectively. Adequate provision for such payment had been made in prior years and the Company believes the outcome of the case will not have a material impact on its financial position or results of operations.

*Other*

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

**14. Discontinued Operations**

In accordance with SFAS No. 144, "Accounting for the Impairment of Disposal of Long-Lived Assets," the results of operations, financial position and cash flows of Temroc and Piper Impact have been reflected in the consolidated financial statements and notes as discontinued operations for all periods presented. Temroc was sold on January 27, 2006, while Piper Impact was sold on January 25, 2005.

**QUANEX CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Comparative balance sheets of the discontinued operations were as follows:

	<u>July 31,</u> <u>2006</u>	<u>October 31,</u> <u>2005</u>
	(In thousands)	
<b>Current assets:</b>		
Accounts and notes receivable, net	\$ —	\$ 3,408
Inventories	—	2,078
Income tax receivable	—	—
Other current assets	—	18
Total current assets	—	5,504
Property, plant and equipment, net	—	5,247
Other assets	—	599
Total assets	<u>\$ —</u>	<u>\$ 11,350</u>
<b>Current liabilities:</b>		
Accounts payable	\$ —	\$ 2,591
Accrued liabilities	—	750
Other current liabilities	—	867
Total current liabilities	—	4,208
Other liabilities	—	2,120
Total liabilities	<u>\$ —</u>	<u>\$ 6,328</u>

Operating results of the discontinued operations were as follows:

	<u>Three Months Ended</u> <u>July 31,</u>		<u>Nine Months Ended</u> <u>July 31,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(In thousands)			
Net sales	<u>\$ —</u>	<u>\$ 6,252</u>	<u>\$ 5,230</u>	<u>\$ 21,111</u>
Income (loss) from discontinued operations	(32)	43	(186)	(3,343)
Gain (loss) on sale of discontinued operations	250	(151)	(61)	(6,509)
Income tax benefit (expense)	12	(82)	71	3,234
Income (loss) from discontinued operations, net of taxes	<u>\$ 230</u>	<u>\$ (190)</u>	<u>\$ (176)</u>	<u>\$ (6,618)</u>

In order to best understand the amounts above, it is important to remember that Piper Impact was sold in January 2005 and Temroc was sold in January 2006. The losses realized in 2005 primarily relate to Piper Impact and the third quarter gain and the year-to-date loss realized in 2006 relate to Temroc.

In the fourth quarter of fiscal 2005, the Company recorded a Temroc loss of \$13.1 million as a result of the annual impairment testing and the classification of Temroc as held for sale at that time. Temroc was sold in January 2006 and the working capital-based purchase price adjustment was settled in the third quarter of fiscal 2006. The sale of Temroc resulted in the disposition of the \$0.4 million remaining Temroc goodwill and resulted in only an additional \$60 thousand loss recorded in fiscal 2006.

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

**General**

The discussion and analysis of Quanex Corporation and its subsidiaries' (the Company's) financial condition and results of operations should be read in conjunction with the July 31, 2006 and October 31, 2005 Consolidated Financial Statements of the Company and the accompanying notes.

**Private Securities Litigation Reform Act**

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

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

**Consolidated Results of Operations***Summary Information*

	Three Months Ended July 31,				Nine months ended July 31,			
	2006	2005	Change	%	2006	2005(1)	Change	%
	(Dollars in millions)							
Net sales	\$ 553.0	\$ 492.5	\$ 60.5	12.3%	\$1,504.9	\$1,485.7	\$ 19.2	1.3%
Cost of sales	442.8	373.3	69.5	18.6	1,191.4	1,141.9	49.5	4.3
Selling, general and administrative	23.9	26.9	(3.0)	(11.2)	68.8	73.9	(5.1)	(6.9)
Depreciation and amortization	17.3	16.1	1.2	7.5	52.6	47.8	4.8	10.0
Operating income	<u>69.0</u>	<u>76.2</u>	<u>(7.2)</u>	<u>(9.4)</u>	<u>192.1</u>	<u>222.1</u>	<u>(30.0)</u>	<u>(13.5)</u>
Operating income margin	12.5%	15.5%	(3.0)%		12.8%	14.9%	(2.1)%	
Interest expense	(1.2)	(2.5)	1.3	(52.0)	(3.7)	(7.7)	4.0	(51.9)
Other, net	2.3	(0.7)	3.0	(428.6)	2.8	(2.1)	4.9	(233.3)
Income tax expense	(25.2)	(28.1)	2.9	(10.3)	(70.0)	(81.7)	11.7	(14.3)
Income from continuing operations	<u>\$ 44.9</u>	<u>\$ 44.9</u>	<u>\$ —</u>	<u>—%</u>	<u>\$ 121.2</u>	<u>\$ 130.6</u>	<u>\$ (9.4)</u>	<u>(7.2)%</u>

(1) Fiscal 2005 includes Mikron's results beginning December 9, 2004.

*Overview*

Net sales for the three and nine months ended July 31, 2006 was higher compared to the same period last year, while operating income was lower for the same comparison periods. The primary reason for the increased net sales in the third quarter was a mixture of higher shipments at a majority of the Company's operations and increased selling prices at select operations. The increased net sales for the first nine months of fiscal 2006 are attributable to the Company's Building Products segment. The pace of the first half of 2005 was best characterized as a period of customer "allocation" at a majority of the Company's operations. This unusually high demand diminished during the second half of 2005 and volumes have returned to more normalized levels in 2006. The trend through the first nine months of fiscal 2006 has been the reverse of the previous year with lower sales volumes in the first half of the year and higher sales volumes thus far and expected to continue in the latter half of the year.

The anticipated operating income decline in 2006 is a result of spreads at some operations returning to more normalized levels, partially offset by gains at others. In all cases, the Company continues to effectively manage "controllable" costs as supported by the comparable reduction in selling, general and administrative costs even after factoring in \$3.1 million of stock option expense in the first nine months of 2006. Non-operating items improved as a result of lower debt and higher cash and equivalents balances coupled with a flip from expense to income from the mark-to-market of the deferred compensation plan liability.

*Business Segments*

Quanex has two market-focused segments: Vehicular Products and Building Products. The Vehicular Products segment produces engineered steel bars for the light vehicle, heavy duty truck, and off-road and construction equipment markets. The Vehicular Products segment's primary market drivers are North American light vehicle builds and, to a lesser extent, heavy duty truck builds. The Building Products segment produces window and door components, and mill finished and coated aluminum sheet serving the broader building products markets. The main market drivers of this segment are residential housing starts and remodeling expenditures.

**Three and Nine Months Ended July 31, 2006 Compared to Three and Nine Months Ended July 31, 2005***Vehicular Products*

	Three Months Ended July 31,				Nine Months Ended July 31,			
	2006	2005	Change	%	2006	2005	Change	%
	(Dollars in millions)							
Net sales	\$ 259.8	\$ 233.6	\$ 26.2	11.2%	\$ 724.0	\$ 786.9	\$ (62.9)	(8.0)%
Cost of sales	206.5	171.5	35.0	20.4	572.2	590.9	(18.7)	(3.2)
Selling, general and administrative	4.5	6.0	(1.5)	(25.0)	12.8	17.2	(4.4)	(25.6)
Depreciation and amortization	8.5	8.2	0.3	3.7	25.0	24.9	0.1	—
Operating income	<u>\$ 40.3</u>	<u>\$ 47.9</u>	<u>\$ (7.6)</u>	<u>(15.9)%</u>	<u>\$ 114.0</u>	<u>\$ 153.9</u>	<u>\$ (39.9)</u>	<u>(25.9)%</u>
Operating income margin	15.5%	20.5%	(5.0)%		15.7%	19.6%	(3.9)%	

North American light vehicle production for the third quarter of fiscal 2006 was up 5% compared to the third quarter of fiscal 2005. The Vehicular Products segment outperformed the market with an 11.9% increase in shipments in the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005. The higher shipments in the third quarter brought year-to-date shipments within 1.1% of fiscal 2005 levels. The first half of 2005 was considered a period of allocation, whereas the second half of 2005 experienced lower shipments as the allocation environment subsided and customer inventory levels were reduced. The trend for fiscal 2006 has thus far been lower shipments in the first half of the year followed by an increase in the third quarter and an expected additional increase in the fourth quarter. The order backlog increased 8.0% over the second quarter, indicating lower inventory levels in the supply chain, the ramp-up of new programs and continued strength in our secondary markets.

Net sales for the third quarter of 2006 were higher than the third quarter of 2005 as a result of an 11.9% increase in volume with relatively level average selling prices. Net sales for the first nine months of 2006 were lower than the same period of 2005 due to a 1.1% decrease in volume, coupled with a 7.0% decrease in average selling prices. The decrease in volume is due to the first half of 2005 being an exceptionally strong period with many customers on allocation. While base prices have been higher in fiscal 2006 compared to fiscal 2005, the scrap surcharges have been lower, which resulted in lower overall average selling prices.

Operating income for the third quarter decreased 15.9% versus the same period last year due primarily to a decrease in the spread partially offset by the increase in volume. During fiscal 2005 scrap surcharges were adjusted quarterly and as a result of the quarterly adjustment the third quarter of fiscal 2005 was a period of higher than normal spreads as raw material costs decreased sharply. In the first quarter of fiscal 2006, scrap surcharges for a majority of the segment's customers were converted to a monthly basis which has resulted in more normalized spreads throughout the period. Operating income for the first nine months of 2006 decreased 25.9% versus the same period last year due to the volume decline and lower spreads. The year to date decline in operating income resulted from varying drivers. The first quarter year over year decline primarily resulted from a volume decrease, whereas the second quarter decline was a spread issue considering the all time high spreads realized in the second quarter of 2005 from the Company's scrap surcharge recovery mechanism. Third quarter, 2006 volume eclipsed third quarter 2005 volume for the first time during the year and spreads in the quarter neared parity, continuing the trend toward more comparable prior year levels. The trend over the past nine months suggests a favorable year over year comparison for the fourth quarter. Partially offsetting this spread decline is an improvement in selling, general and administrative expense primarily due to a reduction in the 2006 bad debt provision compared to 2005. The higher 2005 bad debt provision is associated with the Jernberg Industries, Inc. bankruptcy in 2005 and more exposure from the scrap surcharge environment that existed during the first half of fiscal 2005. The Company received the Jernberg settlement by October 31, 2005 and has not experienced any similar losses in fiscal 2006.

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The decrease in operating income margin for the third quarter versus last year was entirely a spread issue whereas the nine month decrease was a result of both lower spreads and lower volumes when compared to the same period last year. Spreads in 2006 are considered normal compared to higher than normal spreads in 2005 due in part to the change in the Company's surcharge mechanism from quarterly to monthly previously discussed.

### *Building Products*

	<b>Three Months Ended July 31,</b>				<b>Nine Months Ended July 31,</b>			
	<b>2006</b>	<b>2005</b>	<b>Change</b>	<b>%</b>	<b>2006</b>	<b>2005(1)</b>	<b>Change</b>	<b>%</b>
	<b>(Dollars in millions)</b>							
Net sales	\$ 293.2	\$ 258.9	\$ 34.3	13.2%	\$ 780.9	\$ 698.8	\$ 82.1	11.7%
Cost of sales	230.1	195.8	34.3	17.5	613.3	544.3	69.0	12.7
Selling, general and administrative	12.8	12.5	0.3	2.4	36.8	35.5	1.3	3.7
Depreciation and amortization	8.7	7.8	0.9	11.5	27.4	22.7	4.7	20.7
Operating income	<u>\$ 41.6</u>	<u>\$ 42.8</u>	<u>\$ (1.2)</u>	<u>(2.8)%</u>	<u>\$ 103.4</u>	<u>\$ 96.3</u>	<u>\$ 7.1</u>	<u>7.4%</u>
Operating income margin	14.2%	16.5%	(2.3)%		13.2%	13.8%	(0.6)%	

(1) Fiscal 2005 includes Mikron's results beginning December 9, 2004.

New home construction showed signs of a slow down during the quarter as new home construction declined some 9% below the same period last year. Customer demand at the Company's engineered window and door components business was within 1% of the prior year, better than the new home construction decline over the same period. For the first half of fiscal 2006, demand at the engineered window and door components business outpaced the comparable period of fiscal 2005. The third quarter of fiscal 2006 saw a reversal of that trend. The aluminum sheet business experienced a 5.0% increase and 6.6% drop in volume during the third quarter and first nine months of the year, respectively. In addition to the strong allocation environment experienced in the first half of 2005, the year-to-date volume reduction is attributed to customer de-stocking along with a sharp rise in the London Metal Exchange (LME), which caused buyers to delay ordering in the first half of 2006 in hopes of a correction that was realized during the latter part of the third fiscal quarter of 2006. The customer backlog is in line with where it was at the end of the second quarter and should be favorable for the fourth quarter.

The net sales increase for the three months ended July 31, 2006 is a result of increased volumes and average selling prices at the Company's aluminum operation. Increased aluminum sales prices coupled with higher door and window component volumes resulted in an increase in net sales for the nine months ended July 31, 2006 when compared to the year ago period. Additionally, the nine month net sales increase is attributable to having Mikron for the full nine months of 2006 versus seven and a half months of last year. The increase for the third quarter of 2006 comprises a 29.0% increase in aluminum rolled product net sales (5.0% higher volume and a 22.8% increase in average selling prices) and a 0.9% decrease in net sales of the window and door components.

The increase in operating income for the first nine months of fiscal 2006 compared to the same period of 2005 is primarily a result of improvements at the segment's aluminum operation combined with the acquisition of Mikron. Aluminum sheet spreads were higher in the first nine months compared to last year, the result of higher selling prices, relatively lower scrap costs and a better mix of value-added products. Also benefiting fiscal 2006 is a \$2.0 million gain on the sale of Owens Corning receivables for which the Company had been carrying a reserve for several years including an allowance as of October 31, 2005. Partially offsetting these improvements is an increase in selling, general and administrative expenses and the depreciation and amortization expense attributable to having Mikron for the full nine months of 2006 versus seven and a half months of last year.



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During 2006, the rise of aluminum on the LME has increased more than the cost of aluminum scrap thereby favorably impacting the operating income margin. The change in the trend experienced in the third quarter related to the Company's engineered window and door components business coupled with non-aluminum based raw material price increases resulted in reduced operating income.

### *Corporate and Other*

	Three Months Ended July 31,				Nine Months Ended July 31,			
	2006	2005	Change	%	2006	2005	Change	%
	(Dollars in millions)							
Cost of sales	\$ 6.2	\$ 6.0	\$ 0.2	3.3%	\$ 5.9	\$ 6.7	\$ (0.8)	(11.9)%
Selling, general and administrative	6.6	8.4	(1.8)	(21.4)	19.2	21.2	(2.0)	(9.4)
Depreciation and amortization	0.1	0.1	—	—	0.2	0.2	—	—
Operating loss	<u>\$ (12.9)</u>	<u>\$ (14.5)</u>	<u>\$ 1.6</u>	<u>(11.0)%</u>	<u>\$ (25.3)</u>	<u>\$ (28.1)</u>	<u>\$ 2.8</u>	<u>(10.0)%</u>

Corporate and other operating expenses, which are not in the two operating segments mentioned above, include the consolidated LIFO inventory adjustments (calculated on a combined pool basis), corporate office expenses and inter-segment eliminations. Included in the three and nine months ended July 31, 2006 is stock option expense of \$0.7 million and \$3.1 million, respectively, which was not recorded in 2005. The decrease in 2006 versus 2005 is greater than reflected above when taking into consideration the stock option expense amounts. The primary cause for the decrease in corporate office expense in the three and nine month periods ending July 31, 2006 was higher costs in the same periods of last year associated with the Company's implementation of Sarbanes-Oxley Section 404. For the third quarter of fiscal 2006, the Company avoided \$3.1 million compared to the same period last year on Sarbanes-Oxley related expenses.

Interest expense for the three and nine months ended July 31, 2006 decreased \$1.3 million and \$4.0 million, respectively, from the same periods a year ago as a result of the decrease in the average debt outstanding for the comparative periods. During the first quarter of fiscal 2005, the Company borrowed approximately \$200.0 million on its Bank Agreement to fund the December 2004 acquisition of Mikron. All \$200.0 million was repaid prior to the beginning of fiscal 2006. During the first nine months of fiscal 2006, the Company had no amounts outstanding under the Bank Agreement.

Other, net for the three months ended July 31, 2006 was income of \$2.3 million compared to expense of \$0.7 million in the third quarter of 2005. Other, net for the nine months ended July 31, 2006 was income of \$2.8 million compared to expense of \$2.1 million for the same period in 2005. The \$4.9 million improvement is a result of increased interest income on the higher cash and equivalents balances combined with the change in the market value of the Company's deferred compensation plan. Each quarter, the Company values its liability for the deferred compensation plan based upon the value of the underlying investment units, primarily Quanex common stock. The Company's common stock price decreased 6.0% from October 31, 2005 to July 31, 2006. As a comparison, the Company's common stock price increased 80.5% for the same period the previous year, thus generating the higher expense in fiscal 2005.

The Company's effective tax rate declined to 35.9% and 36.6% for the three and nine months ended July 31, 2006, respectively, compared to 38.5% during the same periods of 2005. The lower effective rate in 2006 primarily resulted from the domestic manufacturing income deduction allowed by the passage of the AJC Act of 2004, filing differences (credits) recorded in the third quarter of fiscal 2006 and an overall reduction in effective state tax rates. Fiscal 2006 is the first year the Company could benefit from the domestic manufacturing income deduction.

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The year-over-year changes in income (loss) from discontinued operations, net of taxes, for the three and nine months ended July 31, 2006, are the result of several items. The main difference is the loss recognized in the first quarter of fiscal 2005 related to the sale of Piper Impact.

### *Outlook*

Quanex sales for the fourth quarter of 2006 are expected to be up approximately 10% over the fourth quarter of 2005, supported in part by new program opportunities at the operating segments. The 10% fourth quarter growth compares favorably to a light vehicle market where builds are expected to be down 7% from the fourth quarter 2005, and housing starts projected to be down over 15%.

More specifically, in the Vehicular Products segment, business activity is expected to generate favorable comparisons as fourth quarter steel bar ton shipments are estimated to be some 5% higher than the fourth quarter 2005 and about 3% better than the third quarter 2006. New programs with both the "Big 3" and the Japanese transplant automotive companies should enable the segment to outperform the market in the fourth quarter. The segment is in the process of securing significant new automotive business this calendar year.

At Building Products, segment net sales are estimated to be up 5% compared to the fourth quarter 2005, and down about 5% compared to the third quarter 2006 as the Company anticipates that its window and door components net sales will experience a slowing of demand due to declining original equipment manufacturer (OEM) production levels, partially offset by new business with existing and new customers. Aluminum rolled products demand is expected to remain at healthy levels, with fourth quarter volume (pounds) expected to be some 10% higher than the fourth quarter of 2005. With LME aluminum ingot prices at high levels and aluminum scrap cost increases expected to remain relatively more modest, strong material spreads are anticipated to continue in the fourth quarter.

Taken together, the sales and earnings outlook for the balance of 2006 remains favorable. Accordingly, Quanex expects to report diluted earnings per share from continuing operations for the year within a range of \$4.00 - \$4.10, which includes an estimated non-cash LIFO charge of some \$0.13 - \$0.16 per share. Previous guidance had been a range of \$4.00 - \$4.20, which did not include a provision for LIFO.

### **Liquidity and Capital Resources**

#### *Sources of Funds*

The Company's principal sources of funds are cash on hand, cash flow from operations, and borrowings under its secured \$310.0 million Revolving Credit Agreement (the Bank Agreement). The Bank Agreement expires on February 28, 2007. The Company anticipates executing a new five-year unsecured bank agreement prior to the end of calendar 2006. The new facility is expected to be increased to approximately \$350.0 million.

At July 31, 2006 and October 31, 2005, the Company had no borrowings under the Bank Agreement and had \$125.0 million outstanding 2.50% Senior Convertible Debentures due May 15, 2034 (the Debentures). The aggregate availability under the Bank Agreement was \$296.0 million at July 31, 2006, which is net of \$14.0 million of outstanding letters of credit.

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On August 24, 2006, the Board of Directors of the Company authorized an annual dividend increase of \$0.08 per common share outstanding, or \$0.02 increase per quarter. This raised the annual cash dividend from \$0.48 to \$0.56 and the quarterly dividend from \$0.12 to \$0.14 per common share outstanding. The cash dividend is effective to shareholders of record on September 15, 2006 and payable on September 29, 2006. Additionally, the Board of Directors approved the repurchase of an additional 2 million shares of common stock, to be purchased at appropriate times. As a result, a total of 2.7 million shares are authorized to be repurchased as of August 24, 2006.

The Company believes that it has sufficient funds and adequate financial resources available to meet its anticipated liquidity needs. The Company also believes that cash flow from operations, cash balances and available borrowings will be sufficient in the foreseeable future to finance anticipated working capital requirements, capital expenditures, debt service requirements, environmental expenditures, dividends and the stock buyback program.

The Company's working capital was \$184.5 million on July 31, 2006 compared to \$133.9 million on October 31, 2005. The net change is a \$50.6 million increase in working capital, which includes an \$11.5 million increase in cash and equivalents. The primary reason for the increase is the increased business activity and higher raw material prices realized in the third quarter of 2006 compared to the fourth quarter of 2005. Increased business will typically result in higher accounts receivable and inventories partially offset by higher accounts payable balances. Accounts receivable, inventories and accounts payable increased \$32.3 million, \$23.4 million and \$35.4 million, respectively, from October 31, 2005 to July 31, 2006, resulting in a net \$20.3 million increase in working capital. The inventory increase was also impacted by higher average raw material prices. The other contributing factor to the increase in working capital was the \$16.0 million reduction in accrued liabilities. The accrued liabilities reduction comprises several items including \$5.3 million of lower bonus accrual balances, \$2.2 million of lower medical and workers compensation liabilities, a \$1.0 million payment for settlement of an environmental matter and a \$3.2 million reduction in sales discounts and rebates balances. The majority of the Company's bonuses and sales rebates are paid in the first part of the fiscal year.

### *Operating Activities*

Cash provided by operating activities during the nine months ended July 31, 2006, was \$129.0 million compared to \$160.7 million for the same period of 2005. The decrease is due to \$13.3 million and \$5.6 million more for pension contributions and tax payments, respectively, coupled with a larger increase in working capital for the first nine months of fiscal 2006 compared to the same period of fiscal 2005.

### *Investment Activities*

Net cash used for investment activities during the nine months ended July 31, 2006, was \$54.6 million compared to \$223.9 million for the same period of 2005. Investment activities in 2005 included the acquisition and related costs for Mikron and Besten of \$200.5 million, net of cash acquired. Partially offsetting this decline in acquisition spending is an increase in capital expenditures in 2006. Capital expenditures increased \$25.7 million to \$61.0 million in the nine months ended July 31, 2006 from \$35.3 million in the same period of the previous year. Capital spending in the Vehicular Products segment increased by \$26.8 million primarily due to the value-added capacity projects at Macsteel. The Company estimates that fiscal 2006 capital expenditures will be approximately \$72.0 million. Included in the \$72.0 million expected fiscal 2006 expenditures is approximately \$30.0 million related to the Macsteel value-added and capacity projects; these projects are expected to be near completion by December 2006, and the Company has not currently planned for projects with that level of capital

requirement for 2007. At July 31, 2006, the Company had commitments of approximately \$36.1 million for the purchase or construction of capital assets. The Company plans to fund these capital expenditures with cash flow from operations.

#### *Financing Activities*

The Company used \$62.9 million for financing activities during the nine months ended July 31, 2006 compared to a source of cash from financing activities of \$30.3 million during the same prior year period. This \$93.2 million increase in cash used is primarily related to the Company's stock buyback program. During the nine months ended July 31, 2006, the Company purchased 1,573,950 shares of its common stock for \$58.3 million. The Company did not make any borrowings on the Bank Agreement in the first nine months of 2006 compared to net borrowings of \$29.9 million against the Bank Agreement during the same period of fiscal 2005. Additionally, the Company received \$11.1 million in the nine months ended July 31, 2006, for the issuance of common stock related to the exercise of options (including related tax benefits), versus \$10.3 million in the same period last year. The \$2.8 million increase in dividends paid for the nine months of 2006, compared to 2005, is a result of the increases to the Company's dividend rate effective September 2005 and March 2006.

#### **Critical Accounting Estimates**

In preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, the Company's management must make decisions which impact the reported amounts and the related disclosures. Such decisions include the selection of the appropriate accounting principles to be applied and assumptions on which to base estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to revenue recognition, allowances for doubtful accounts, inventory, long-lived assets, environmental contingencies, insurance, U.S. pension and other post-employment benefits, litigation and contingent liabilities, and income taxes. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company's management believes the critical accounting estimates listed and described in Part II, Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company's 2005 Annual Report on Form 10-K are the most important to the fair presentation of the Company's financial condition and results. These policies require management's significant judgments and estimates in the preparation of the Company's consolidated financial statements. There have been no significant changes to the Company's critical accounting estimates since October 31, 2005 other than those discussed below under New Accounting Pronouncements.

#### **New Accounting Pronouncements**

##### *Stock—Based Compensation*

On November 1, 2005, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), "*Share-Based Payment*" (SFAS 123R) issued by the Financial Accounting Standards Board (FASB) in December 2004. SFAS 123R requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in the consolidated financial statements. Prior to November 1, 2005, under the disclosure only provisions of SFAS No. 123, "*Accounting for Stock-Based Compensation*" (SFAS 123), the Company applied

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Accounting Principles Board (APB) Opinion No. 25, “*Accounting for Stock Issued to Employees*” (APB 25), and related Interpretations in accounting for its stock option plans. Accordingly, prior to fiscal 2006, the Company recognized zero stock-based compensation expense in its income statement for non-qualified stock options, as the exercise price was equal to the closing market price of the Company’s stock on the date of grant. However, the Company did recognize stock-based compensation expense for its restricted stock plans as discussed in Note 15, Restricted Stock and Stock Option Plans, of the Notes to the Consolidated Financial Statements in its Annual Report on Form 10-K for the fiscal year ended October 31, 2005. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123R. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R.

The Company elected the modified prospective transition method as permitted by the adoption of SFAS 123R. Under this transition method, stock-based compensation expense beginning as of November 1, 2005 includes (i) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of October 31, 2005, based on the grant-date fair value estimated in accordance with the original proforma provisions of SFAS 123; and (ii) compensation expense for all stock-based compensation awards granted subsequent to October 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Prior to the adoption of SFAS 123R, unearned compensation was shown as a reduction of stockholders’ equity. The November 1, 2005 unearned compensation balance of \$1.4 million was reclassified against additional paid-in-capital upon adoption of SFAS 123R. In fiscal 2006 and future periods, common stock par value will be recorded when the restricted stock is issued and additional paid-in-capital will be increased as the restricted stock compensation cost is recognized for financial reporting purposes. In accordance with the modified prospective transition method, the Company’s Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R.

The Company recognizes compensation expense on a straight-line basis over the requisite service period of the award. As stock-based compensation expense recognized in the income statement beginning November 1, 2005 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, when necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. In the Company’s proforma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred. Prior to the implementation of SFAS 123R, the Company computed stock-based compensation cost for employees eligible to retire over the standard vesting period of the grants. Upon adoption of SFAS 123R, the Company amortizes new option grants to such retirement-eligible employees immediately upon grant, consistent with the retirement vesting acceleration provisions of these grants. For employees near retirement age, the Company amortizes such grants over the period from the grant date to the retirement date if such period is shorter than the standard vesting schedule.

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The following is the effect of adopting SFAS 123R as of November 1, 2005 (in thousands except per share amounts):

	<b>Three Months Ended</b>	<b>Nine Months Ended</b>
	<b>July 31, 2006</b>	<b>July 31, 2006</b>
Decrease in operating income and income from continuing operations	\$ 744	\$ 3,104
Related deferred income tax benefit	(275)	(1,148)
Decrease in net income	<u>\$ 469</u>	<u>\$ 1,956</u>
Decrease in basic earnings per common share	\$ (0.01)	\$ (0.05)
Decrease in diluted earnings per common share	\$ (0.01)	\$ (0.05)

The amounts above relate to the impact of recognizing compensation expense for stock options only, as compensation expense related to restricted stock was recognized by the Company before implementation of SFAS 123R under previous accounting standards.

In accordance with SFAS 123R, the consolidated statements of cash flow report the excess tax benefits from the stock-based compensation as financing cash inflows. For the three and nine months ended July 31, 2006, \$0.3 million and \$4.7 million, respectively, of excess tax benefits were reported as financing cash inflows.

Under SFAS 123R, the Company continues to use the Black-Scholes-Merton option-pricing model to estimate the fair value of its stock options. However, the Company has applied the expanded guidance under SFAS 123R and SAB 107 for the development of its assumptions used as inputs for the Black-Scholes-Merton option pricing model for grants beginning November 1, 2005. The Company's fair value determination of stock-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company's expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behavior. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company's employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management's opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company's employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123R and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

On November 10, 2005, the FASB issued FASB Staff Position No. SFAS 123(R)-3, "*Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*" (FSP 123R-3). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123R. The Company has until November 2006 to make a one-time election to adopt the transition method described in FSP 123R-3. The Company is currently evaluating FSP 123R-3; however, the one-time election is not expected to affect operating income or net income.

See Note 11 in Item 1 of this Form 10-Q for additional stock-based compensation disclosures.

*Other*

In October 2004, the President signed into law the American Jobs Creation Act (the AJC Act). The AJC Act allows for a federal income tax deduction for a percentage of income earned from certain domestic production activities. The Company's U.S. production activities qualify for the deduction. Based on the effective date of this provision of the AJC Act, the Company is eligible for this deduction beginning in fiscal 2006. Additionally, in December 2004, the FASB issued FASB Staff Position 109-1, "Application of FASB Statement No. 109, Accounting for Income Taxes (SFAS 109), to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004" (FSP 109-1). FSP 109-1, which was effective upon issuance, requires the Company to treat the tax deduction as a special deduction instead of a change in tax rate that would have impacted the existing deferred tax balances. The Company has estimated that this special deduction will reduce the Company's effective tax rate in fiscal 2006 by approximately 1%.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The following discussion of the Company and its subsidiaries' exposure to various market risks contains "forward looking statements" that involve risks and uncertainties. These projected results have been prepared utilizing certain assumptions considered reasonable in light of information currently available to the Company. Nevertheless, because of the inherent unpredictability of interest rates, foreign currency rates and metal commodity prices as well as other factors, actual results could differ materially from those projected in such forward looking information. The Company does not use derivative financial instruments for speculative or trading purposes.

**Interest Rate Risk**

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

At July 31, 2006, the Company had fixed-rate debt totaling \$126.8 million or 95% of total debt, which does not expose the Company to the risk of earnings loss due to changes in market interest rates. The Company and certain of its subsidiaries' floating-rate obligations totaled \$6.6 million, or 5% of total debt, at July 31, 2006. Based on the floating-rate obligations outstanding at July 31, 2006, a one percent increase or decrease in the average interest rate would result in a change to pre-tax interest expense of approximately \$66 thousand.

**Commodity Price Risk**

The Vehicular Products segment has a scrap surcharge program in place, which is a practice that is well established within the engineered steel bar industry. The scrap surcharge is based on a three city, three- or one- month trailing average of #1 bundle scrap prices. The Company's long-term exposure to changes in scrap costs is significantly reduced because of the surcharge program. Over time, the Company recovers the majority of its scrap cost increases, though there is a level of exposure to short-term volatility because of this lag. Historically, the segment's scrap surcharge has been based on a three-month trailing average. However, during the first quarter of 2006, Quanex has moved approximately 85% of the accounts, representing about 70% of shipments, to a one-month cycle. Reducing the adjustment period from three months to one month is expected to reduce the segment's margin volatility in the future.

Within the Building Products segment, the Company uses various grades of aluminum scrap as well as minimal amounts of prime aluminum ingot as raw materials for its manufacturing processes. The price of raw materials is subject to fluctuations due to many factors in the aluminum market. In the normal course of business, Nichols Aluminum enters into firm price sales commitments with its customers. In an effort to reduce the risk of fluctuating raw material prices, Nichols Aluminum enters into firm price raw material purchase commitments (which are designated as “normal purchases” under SFAS 133) as well as option contracts on the LME. The Company’s risk management policy as it relates to these LME contracts is to enter into contracts to cover the raw material needs of the Company’s committed sales orders to the extent not covered by fixed price purchase commitments.

Through the use of firm price raw material purchase commitments and LME contracts, the Company intends to protect cost of sales from the effects of changing prices of aluminum. To the extent that the raw material costs factored into the firm price sales commitments are matched with firm price raw material purchase commitments, changes in aluminum prices should have no effect. During the fiscal 2006, the Company primarily relied upon firm price raw material purchase commitments to protect cost of sales tied to firm price sales commitments. There were no outstanding LME hedges as of July 31, 2006.

Within the Building Products segment, polyvinyl resin (PVC) is the significant raw material consumed during the manufacture of vinyl extrusions. The Company has a monthly resin adjuster in place with its customers that is adjusted based upon published industry resin prices. This adjuster effectively shares the base pass-through price changes of PVC with its customers commensurate with the market at large. The Company’s long-term exposure to changes in PVC prices is thus significantly reduced due to the contractual component of the resin adjuster program.

#### ***Item 4. Controls and Procedures***

##### **Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (1934 Act) as of July 31, 2006. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of July 31, 2006, the disclosure controls and procedures are effective.

##### **Changes in Internal Control over Financial Reporting**

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



**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

Information regarding legal proceedings is set forth in Note Thirteen to the consolidated financial statements in Item 1 of Part I of this Form 10-Q, which information is hereby incorporated by reference herein.

**Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Description of Exhibits</b>
3.1	Restated Certificate of Incorporation of the Registrant dated as of November 10, 1995, filed as Exhibit 3.1 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1995 and incorporated herein by reference.
3.2	Certificate of Amendment to Restated Certificate of Incorporation of the Registrant dated as of February 27, 1997, filed as Exhibit 3.2 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference.
3.3	Amendment to Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock of the Registrant dated as of April 15, 1999, filed as Exhibit 3.3 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference.
3.4	Certificate of Correction of Amendment to Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock dated as of April 16, 1999, filed as Exhibit 3.4 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference.
3.5	Amended and Restated Bylaws of the Registrant, as amended June 1, 2005, filed as Exhibit 3.5 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2005 and incorporated herein by reference.
4.1	Form of Registrant's Common Stock certificate, filed as Exhibit 4.1 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 1987, and incorporated herein by reference.
4.2	Revolving Credit Agreement dated as of November 26, 2002, by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks filed as Exhibit 4.4 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 2002, and incorporated herein by reference. Certain schedules and exhibits to this Revolving Credit Agreement were not filed with this exhibit. The Company agrees to furnish supplementally any omitted schedule or exhibit to the SEC upon request.
4.3	First Amendment to Security Agreement, dated February 17, 2003, effective November 26, 2002, filed as Exhibit 4.5 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2003, and incorporated herein by reference.

<b>Exhibit Number</b>	<b>Description of Exhibits</b>
4.4	Consent and First Amendment to Revolving Credit Agreement dated December 19, 2003, by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks filed as Exhibit 4.5 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 2003, and incorporated herein by reference. Certain schedules and exhibits to this Consent and First Amendment to Revolving Credit Agreement have not been filed with this exhibit. The Company agrees to furnish supplementally any omitted schedule or exhibit to the SEC upon request.
4.5	Waiver and Second Amendment to Revolving Credit Agreement dated March 11, 2004, by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks filed as Exhibit 4.6 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 2004, and incorporated herein by reference.
4.6	Form of Consent to Requested Extension to Revolving Credit Maturity Date under the Quanex Corporation Revolving Credit Agreement dated April 7, 2004, filed as Exhibit 4.7 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2004, and incorporated herein by reference.
4.7	Form of Consent and Third Amendment to Revolving Credit Agreement dated April 9, 2004, by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks, filed as Exhibit 4.8 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2004, and incorporated herein by reference.
4.8	Indenture dated as of May 5, 2004 between Quanex Corporation and Union Bank of California, N.A. as trustee relating to the Company's 2.50% Convertible Senior Debentures due May 15, 2034, filed as Exhibit 4.9 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2004, and incorporated herein by reference.
4.9	Registration Rights Agreement dated as of May 5, 2004 among Quanex Corporation, Credit Suisse First Boston LLC, Bear, Stearns & Co. Inc., Robert W. Baird & Co. Incorporated, and KeyBanc Capital Markets relating to the Company's 2.50% Convertible Senior Debentures due May 15, 2034, filed as Exhibit 4.10 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2004, and incorporated herein by reference.
4.10	Third Amended and Restated Rights Agreement dated as of September 15, 2004, between the Registrant and Wells Fargo Bank, N.A. as Rights Agent, filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K (Reg. No. 001-05725) dated September 17, 2004, and incorporated herein by reference.
4.11	Form of Consent and Fourth Amendment to Revolving Credit Agreement dated November 18, 2004 by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks, filed as Exhibit 4.11 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 2004, and incorporated herein by reference.

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<b>Exhibit Number</b>	<b>Description of Exhibits</b>
4.12	Supplemental Indenture dated as of January 25, 2005 by and between the Company and Union Bank of California, N.A., as trustee, to the indenture governing the Company's 2.50% Convertible Senior Debentures due May 15, 2034, filed as Exhibit 99.1 to the Registrant's Current Report on Form 8-K (Reg. No. 001-05725) dated January 26, 2005, and incorporated herein by reference.
4.13	Fifth Amendment to Revolving Credit Agreement dated March 11, 2005 by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks, filed as Exhibit 4.12 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 2005, and incorporated herein by reference.
† * 10.1	Fourth Amendment to the Quanex Corporation Employee Savings Plan, dated June 20, 2006.
† * 10.2	Fifth Amendment to the Quanex Corporation Hourly Bargaining Unit Employee Savings Plan, dated June 20, 2006.
† * 10.3	First Amendment to the Quanex Corporation 401(k) Savings Plan, dated July 26, 2006.
† * 10.4	Fourth Amendment to the Quanex Corporation 401(k) Savings Plan for Hourly Employees, dated July 26, 2006.
* 31.1	Certification by chief executive officer pursuant to Rule 13a-14(a)/15d-14(a).
* 31.2	Certification by chief financial officer pursuant to Rule 13a-14(a)/15d-14(a).
* 32.1	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

† Management Compensation or Incentive Plan

\* Filed herewith

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

**SIGNATURES**

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

**QUANEX CORPORATION**

/s/ Thomas M. Walker

Thomas M. Walker

Senior Vice President – Finance and Chief Financial Officer

(Principal Financial Officer)

Date: August 30, 2006

**EXHIBIT INDEX**

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3.3	Amendment to Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock of the Registrant dated as of April 15, 1999, filed as Exhibit 3.3 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference.
3.4	Certificate of Correction of Amendment to Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock dated as of April 16, 1999, filed as Exhibit 3.4 of the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 1999 and incorporated herein by reference.
3.5	Amended and Restated Bylaws of the Registrant, as amended June 1, 2005, filed as Exhibit 3.5 of the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2005 and incorporated herein by reference.
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4.3	First Amendment to Security Agreement, dated February 17, 2003, effective November 26, 2002, filed as Exhibit 4.5 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2003, and incorporated herein by reference.

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4.4	Consent and First Amendment to Revolving Credit Agreement dated December 19, 2003, by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks filed as Exhibit 4.5 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 2003, and incorporated herein by reference. Certain schedules and exhibits to this Consent and First Amendment to Revolving Credit Agreement have not been filed with this exhibit. The Company agrees to furnish supplementally any omitted schedule or exhibit to the SEC upon request.
4.5	Waiver and Second Amendment to Revolving Credit Agreement dated March 11, 2004, by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks filed as Exhibit 4.6 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 2004, and incorporated herein by reference.
4.6	Form of Consent to Requested Extension to Revolving Credit Maturity Date under the Quanex Corporation Revolving Credit Agreement dated April 7, 2004, filed as Exhibit 4.7 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2004, and incorporated herein by reference.
4.7	Form of Consent and Third Amendment to Revolving Credit Agreement dated April 9, 2004, by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks, filed as Exhibit 4.8 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2004, and incorporated herein by reference.
4.8	Indenture dated as of May 5, 2004 between Quanex Corporation and Union Bank of California, N.A. as trustee relating to the Company's 2.50% Convertible Senior Debentures due May 15, 2034, filed as Exhibit 4.9 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2004, and incorporated herein by reference.
4.9	Registration Rights Agreement dated as of May 5, 2004 among Quanex Corporation, Credit Suisse First Boston LLC, Bear, Stearns & Co. Inc., Robert W. Baird & Co. Incorporated, and KeyBanc Capital Markets relating to the Company's 2.50% Convertible Senior Debentures due May 15, 2034, filed as Exhibit 4.10 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended April 30, 2004, and incorporated herein by reference.
4.10	Third Amended and Restated Rights Agreement dated as of September 15, 2004, between the Registrant and Wells Fargo Bank, N.A. as Rights Agent, filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K (Reg. No. 001-05725) dated September 17, 2004, and incorporated herein by reference.
4.11	Form of Consent and Fourth Amendment to Revolving Credit Agreement dated November 18, 2004 by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks, filed as Exhibit 4.11 to the Registrant's Annual Report on Form 10-K (Reg. No. 001-05725) for the fiscal year ended October 31, 2004, and incorporated herein by reference.

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<b>Exhibit Number</b>	<b>Description of Exhibits</b>
4.12	Supplemental Indenture dated as of January 25, 2005 by and between the Company and Union Bank of California, N.A., as trustee, to the indenture governing the Company's 2.50% Convertible Senior Debentures due May 15, 2034, filed as Exhibit 99.1 to the Registrant's Current Report on Form 8-K (Reg. No. 001-05725) dated January 26, 2005, and incorporated herein by reference.
4.13	Fifth Amendment to Revolving Credit Agreement dated March 11, 2005 by and among Quanex Corporation, the financial institutions from time to time signatory thereto and Comerica Bank, as agent for the banks, filed as Exhibit 4.12 to the Registrant's Quarterly Report on Form 10-Q (Reg. No. 001-05725) for the quarter ended January 31, 2005, and incorporated herein by reference.
† * 10.1	Fourth Amendment to the Quanex Corporation Employee Savings Plan, dated June 20, 2006.
† * 10.2	Fifth Amendment to the Quanex Corporation Hourly Bargaining Unit Employee Savings Plan, dated June 20, 2006.
† * 10.3	First Amendment to the Quanex Corporation 401(k) Savings Plan, dated July 26, 2006.
† * 10.4	Fourth Amendment to the Quanex Corporation 401(k) Savings Plan for Hourly Employees, dated July 26, 2006.
* 31.1	Certification by chief executive officer pursuant to Rule 13a-14(a)/15d-14(a).
* 31.2	Certification by chief financial officer pursuant to Rule 13a-14(a)/15d-14(a).
* 32.1	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

† Management Compensation or Incentive Plan

\* Filed herewith

**CHIEF EXECUTIVE OFFICER CERTIFICATION**

I, Raymond A. Jean, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Quanex Corporation (the "Registrant");
2. 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;
3. 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;
4. The Registrant's other certifying officer 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)] and internal control over financial reporting [as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)] 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. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. 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
  - d. 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
5. The Registrant's other certifying officer 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.

August 30, 2006

/s/ Raymond A. Jean

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Raymond A. Jean

Chairman of the Board, President and Chief Executive Officer  
(Principal Executive Officer)



**CHIEF FINANCIAL OFFICER CERTIFICATION**

I, Thomas M. Walker, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Quanex Corporation (the "Registrant");
2. 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;
3. 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;
4. The Registrant's other certifying officer 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)] and internal control over financial reporting [as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)] 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. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. 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
  - d. 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
5. The Registrant's other certifying officer 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.

August 30, 2006

/s/ Thomas M. Walker

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Thomas M. Walker

Senior Vice President – Finance and Chief Financial Officer  
(Principal Financial Officer)



**FOURTH AMENDMENT TO THE  
QUANEX CORPORATION EMPLOYEE SAVINGS PLAN**

**THIS AGREEMENT** by Quanex Corporation, a Delaware corporation (the “*Sponsor*”),

**W I T N E S S E T H:**

**WHEREAS**, the Sponsor maintains the Quanex Corporation Employee Savings Plan, as amended and restated effective January 1, 2002 (the “*Plan*”);

**WHEREAS**, pursuant to Section 12.01 of the Plan, the Sponsor has the right to amend the Plan; and

**WHEREAS**, the Sponsor has determined to amend the Plan;

**NOW, THEREFORE**, the Sponsor agrees that, effective July 3, 2006, the Plan is amended as set forth below:

1. Section 1.24 of the Plan, the definition for “Entry Date,” shall be deleted in its entirety and the Sections in Article I shall be renumbered accordingly.

2. Section 2.01 of the Plan shall be completely amended and restated to provide as follows:

**2.01 Eligibility Requirements.** Each Eligible Employee shall be eligible to participate in the Plan beginning on the first day he performs one Hour of Service. However, an Employee who is included in a unit of Employees covered by a collective bargaining agreement between the Employees’ representative and the Employer shall be excluded, even if he has met the requirements for eligibility, if there has been good faith bargaining between the Employer and the Employees’ representative pertaining to retirement benefits and the agreement does not require the Employer to include such Employees in the Plan. In addition, a Leased Employee shall not be eligible to participate in the Plan unless the Plan’s qualified status is dependent upon coverage of the Leased Employee. An Employee who is a nonresident alien (within the meaning of section 7701(b) of the Code) and receives no earned income (within the meaning of section 911(d)(2) of the Code) from any Affiliated Employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3) of the Code) is not eligible to participate in the Plan. An Employee who is a nonresident alien (within the meaning of section 7701(b) of the Code) and who does receive earned income (within the meaning of section 911(d)(2) of the Code) from any Affiliated Employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3) of the Code) all of which is exempt from United States income tax under an applicable tax convention is not eligible to participate in the Plan. During any period in which an individual is classified by an Employer as an independent contractor

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with respect to such Employer, the individual is not eligible to participate in the Plan (even if he is subsequently reclassified by the Internal Revenue Service as a common law employee of the Employer and the Employer acquiesces to the reclassification). During any period in which an individual is classified by an Employer as an intern or student with respect to such Employer, the individual is not eligible to participate in the Plan. Finally, an Employee who is employed outside the United States is not eligible to participate in the Plan unless the Committee elects to permit him to participate in the Plan.

3. Section 2.02 of the Plan shall be deleted in its entirety and the Sections in Article II shall be renumbered accordingly.

4. Section 2.03 of the Plan, renumbered as Section 2.02 in accordance with paragraph 3 above, shall be amended to provide as follows:

**2.02 Eligibility Upon Reemployment.** If an Employee incurs a Separation From Service, he shall be eligible to recommence participation in the Plan beginning on the first day he performs one Hour of Service following his Separation From Service. Subject to Section 2.03, once an Employee becomes a Participant, his eligibility to participate in the Plan shall continue until he Severs Service.

5. Section 6.02 shall be completely amended and restated to provide as follows:

**6.02 In-Service Distribution of After-Tax Contributions, Matching Contributions and Supplemental Contributions.** Each Participant shall be entitled to withdraw a portion or all of his After-Tax Contribution Account and his Nonforfeitable Interest in his Matching Contribution Account and his Supplemental Contribution Account. However, the minimum amount of the distribution permitted under this Section 6.02 shall be the lesser of \$1,000.00 or the total amount which could otherwise be distributed under this Section 6.02. Also, a Participant may make a withdrawal of a portion of his Nonforfeitable Interest in his Matching Contribution Account and his Supplemental Contribution Account only if the Participant has been a Participant in this Plan for five or more years or the amounts withdrawn from the Matching Contribution Account and his Supplement Contribution Account have been credited to his Account for a minimum of two years. A Participant may not make another distribution request under this Section 6.02 for a period of 12 months after receiving a distribution pursuant to this Section 6.02.

6. Section 5.09 shall be completely amended and restated to provide as follows:

**5.09 Designation of Beneficiary.** Each Participant and former Participant has the right to designate and to revoke the designation of his Beneficiary or Beneficiaries. Each designation or revocation must be evidenced in the form required by the Committee, signed by the Participant or former Participant and filed with the Committee or its designee. If no designation is on file at the time of a Participant's or former Participant's death or if the Committee determines that the designation is ineffective, the designated Beneficiary shall be

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the Participant's or former Participant's Spouse, if living, or if not, the executor, administrator or other personal representative of the Participant's or former Participant's estate. If a Participant or former Participant is considered to be married under local law, his designation of any Beneficiary, other than his Spouse, shall not be valid unless the Spouse acknowledges in writing or such form as required by the Committee that the Spouse understands the effect of the Participant's or former Participant's beneficiary designation and consents to it. The consent must be to a specific Beneficiary. The acknowledgement and consent must be filed with the Committee or its designee, signed by the Spouse and at least two witnesses, one of whom must be a member of the Committee or a notary public. However, if the Spouse cannot be located or there exist other circumstances as described in sections 401(a)(11) and 417(a)(2) of the Code, the requirement of the Participant's or former Participant's Spouse's acknowledgement and consent may be waived. If a Beneficiary other than the Participant's or former Participant's Spouse is named, the designation shall become invalid if the Participant or former Participant is later determined to be married under local law, the Participant's or former Participant's missing Spouse is located or the circumstances which resulted in the waiver of the requirement of obtaining the consent of his Spouse no longer exist.

7. Sections 5.12 and 5.13 shall be completely amended and restated to provide as follows:

**5.12 *Claims Review Procedures; Claims Appeal Procedures.***

(a) *Claims Review Procedures.* When a benefit is due, the Claimant should submit a claim in accordance with procedures prescribed by the Committee. Under normal circumstances, the Committee will make a final decision as to a claim within 90 days after receipt of the claim. If the Claimant is notified in writing during the initial 90-day period, the period may be extended up to 180 days after the initial receipt of the claim. The written notice must indicate the circumstances necessitating the extension and the anticipated date for the final decision. If a claim is denied during the claims period, the Claimant must be notified in writing, and the written notice must set forth in a manner calculated to be understood by the Claimant:

- i. the specific reason or reasons for denial;
  - ii. specific reference to the Plan provisions on which the denial is based;
  - iii. a description of any additional material or information necessary for the Claimant to perfect the claim and an explanation of why such material or information is necessary; and
  - iv. an explanation of the Plan claims review procedures and time limits, including a statement of the Claimant's right to bring a civil action under section 502(a) of ERISA.
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If a decision is not given to the Claimant within the claims review period, the claim is treated as if it were denied on the last day of the claims review period.

(b) *Claims Appeals Procedures.* If a Claimant's claim made pursuant to Section 5.12(a) is denied and he wants a review, he must apply to the Committee or its designee in writing. That application can include any arguments, written comments, documents, records, and other information relating to the claim for benefits. In addition, the Claimant is entitled to receive on request and free of charge reasonable access to and copies of all information relevant to the claim. For this purpose, "relevant" means information that was relied on in making the benefit determination or that was submitted, considered or generated in the course of making the determination, without regard to whether it was relied on, and information that demonstrates compliance with the Plan's administrative procedures and safeguards for assuring and verifying that Plan provisions are applied consistently in making benefit determinations. The review must take into account all comments, documents, records, and other information submitted by the Claimant relating to the claim, without regard to whether the information was submitted or considered in the initial benefit determination. The Claimant may either represent himself or appoint a representative, either of whom has the right to inspect all documents pertaining to the claim and its denial. The Committee or its designee can schedule any meeting with the Claimant or his representative that it finds necessary or appropriate to complete its review.

This Section 5.12 does not apply in connection with determinations as to whether a Participant or former Participant has incurred a Disability. Rather, such determinations shall be subject to the procedures specified in Section 5.13.

#### **5.13 Disability Benefit Claims Procedure.**

(a) **Disability Benefit Initial Determination Procedure.** In the case of a claim for Disability benefits, the Claimant should submit a claim to the office designated by the Committee to receive claims. Under normal circumstances, the Claimant shall be notified of any Disability claims denial (wholly or partially) within 45 days after receipt of the claim.

The initial 45-day Disability claims determination period may be extended by a period not to exceed an additional 30 days, if it is determined that such extension is necessary due to matters beyond the control of the Committee or its designee. If the initial Disability claims determination period is extended, the Claimant shall, prior to the expiration of the initial 45 day Disability claims determination period, be notified in writing of the extension and of the circumstances requiring the extension of the Disability claims determination period.

If, prior to the end of the first 30-day extension, it is determined that, due to matters beyond the control of the Plan, a decision cannot be rendered within the extension period, the Disability claims determination period may be extended for an additional 30 days, provided that, prior to the expiration of the first 30-day extension period, the Claimant is notified in writing of the circumstances

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requiring the extension and the date on which the Plan expects to render a decision. In the case of any notice extending the Disability claims determination period, the notice must be in writing and shall specifically explain the standards on which the entitlement to a benefit is based; the unresolved issues that prevent a determination on a claim; additional information that is needed to resolve those issues; and, if additional information is required from the Claimant, a statement as to the amount of time the Claimant has to supply that information.

*Calculation of Time Periods.* The period of time within which a Disability benefit determination is required to be made shall begin on that date the claim is filed in accordance with this Section, without regard to whether all the information necessary to make the Disability benefits determination accompanies the filing. In the event the Disability claims determination period is extended due to the Claimant's failure to submit information necessary to such determination, the Disability claims determination period shall be tolled from the date on which the notification of the extension is sent to the Claimant until the date on which the Claimant responds to the request for additional information. The Claimant shall be afforded at least 45 days from receipt of the notice of extension to provide the specified information. If the Claimant fails to supply the specified information within the 45-day period, the claim determination process shall continue and the specified information shall be deemed not to exist.

**(b) Disability Claims Appeal Procedure.** If a Claimant's claim for a Disability benefit is denied (in whole or in part), he is entitled to a full and fair review of that denial. A full and fair review of a Disability benefit claim denial shall provide the Claimant with 180 days from the receipt of any adverse claim determination to appeal the denial. If the Claimant does not file an appeal within 180 days of the adverse claim determination, such denial becomes final.

Under the full and fair review, the Claimant shall be afforded an opportunity to submit written comments, documents, records, and other information relating to the claim for benefits to the reviewing fiduciary. The Claimant shall be entitled to receive upon request and free of charge reasonable access to and copies of all information relevant to the claim. For purposes of a Disability benefit claim denial, the term "relevant" shall mean information that was relied on in making the benefit determination or that was submitted, considered or generated in the course of making the determination, without regard to whether it was relied on, and information that demonstrates compliance with the Plan's administrative procedures and safeguards for assuring and verifying that Plan provisions are applied consistently in making benefit determinations. For this purpose, the term "relevant" shall also include a statement of policy or guidance with respect to the Plan concerning the Disability benefit for the diagnoses of the Claimant, without regard to whether such advice or statement was relied upon in making the claims determination. The review of a benefit claim denial shall not afford any deference to the initial adverse claim determination.

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The review of the Disability claims denial shall be conducted by the appropriate named fiduciary who is *neither* the named fiduciary who made the initial adverse claim determination *nor* subordinate to such individual.

In reviewing a denial of a claim for a Disability benefit, in which the denial was based in whole or in part on medical judgment, the appropriate named fiduciary shall consult with a health care professional who has appropriate training and experience in the field of medicine involved in the medical judgment. The health care professional consulted upon review of an adverse benefit claim denial shall be *neither* the health care professional that was consulted in connection with the adverse benefit determination that is the subject of the appeal *nor* a subordinate of any such individual. The reviewing fiduciary shall provide the identification of the medical or vocational experts whose advice was obtained on behalf of the Plan in connection with Claimant's Disability benefit claim denial, without regard as to whether the advice was relied upon in making the benefit determination.

The appropriate reviewing fiduciary must take into account all comments, documents, records, and other information submitted by the Claimant relating to the claim, without regard as to whether the information was submitted or considered in the initial benefit determination. The Claimant may either represent himself or appoint a representative, either of whom has the right to inspect all documents pertaining to the claim and its denial. The reviewing fiduciary can schedule any meeting with the Claimant or his representative that it finds necessary or appropriate to complete its review.

If a timely request is made, the reviewing fiduciary shall notify the Claimant of the determination upon appeal within 45 days after receipt of the request for review (without regard to whether all the information necessary to make the benefit determination accompanies the filing). The reviewing fiduciary retains the authority to unilaterally extend the initial 45-day review period by a period not to exceed an additional 45 days, if the fiduciary determines that special circumstances exist requiring additional time for reviewing the claim. If the initial review period is extended by the unilateral action of the appropriate reviewing fiduciary, the fiduciary shall, prior to the expiration of the initial 45 day review period, notify the Claimant in writing of the extension. The written notice of extension shall identify the special circumstances necessitating the extension and provide the anticipated date by which the Plan expects to render the determination on review.

*Calculation of Time Periods Upon Appeal.* The period of time within which a determination on a Disability claims appeal is required to be made shall begin on that date the appeal is filed in accordance with this Section, without regard to whether all the information necessary to make the Disability benefits determination accompanies the filing. In the event the Disability claims review period is extended due to the Claimant's failure to submit information necessary to such determination, the Disability claims review period shall be tolled from the date on which the notification of the extension is sent to the Claimant until the date on which the Claimant responds to the request for additional information.

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The Claimant shall be afforded at least 45 days from receipt of the notice of extension to provide the requested information. If the Claimant fails to supply the requested information within the 45-day period, the claims review process shall continue and the specified information shall be deemed not to exist.

The reviewing fiduciary shall provide the Claimant with a written notice of the Plan's benefit determination upon review. The notice shall set forth the specific reasons for its action, the Plan provisions on which its decision is based, and a statement that the Claimant is entitled to receive, upon request and free of charge, reasonable access to, and copies of, all documents, records, and other information relevant to the Claimant's claim for benefits, and a statement of the Claimant's right to bring an action under section 502(a) of ERISA. The notice shall also include the following statement,

*"You and the Plan may have other voluntary alternative dispute resolution options, such as mediation. One way to find out what may be available is to contact your local U.S. Department of Labor Office and your State insurance regulatory agency."*

If a decision is not given to the Claimant within the review period, the claim is treated as if it were denied on the last day of the review period.

The request for review must be filed within 90 days after the denial. If it is not, the denial becomes final. If a timely request is made, the reviewing fiduciary must make its decision, under normal circumstances, within 60 days of the receipt of the request for review. However, if the reviewing fiduciary notifies the Claimant prior to the expiration of the initial review period, it may extend the period of review up to 120 days following the initial receipt of the request for a review. The written notice must indicate the circumstances necessitating the extension and the anticipated date for the final decision. All decisions of the reviewing fiduciary must be in writing and must include the specific reasons for its action, the Plan provisions on which its decision is based, and a statement that the Claimant is entitled to receive, upon request and free of charge, reasonable access to, and copies of, all documents, records, and other information relevant to the Claimant's claim for benefits, and a statement of the Claimant's right to bring an action under section 502(a) of ERISA. If a decision is not given to the Claimant within the review period, the claim is treated as if it were denied on the last day of the review period.

8. Section 6.03 of the Plan shall be renumbered Section 6.04, and Article VI of the Plan shall be amended by adding thereto the following new Section 6.03 to provide as follows:

**6.03 In-Service Distributions for Participants Who Have Attained Age 59½.** Prior to his Separation From Service, a Participant who is at least age 59½ is entitled to withdraw all or any portion of any amounts in his Salary Deferral Contribution Account or his Catch-up Salary Deferral Contribution Account.

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**IN WITNESS WHEREOF**, the Sponsor has caused this Agreement to be executed on the 20th day of June, 2006.

**QUANEX CORPORATION**

By: /s/ Kevin P. Delaney  
Title: Senior Vice President — General Counsel  
and Secretary

**FIFTH AMENDMENT TO THE  
QUANEX CORPORATION HOURLY BARGAINING UNIT EMPLOYEE SAVINGS PLAN**

**THIS AGREEMENT** by Quanex Corporation, a Delaware corporation (the “*Sponsor*”),

**W I T N E S S E T H:**

**WHEREAS**, the Sponsor maintains the Quanex Corporation Hourly Bargaining Unit Employee Savings Plan, as amended and restated effective January 1, 1998 (the “*Plan*”);

**WHEREAS**, pursuant to Section 12.01 of the Plan, the Sponsor has the right to amend the Plan; and

**WHEREAS**, the Sponsor has determined to amend the Plan;

**NOW, THEREFORE**, the Sponsor agrees that, effective July 3, 2006, the Plan is amended as set forth below:

1. Section 1.24 of the Plan, the definition for “Entry Date,” shall be deleted in its entirety and the Sections in Article I shall be renumbered accordingly.

2. Section 2.01 of the Plan shall be completely amended and restated to provide as follows:

**2.01 Eligibility Requirements.** Each Eligible Employee shall be eligible to participate in the Plan beginning on the first day he performs one Hour of Service.

3. Section 2.02 of the Plan shall be deleted in its entirety and the Sections in Article II shall be renumbered accordingly.

4. Section 2.03 of the Plan, renumbered as Section 2.02 in accordance with paragraph 3 above, shall be amended to provide as follows:

**2.02 Eligibility Upon Reemployment.** If an Employee incurs a Separation From Service, he shall be eligible to recommence participation in the Plan beginning on the first day he performs one Hour of Service following his Separation From Service. Subject to Section 2.03, once an Employee becomes a Participant, his eligibility to participate in the Plan shall continue until he Severs Service.

5. Section 6.02 shall be completely amended and restated to provide as follows:

**6.02 In-Service Distribution of After-Tax Contributions, Matching Contributions and Supplemental Contributions.** Each Participant shall be entitled to withdraw a portion or all of his After-Tax Contribution Account and



his Nonforfeitable Interest in his Matching Contribution Account and his Supplemental Contribution Account. However, the minimum amount of the distribution permitted under this Section shall be the lesser of \$1,000.00 or the total amount which could otherwise be distributed under this Section. Also, a Participant may make a withdrawal of a portion of his Nonforfeitable Interest in his Matching Contribution Account and his Supplemental Contribution Account only if the Participant has been a Participant in this Plan for five or more years or the amounts withdrawn from the Matching Contribution Account and his Supplemental Contribution Account have been credited to his Account for a minimum of two years. A Participant may not make another distribution request under this Section for a period of 12 months after receiving a distribution pursuant to this Section

6. Section 5.09 shall be completely amended and restated to provide as follows:

5.09 **Designation of Beneficiary.** Each Participant and former Participant has the right to designate and to revoke the designation of his Beneficiary or Beneficiaries. Each designation or revocation must be evidenced in the form required by the Committee, signed by the Participant or former Participant and filed with the Committee or its designee. If no designation is on file at the time of a Participant's or former Participant's death or if the Committee determines that the designation is ineffective, the designated Beneficiary shall be the Participant's or former Participant's Spouse, if living, or if not, the executor, administrator or other personal representative of the Participant's or former Participant's estate. If a Participant or former Participant is considered to be married under local law, his designation of any Beneficiary, other than his Spouse, shall not be valid unless the Spouse acknowledges in writing or such form as required by the Committee that the Spouse understands the effect of the Participant's or former Participant's beneficiary designation and consents to it. The consent must be to a specific Beneficiary. The acknowledgement and consent must be filed with the Committee or its designee, signed by the Spouse and at least two witnesses, one of whom must be a member of the Committee or a notary public. However, if the Spouse cannot be located or there exist other circumstances as described in sections 401(a)(11) and 417(a)(2) of the Code, the requirement of the Participant's or former Participant's Spouse's acknowledgement and consent may be waived. If a Beneficiary other than the Participant's or former Participant's Spouse is named, the designation shall become invalid if the Participant or former Participant is later determined to be married under local law, the Participant's or former Participant's missing Spouse is located or the circumstances which resulted in the waiver of the requirement of obtaining the consent of his Spouse no longer exist.

7. Sections 5.12 and 5.13 shall be completely amended and restated to provide as follows:

**5.12 *Claims Review Procedures; Claims Appeal Procedures.***

(a) *Claims Review Procedures.* When a benefit is due, the Claimant should submit a claim in accordance with procedures prescribed by the

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Committee. Under normal circumstances, the Committee will make a final decision as to a claim within 90 days after receipt of the claim. If the Claimant is notified in writing during the initial 90-day period, the period may be extended up to 180 days after the initial receipt of the claim. The written notice must indicate the circumstances necessitating the extension and the anticipated date for the final decision. If a claim is denied during the claims period, the Claimant must be notified in writing, and the written notice must set forth in a manner calculated to be understood by the Claimant:

- i. the specific reason or reasons for denial;
- ii. specific reference to the Plan provisions on which the denial is based;
- iii. a description of any additional material or information necessary for the Claimant to perfect the claim and an explanation of why such material or information is necessary; and
- iv. an explanation of the Plan claims review procedures and time limits, including a statement of the Claimant's right to bring a civil action under section 502(a) of ERISA.

If a decision is not given to the Claimant within the claims review period, the claim is treated as if it were denied on the last day of the claims review period.

(b) *Claims Appeals Procedures.* If a Claimant's claim made pursuant to Section 5.12(a) is denied and he wants a review, he must apply to the Committee or its designee in writing. That application can include any arguments, written comments, documents, records, and other information relating to the claim for benefits. In addition, the Claimant is entitled to receive on request and free of charge reasonable access to and copies of all information relevant to the claim. For this purpose, "relevant" means information that was relied on in making the benefit determination or that was submitted, considered or generated in the course of making the determination, without regard to whether it was relied on, and information that demonstrates compliance with the Plan's administrative procedures and safeguards for assuring and verifying that Plan provisions are applied consistently in making benefit determinations. The review must take into account all comments, documents, records, and other information submitted by the Claimant relating to the claim, without regard to whether the information was submitted or considered in the initial benefit determination. The Claimant may either represent himself or appoint a representative, either of whom has the right to inspect all documents pertaining to the claim and its denial. The Committee or its designee can schedule any meeting with the Claimant or his representative that it finds necessary or appropriate to complete its review.

This Section 5.12 does not apply in connection with determinations as to whether a Participant or former Participant has incurred a Disability. Rather, such determinations shall be subject to the procedures specified in Section 5.13.

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### 5.13 Disability Benefit Claims Procedure.

(a) **Disability Benefit Initial Determination Procedure.** In the case of a claim for Disability benefits, the Claimant should submit a claim to the office designated by the Committee to receive claims. Under normal circumstances, the Claimant shall be notified of any Disability claims denial (wholly or partially) within 45 days after receipt of the claim.

The initial 45-day Disability claims determination period may be extended by a period not to exceed an additional 30 days, if it is determined that such extension is necessary due to matters beyond the control of the Committee or its designee. If the initial Disability claims determination period is extended, the Claimant shall, prior to the expiration of the initial 45 day Disability claims determination period, be notified in writing of the extension and of the circumstances requiring the extension of the Disability claims determination period.

If, prior to the end of the first 30-day extension, it is determined that, due to matters beyond the control of the Plan, a decision cannot be rendered within the extension period, the Disability claims determination period may be extended for an additional 30 days, provided that, prior to the expiration of the first 30-day extension period, the Claimant is notified in writing of the circumstances requiring the extension and the date on which the Plan expects to render a decision. In the case of any notice extending the Disability claims determination period, the notice must be in writing and shall specifically explain the standards on which the entitlement to a benefit is based; the unresolved issues that prevent a determination on a claim; additional information that is needed to resolve those issues; and, if additional information is required from the Claimant, a statement as to the amount of time the Claimant has to supply that information.

*Calculation of Time Periods.* The period of time within which a Disability benefit determination is required to be made shall begin on that date the claim is filed in accordance with this Section, without regard to whether all the information necessary to make the Disability benefits determination accompanies the filing. In the event the Disability claims determination period is extended due to the Claimant's failure to submit information necessary to such determination, the Disability claims determination period shall be tolled from the date on which the notification of the extension is sent to the Claimant until the date on which the Claimant responds to the request for additional information. The Claimant shall be afforded at least 45 days from receipt of the notice of extension to provide the specified information. If the Claimant fails to supply the specified information within the 45-day period, the claim determination process shall continue and the specified information shall be deemed not to exist.

(b) **Disability Claims Appeal Procedure.** If a Claimant's claim for a Disability benefit is denied (in whole or in part), he is entitled to a full and fair review of that denial. A full and fair review of a Disability benefit claim denial shall provide the Claimant with 180 days from the receipt of any adverse claim determination to appeal the denial. If the Claimant does not file an appeal within 180 days of the adverse claim determination, such denial becomes final.

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Under the full and fair review, the Claimant shall be afforded an opportunity to submit written comments, documents, records, and other information relating to the claim for benefits to the reviewing fiduciary. The Claimant shall be entitled to receive upon request and free of charge reasonable access to and copies of all information relevant to the claim. For purposes of a Disability benefit claim denial, the term “relevant” shall mean information that was relied on in making the benefit determination or that was submitted, considered or generated in the course of making the determination, without regard to whether it was relied on, and information that demonstrates compliance with the Plan’s administrative procedures and safeguards for assuring and verifying that Plan provisions are applied consistently in making benefit determinations. For this purpose, the term “relevant” shall also include a statement of policy or guidance with respect to the Plan concerning the Disability benefit for the diagnoses of the Claimant, without regard to whether such advice or statement was relied upon in making the claims determination. The review of a benefit claim denial shall not afford any deference to the initial adverse claim determination.

The review of the Disability claims denial shall be conducted by the appropriate named fiduciary who is *neither* the named fiduciary who made the initial adverse claim determination *nor* subordinate to such individual.

In reviewing a denial of a claim for a Disability benefit, in which the denial was based in whole or in part on medical judgment, the appropriate named fiduciary shall consult with a health care professional who has appropriate training and experience in the field of medicine involved in the medical judgment. The health care professional consulted upon review of an adverse benefit claim denial shall be *neither* the health care professional that was consulted in connection with the adverse benefit determination that is the subject of the appeal *nor* a subordinate of any such individual. The reviewing fiduciary shall provide the identification of the medical or vocational experts whose advice was obtained on behalf of the Plan in connection with Claimant’s Disability benefit claim denial, without regard as to whether the advice was relied upon in making the benefit determination.

The appropriate reviewing fiduciary must take into account all comments, documents, records, and other information submitted by the Claimant relating to the claim, without regard as to whether the information was submitted or considered in the initial benefit determination. The Claimant may either represent himself or appoint a representative, either of whom has the right to inspect all documents pertaining to the claim and its denial. The reviewing fiduciary can schedule any meeting with the Claimant or his representative that it finds necessary or appropriate to complete its review.

If a timely request is made, the reviewing fiduciary shall notify the Claimant of the determination upon appeal within 45 days after receipt of the request for review (without regard to whether all the information necessary to make the benefit determination accompanies the filing). The reviewing fiduciary retains the authority to unilaterally extend the initial 45-day review period by a

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period not to exceed an additional 45 days, if the fiduciary determines that special circumstances exist requiring additional time for reviewing the claim. If the initial review period is extended by the unilateral action of the appropriate reviewing fiduciary, the fiduciary shall, prior to the expiration of the initial 45 day review period, notify the Claimant in writing of the extension. The written notice of extension shall identify the special circumstances necessitating the extension and provide the anticipated date by which the Plan expects to render the determination on review.

*Calculation of Time Periods Upon Appeal.* The period of time within which a determination on a Disability claims appeal is required to be made shall begin on that date the appeal is filed in accordance with this Section, without regard to whether all the information necessary to make the Disability benefits determination accompanies the filing. In the event the Disability claims review period is extended due to the Claimant's failure to submit information necessary to such determination, the Disability claims review period shall be tolled from the date on which the notification of the extension is sent to the Claimant until the date on which the Claimant responds to the request for additional information. The Claimant shall be afforded at least 45 days from receipt of the notice of extension to provide the requested information. If the Claimant fails to supply the requested information within the 45-day period, the claims review process shall continue and the specified information shall be deemed not to exist.

The reviewing fiduciary shall provide the Claimant with a written notice of the Plan's benefit determination upon review. The notice shall set forth the specific reasons for its action, the Plan provisions on which its decision is based, and a statement that the Claimant is entitled to receive, upon request and free of charge, reasonable access to, and copies of, all documents, records, and other information relevant to the Claimant's claim for benefits, and a statement of the Claimant's right to bring an action under section 502(a) of ERISA. The notice shall also include the following statement,

*"You and the Plan may have other voluntary alternative dispute resolution options, such as mediation. One way to find out what may be available is to contact your local U.S. Department of Labor Office and your State insurance regulatory agency.*

If a decision is not given to the Claimant within the review period, the claim is treated as if it were denied on the last day of the review period.

The request for review must be filed within 90 days after the denial. If it is not, the denial becomes final. If a timely request is made, the reviewing fiduciary must make its decision, under normal circumstances, within 60 days of the receipt of the request for review. However, if the reviewing fiduciary notifies the Claimant prior to the expiration of the initial review period, it may extend the period of review up to 120 days following the initial receipt of the request for a review. The written notice must indicate the circumstances necessitating the extension and the anticipated date for the final decision. All decisions of the reviewing fiduciary must be in writing and must include the specific reasons for

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its action, the Plan provisions on which its decision is based, and a statement that the Claimant is entitled to receive, upon request and free of charge, reasonable access to, and copies of, all documents, records, and other information relevant to the Claimant's claim for benefits, and a statement of the Claimant's right to bring an action under section 502(a) of ERISA. If a decision is not given to the Claimant within the review period, the claim is treated as if it were denied on the last day of the review period.

8. Section 6.03 and 6.04 of the Plan shall be renumbered Section 6.04 and 6.05, respectively, and Article VI of the Plan shall be amended by adding thereto the following new Section 6.03 to provide as follows:

**6.03 In-Service Distributions for Participants Who Have Attained Age 59½.** Prior to his Separation From Service, a Participant who is at least age 59½ is entitled to withdraw all or any portion of any amounts in his Salary Deferral Contribution Account or his Catch-up Salary Deferral Contribution Account.

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**IN WITNESS WHEREOF**, the Sponsor has caused this Agreement to be executed on the 20th day of June, 2006.

**QUANEX CORPORATION**

By: /s/ Kevin P. Delaney  
Title: Senior Vice President — General Counsel  
and Secretary

**FIRST AMENDMENT TO THE  
QUANEX CORPORATION 401(k) SAVINGS PLAN**

**THIS AGREEMENT** by Quanex Corporation, a Delaware corporation (the "*Sponsor*"),

**W I T N E S S E T H:**

**WHEREAS**, the Sponsor maintains the Quanex Corporation 401(k) Savings Plan, as amended and restated effective January 1, 2005 (the "*Plan*");

**WHEREAS**, pursuant to Section 13.01 of the Plan, the Sponsor has the right to amend the Plan; and

**WHEREAS**, the Sponsor has determined to amend the Plan;

**NOW, THEREFORE**, the Sponsor agrees that, effective August 1, 2006, the Plan is amended as set forth below:

1. Section 1.06 of the Plan shall be amended and restated to provide as follows:

1.06 "***Benefit Payment Date***" means the date on which the Trustee disburses the cash lump sum.

2. Sections 1.06 and 1.08 of the Plan, the definitions for "***Benefit Payment Date***" and "***Beneficiary or Beneficiaries***," shall be renumbered as Sections 1.08 and 1.06 respectively.

3. Sections 1.27, 1.42, 1.43 and 1.56 of the Plan, the definitions for "***Entry Date***," "***QJSA***," "***QPSA***" and "***Temroc Plan***," respectively, shall be deleted in their entirety and the remaining Sections in Article I shall be renumbered accordingly.

4. Section 1.13 of the Plan shall be completely amended and restated to provide as follows:

1.13 "***Committee***" means the committee appointed by the Sponsor to administer the Plan, and, as applicable, the individual or entity to which the Committee has delegated its duties.

5. Section 1.22 of the Plan shall be completely amended and restated to provide as follows:

1.22 "***Eligible Employee***" means an Employee who is employed by the Sponsor at its plant in Lincolnshire, Illinois, or primarily in connection with its Nichols Aluminum or HOMESHIELD division. Effective July 1, 1999, "***Eligible Employee***" also means an Employee who is employed by Nichols Aluminum Alabama, Inc., a Delaware corporation. Effective June 1, 2000, "***Eligible Employee***" also means an Employee who is employed by Imperial Products, Inc.,

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a Delaware corporation. Effective February 13, 2002, "Eligible Employee" also means an Employee who is employed by Colonial Craft, Inc., a Delaware corporation.

6. Section 1.22 of the Plan shall be completely amended and restated to provide as follows:

1.22 "**Employer**" or "**Employers**" means the Sponsor, Nichols Aluminum-Alabama, Inc., a Delaware corporation (previously named Decatur Aluminum Corp.), a Delaware corporation, Imperial Products, Inc., a Delaware corporation, Colonial Craft, Inc., a Delaware corporation and any other business organization that adopts the Plan.

7. Section 1.55 of the Plan, renumbered as Section 1.52 in accordance with paragraph 2 above, shall be completely amended and restated to provide as follows:

1.52 "**Spouse**" means the person to whom the Participant or former Participant is married under applicable local law. In addition, to the extent provided in a Qualified Domestic Relations Order, a surviving former spouse of a Participant or former Participant will be treated as the Spouse of the Participant or former Participant, and to the same extent any current spouse of the Participant or former Participant will not be treated as a Spouse of the Participant or former Participant. A former Spouse to whom all or a portion of a Participant's or former Participant's Plan benefit is payable under a Qualified Domestic Order shall, to that extent, be treated as a Spouse or surviving Spouse regardless of whether the Qualified Domestic Relations Order specifically provides that the former Spouse is to be treated as the Spouse for purposes of Sections 401(a)(11) and 417 of the Code.

8. Section 2.01 of the Plan shall be completely amended and restated to provide as follows:

2.01 **Eligibility Requirements.** Except as specified below, each Eligible Employee who is employed by an Employer shall be eligible to participate in the Plan for purposes of Salary Deferral Contributions, Catch-Up Salary Deferral Contributions and Rollover Contributions to the Plan, in each case, on the date on which he completes an Hour of Service. However, unless the Employee is employed by the Sponsor at its plant in Lincolnshire, Illinois, an Employee who is included in a unit of Employees covered by a collective bargaining agreement between the Employees' representative and the Employer is not eligible to participate in the Plan if there has been good faith bargaining between the Employer and the Employees' representative pertaining to retirement benefits and the agreement does not require the Employer to include such Employees in the Plan. In addition, a Leased Employee shall not be eligible to participate in the Plan unless the Plan's qualified status is dependent upon coverage of the Leased Employee. An Employee who is a nonresident alien (within the meaning of section 7701(b) of the Code) and receives no earned income (within the meaning of section 911(d)(2) of the Code) from any Affiliated Employer that constitutes income from sources within the United States (within

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the meaning of section 861(a)(3) of the Code) is not eligible to participate in the Plan. An Employee who is a nonresident alien (within the meaning of section 7701(b) of the Code) and who does receive earned income (within the meaning of section 911(d)(2) of the Code) from any Affiliated Employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3) of the Code) all of which is exempt from United States income tax under an applicable tax convention is not eligible to participate in the Plan. During any period in which an individual is classified by an Employer as an independent contractor with respect to such Employer, the individual is not eligible to participate in the Plan (even if he is subsequently reclassified by the Internal Revenue Service as a common law employee of the Employer and the Employer acquiesces to the reclassification). During any period in which an individual is classified by an Employer as an intern or student with respect to such Employer, the individual is not eligible to participate in the Plan. Finally, an Employee who is employed outside the United States is not eligible to participate in the Plan unless the Committee elects to permit him to participate in the Plan.

9. Section 2.02 of the Plan shall be completely amended and restated to provide as follows:

**2.02 Participation for Purposes of Matching Contributions and Supplemental Contributions.** An Employee who satisfies the eligibility requirements specified in Section 2.01 shall be eligible to participate in the Plan for all purposes relating to Matching Contributions and Supplemental Contributions on the date on which he completes on year of Active Service

10. Section 2.03 of the Plan shall be completely amended and restated to provide as follows:

**2.03 Eligibility Upon Reemployment.** If an Employee incurs a Separation From Service prior to the date he initially begins participating in the Plan, he shall be eligible to begin participation in the Plan on the first date on which he performs an Hour of Service after he incurs a Separation From Service. Subject to Section 2.04, once an Employee becomes a Participant, his eligibility to participate in the Plan shall continue until he Severs Service.

11. Sections 3.03, 3.04, 3.05 and 3.06 of the Plan shall be completely amended and restated to provide as follows:

**3.03 Matching Contributions.** Except with respect to Employees who are included in a unit of employees covered by a collective bargaining agreement between the Employers' representative and the Sponsor and are employed at the Sponsor's plant in Lincolnshire, Illinois, each Employer will make a Matching Contribution on behalf of each of its Employees who is a Participant in an amount equal to 50 percent of the first five percent of such Participant's Considered Compensation contributed to the Plan pursuant to such Participant's Salary Deferral Contributions and Catch-up Salary Deferral Contributions.

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**3.04 Supplemental Contributions for Hourly Employees Other Than Employees of Nichols Aluminum-Alabama, Inc., Imperial Products, Inc. and Colonial Craft, Inc.** Each Employer other than Nichols Aluminum-Alabama, Inc., Imperial Products, Inc. and Colonial Craft, Inc. may contribute for an Allocation Period a Supplemental Contribution to be allocated among Employees who receive hourly remuneration and are eligible to participate in the Plan in such amount, if any, as shall be determined by the Employer. The rate of the Supplemental Contribution need not be uniform among all divisions of the Employer. Unless the Employer determines otherwise by a resolution of its board of directors, the Employer shall not make a Supplemental Contribution to the Plan for an Allocation Period on behalf of its Employees who are compensated on an hourly basis and are eligible to participate in the Plan unless during the fiscal year of the Sponsor immediately preceding the Allocation Period the Sponsor had positive Earnings Before Interest and Taxes.

**3.05 Supplemental Contributions for Salaried Employees Other Than Employees of Nichols Aluminum-Alabama, Inc., Imperial Products, Inc. and Colonial Craft, Inc.** If during the fiscal year of the Sponsor immediately preceding an Allocation Period the Sponsor had positive Earnings Before Interest and Taxes, each Employer other than Nichols Aluminum-Alabama, Inc., Imperial Products, Inc. and Colonial Craft, Inc. shall contribute for such Allocation Period on behalf of its Employees who are compensated on a salaried basis and are eligible to participate in the Plan an amount equal to 6<sup>1</sup>/<sub>2</sub> percent of such Participants or former Participants' Considered Compensation for the Allocation Period.

**3.06 Supplemental Contributions for Employees of Nichols Aluminum-Alabama, Inc., Imperial Products, Inc. and Colonial Craft, Inc.** Notwithstanding Sections 3.04 or 3.05, Nichols Aluminum-Alabama, Inc., Imperial Products, Inc. and Colonial Craft, Inc. may contribute for an Allocation Period a Supplemental Contribution to be allocated among its Employees who are Participants in such amount, if any, as shall be determined by it.

12. Section 4.01 of the Plan shall be amended and restated to provide as follows:

**4.01 Information Statements from Employer.** Upon request by the Committee, the Employer shall provide the Committee with a schedule setting forth the amount of its Salary Deferral Contribution, Catch-Up Salary Deferral Contribution, Supplemental Contribution, QNEC, and restoration contribution; the names of its Participants, the number of years of Active Service of each of its Participants, the amount of Considered Compensation and Annual Compensation paid to each Participant, and the amount of Considered Compensation and Annual Compensation paid to all its Participants. Such schedules shall be conclusive evidence of such facts.

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13. The last sentence of Section 4.05 of the Plan shall be amended and restated to provide as follows:

This Section 4.05 shall not apply to Participants or former Participants who are not entitled to Supplemental Contributions under the Plan.

14. Section 5.03 of the Plan shall be amended and restated to provide as follows:

**5.03 Form and Method of Distribution.** Any distribution under the Plan shall be made in the form of (1) a single lump sum cash payment or (b) as a Direct Rollover as provided in Section 5.05.

15. Sections 5.04, 5.08 and 5.09 of the Plan shall be deleted in their entireties and the remaining Section in Article V shall be renumbered accordingly.

16. Section 5.05 of the Plan, renumbered as Section 5.04 in accordance with paragraph 15 above, shall be completely amended and restated to provide as follows:

17. Section 5.05 of the Plan, renumbered as Section 5.04 in accordance with paragraph 15 above, shall be completely amended and restated to provide as follows:

**5.04 Immediate Payment of Small Amount Upon Separation From Service.** Effective as of March 28, 2005, each Participant or former Participant whose Nonforfeitable Interest in his Account balance at the time of a distribution to him on account of his Separation From Service is, in the aggregate, less than or equal to \$1,000.00, shall be paid in the form of an immediate single sum cash payment and/or as a Direct Rollover, as elected by him under Section 5.05. However, if a Distributee who is subject to this Section 5.04 does not furnish instructions in accordance with Plan procedures to directly roll over his Plan benefit within 45 days after he becomes eligible for such distribution, he will be deemed to have elected to receive an immediate lump sum cash distribution of his entire Plan benefit. If a Participant's or former Participant's Nonforfeitable Interest in his Account balance payable upon his Separation From Service is zero (because he has no Nonforfeitable Interest in his Account balance), he will be deemed to have elected and to have received an immediate distribution of his entire Nonforfeitable Interest in his Account balance.

18. Section 5.07 of the Plan, renumbered as Section 5.06 in accordance with paragraph 15 above, shall be completely amended and restated to provide as follows:

**5.06 Consent to Distribution.** Notwithstanding any other provision of the Plan, no benefit shall be distributed or commence to be distributed to a Participant or former Participant prior to his attainment of the later of age 62 or Retirement Age without his consent, unless the benefit is payable immediately under Section 5.04. Any such consent shall be valid only if given not more than 90 days prior to the Participant's or former Participant's Benefit Payment Date and after his receipt of the notice regarding benefits described in Section 5.07(a).

19. Section 5.10 of the Plan, renumbered as Section 5.07 in accordance with paragraph 15 above, shall be completely amended and restated to provide as follows:

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**5.07 Information Provided to Participants and Former Participants.** Information regarding the form of benefits available under the Plan shall be provided to Participants or former Participants in accordance with the following provisions:

(a) *General Information.* The Sponsor shall provide each Participant or former Participant with a written general explanation of the Participant's or former Participant's right, if any, to defer receipt of the distribution.

(b) *Time for Giving Notice.* The written general explanation or description regarding any optional forms of benefit available under the Plan shall be provided to a Participant or former Participant no less than 30 days and no more than 90 days before his Benefit Payment Date unless he legally waives this requirement.

20. Section 5.12 of the Plan, renumbered as Section 5.08 in accordance with paragraph 7 above, shall be completely amended and restated to provide as follows:

(a) **5.08 Required Distributions.** Notwithstanding any other provision of the Plan, all benefits payable under the Plan shall be distributed, or commence to be distributed, in compliance with the following provisions:

(b) **Required Distributions for Certain Persons Who are 70½ or Older.** Unless a Participant's or former Participant's entire Nonforfeitable Interest in his Plan benefit is distributed to him in a single sum no later than his Required Beginning Date or in the form of an annuity purchased from an insurance company, the Participant's or former Participant's Nonforfeitable Interest in his Plan benefit must begin to be distributed, not later than his Required Beginning Date, over the life of the Participant or former Participant, or the joint lives of the Participant or former Participant and his Section 401(a)(9) Beneficiary, or over a period not extending beyond the life expectancy of the Participant or former Participant or the joint and last survivor expectancy of the Participant or former Participant and his Section 401(a)(9) Beneficiary. The distribution required to be made on or before the Participant's or former Participant's Required Beginning Date shall be the distribution required for his first Distribution Calendar Year. The minimum required distribution for other Distribution Calendar Years, including the required minimum distribution for the Distribution Calendar Year in which the Participant's or former Participant's Required Beginning Date occurs must be made on or before December 31 of that Distribution Calendar Year. In the case of a benefit payable in a form other than a single sum or an annuity purchased from an insurance company, the amount that must be distributed for a Distribution Calendar Year is an amount equal to the amount specified in Paragraph (b) of this Section 5.08.

(c) **Required Minimum Distributions.** If a Participant's or former Participant's Required Beginning Date is before the date on which he incurs a Separation From Service, the Participant or former Participant

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(if he is then alive) must be paid either the entire amount credited to his Account or annual distributions from the Plan in the amounts required under section 401(a)(9) of the Code and Regulations thereunder commencing no later than his Required Beginning Date until his entire interest under the Plan has been distributed under this Article V. The distribution required to be made on or before the Participant's or former Participant's Required Beginning Date shall be the distribution required for his first Distribution Calendar Year. The minimum required distribution for other Distribution Calendar Years, including the required minimum distribution for the Distribution Calendar Year in which the Participant's or former Participant's Required Beginning Date occurs must be made on or before December 31 of that Distribution Calendar Year. The amount that must be distributed for a Distribution Calendar Year is an amount equal to (1) the Participant's or former Participant's Account balance as of the last Valuation Date in the calendar year immediately preceding the Distribution Calendar Year, increased by any contributions or forfeitures allocated and made to the Account during such immediately preceding calendar year after the Valuation Date, and decreased by distributions made during such immediately preceding calendar year after the Valuation Date, divided by (2) the Participant's or former Participant's Applicable Distribution Period.

(d) Distribution Deadline for Death Benefit When Participant or Former Participant Dies Before His Distributions Begin. If a Participant or former Participant dies before the date distribution of his Nonforfeitable Interest in his Plan benefit begins, his entire Nonforfeitable Interest in his Plan benefit will be distributed, or begin to be distributed, to his Section 401(a)(9) Beneficiary no later than as follows:

(e) If the Participant's or former Participant's surviving Spouse is the Participant's or former Participant's sole Section 401(a)(9) Beneficiary, then distributions to the surviving Spouse will begin by December 31 of the calendar year immediately following the calendar year in which the Participant or former Participant died, or by December 31 of the calendar year in which the Participant or former Participant would have attained age 70 1/2, if later.

(f) If the Participant's or former Participant's surviving Spouse is not the Participant's or former Participant's sole Section 401(a)(9) Beneficiary and the payment of Plan death benefits to the Section 401(a)(9) Beneficiary will not be in the form of a single sum, then distributions to the Section 401(a)(9) Beneficiary will begin by December

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31 of the calendar year immediately following the calendar year in which the Participant or former Participant died.

(g) If the Participant's or former Participant's surviving Spouse is the Participant's or former Participant's sole Section 401(a)(9) Beneficiary, and the payment of a Plan death benefit to the Section 401(a)(9) Beneficiary will be in the form of a single sum, then the Participant's or former Participant's entire Nonforfeitable Interest in his Plan benefit will be distributed by December 31 of the calendar year containing the fifth anniversary of the Participant's or former Participant's death.

(h) If there is no Section 401(a)(9) Beneficiary as of September 30 of the calendar year following the calendar year of the Participant's or former Participant's death, then the Participant's or former Participant's entire Nonforfeitable Interest in his Plan benefit will be distributed by December 31 of the calendar year containing the fifth anniversary of the Participant's or former Participant's death.

(i) If the Participant's or former Participant's surviving Spouse is the Participant's or former Participant's sole Section 401(a)(9) Beneficiary and the surviving Spouse dies after the Participant or former Participant but before distributions to the surviving Spouse begin, this Section 5.08(e), other than Section 5.08(e)(1), will apply as if the surviving Spouse were the Participant.

(j) Unless the Participant's or former Participant's interest is distributed in the form of an annuity or in a single sum on or before the Required Beginning Date, as of the first Distribution Calendar Year distributions will be made in accordance with Paragraph (b) of this Section 5.08.

(k) Distribution of Death Benefit When Participant or Former Participant Dies On or After His Required Beginning Date. If a Participant or former Participant dies on or after his Required Beginning Date, his Plan benefit must be distributed to his Section 401(a)(9) Beneficiary at least as rapidly as the method of payment of minimum required distributions being used as of the date of his death.

(l) Limitations on Death Benefits. Benefits payable under the Plan shall not be provided in any form that would cause a Participant's or former Participant's death benefit to be more than incidental. Any distribution required to satisfy the incidental benefit requirement shall be considered a required distribution for purposes of section 401(a)(9) of the Code.

(m) Compliance with Section 401(a)(9). All distributions under the Plan will be made in accordance with the requirements of section 401(a)(9) of the Code and all Regulations promulgated thereunder,

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including, effective January 1, 2003, the Final Section 401(a)(9) Regulations, including sections 1.401(a)(9)-1 through 1.401(a)(9)-9 of the Final Section 401(a)(9) Regulations. The provisions of the Plan reflecting section 401(a)(9) of the Code override any distribution options in the Plan inconsistent with section 401(a)(9) of the Code.

(n) Compliance with Section 401(a)(14). Unless the Participant or former Participant otherwise elects, the payment of benefits under the Plan to the Participant or former Participant will begin not later than the 60th day after the close of the Plan Year in which occurs the latest of (a) the date on which the Participant or former Participant attains the later of age 62 or Retirement Age, (b) the tenth anniversary of the year in which the Participant or former Participant commenced participation in the Plan, or (c) the Participant's or former Participant's Separation From Service.

21. Subsection 5.16(c) of the Plan, renumbered as Subsection 5.12(c), in accordance with paragraph 15 above, shall be completely amended and restated to provide as follows:

(c) This Section 5.12 does not apply in connection with determinations as to whether a Participant or former Participant has incurred a Disability. Rather, such determinations shall be subject to the procedures specified in Section 5.13.

22. Subsection (e) of Section 6.01 of the Plan shall be deleted in its entirety and subsection (f) of Section 6.01 shall be renumbered as subsection (e) of Section 6.01.

23. Section 6.03 of the Plan is hereby amended and restated to provide as follows:

**6.03 Form and Method of Payment.** Any distribution made pursuant to this Article VI, will be paid in the form of a single lump sum cash payment.

24. Sections 6.04 and 6.05 of the Plan shall be deleted in their entireties.

25. Article VII of the Plan is hereby amended and restated to provide as follows:

## **ARTICLE VII**

### **LOANS**

(a) Except as specified below, the Committee may direct the Trustees to make loans to Participants (and Beneficiaries who are "parties in interest" within the meaning of ERISA) who have Nonforfeitable Interests in their Account balances. The Committee will be responsible for administering the Plan loan program. All loans will comply with the following requirements:

(b) All loans will be made solely from the Participant's or Beneficiary's Account.

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(c) Loans will be available on a nondiscriminatory basis to all Beneficiaries who are “parties in interest” within the meaning of ERISA, and to all Participants.

(d) Loans will not be made for less than \$1,000.00.

(e) The maximum amount of a loan may not exceed the lesser of (A)

\$50,000.00 reduced by the person’s highest outstanding loan balance from the Plan during the preceding one-year period, or (B) one-half of the person’s Nonforfeitable Interest in his Account balance under the Plan determined as of the date on which the loan is approved by the Committee.

(f) Any loan from the Plan will be evidenced by a note or notes (signed by the person applying for the loan in accordance with procedures established by the Committee) having such maturity, bearing such rate of interest, and containing such other terms as the Committee will require by uniform and nondiscriminatory rules consistent with this Article and proper lending practices.

(g) All loans will bear a reasonable rate of interest which will be established by the Committee. In determining the proper rate of interest to be charged, at the time any loan is made or renewed, the Committee will contact at least two of the largest banks in the geographic location in which the Participant or Beneficiary resides to determine what interest rate the banks would charge for a similar loan taking into account the collateral offered.

(h) Each loan will be fully secured by a pledge of the borrowing person’s Nonforfeitable Interest in his Account balance. No more than 50 percent of the person’s Nonforfeitable Interest in his Account balance (determined immediately after the origination of the loan) will be considered as security for any loan.

(i) The term of the loan will not be less than 18 months. Generally, the term of the loan will not be more than five years. The Committee may agree to a longer term (but not more than seven years) only if such term is otherwise reasonable and the proceeds of the loan are to be used to acquire a dwelling which will be used within a reasonable time (determined at the time the loan is made) as the principal residence of the borrowing person.

(j) The terms of each Plan loan agreement will require substantially level amortization of the loan (with payments not less frequently than quarterly) over the term of the loan. However, the level amortization requirement will not apply for a period, not longer than one year (or such longer period as may apply under the Uniformed Services Employment and Reemployment Rights Act of 1994) that an eligible borrower is on a bona fide leave of absence, either without pay from the District or at a rate of pay (after income and employment tax withholding) that is less than the amount of the installment payments required under the terms of the loan. However, the loan (including interest that accrues during the leave of absence) must be repaid by the five-year loan maturity deadline specified in paragraph (h) above (unless the loan was a home loan described in paragraph (h) above), and the amount of the installments due after the leave ends (or, if earlier, after the first anniversary of the leave or such longer period as may apply under the Uniformed Services Employment and Reemployment Rights Act of 1994) must not be less than the amount required under the terms of the original loan.

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(k) Except with respect to a former Employee as provided in subsection (l) herein, a Participant's loan agreement will require that loan repayments be made through payroll deductions.

(l) If a person fails to make a required payment within 30 days of the due date set forth in the loan agreement, the loan will be in default.

(m) If a Participant or former Participant has an outstanding loan from the Plan at the time of his Separation From Service, the Participant or former Participant will have the right to elect to continue to repay the loan in accordance with its terms; provided that if such an election is made such election shall be irrevocable and the Participant shall not be eligible to receive a distribution from the Plan until he has fully repaid the loan. If the Participant or former Participant does not elect to continue to repay the loan in accordance with its terms, the outstanding loan principal balance and any accrued but unpaid interest will become immediately due in full. The Participant or former Participant will have the right to immediately pay the Trustee that amount. If the Participant or former Participant fails to repay the loan, the Trustee will foreclose on the loan and the Participant will be deemed to have received a Plan distribution of the amount foreclosed upon. The Trustee will not foreclose upon a Participant's or former Participant's Salary Deferral Contribution Account or Catch-up Salary Deferral Contributions Account until the Participant's Separation From Service.

(n) If a Beneficiary defaults on his loan, the Trustee will foreclose on the loan and the Beneficiary will be deemed to have received a Plan distribution of the amount foreclosed upon.

(o) No amount that is pledged as collateral for a Plan loan to a Participant will be available for withdrawal before he has fully repaid his loan.

(p) All interest payments made pursuant to the terms of the loan agreement will be credited to the borrowing person's Account and will not be considered as general earnings of the Trust Fund to be allocated to other Participants.

26. The first paragraph of Article VIII shall be amended and restated in its entirety to provide as follows:

A Participant or former Participant has a fully Nonforfeitable Interest in his entire Account balance when he (a) incurs a Disability on or prior to the date of his Separation From Service, (b) attains his Normal Retirement Age on or prior to the date of his Separation From Service, or (c) incurs a Separation From Service due to death. A Participant or former Participant shall at all times have a fully Nonforfeitable Interest in amounts credited to his Salary Deferral Contribution Account, his Catch-up Salary Deferral Contribution Account, his QNEC Account, and his Rollover Account. A Participant or former Participant shall have a Nonforfeitable Interest in the following percentage of amounts credited to his Matching Contribution Account and his Supplemental Contribution Account:

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27. Section 9.04 of the Plan shall be deleted in its entirety.

28. Section 10.07 of the Plan shall be amended and restated in its entirety to provide as follows:

**10.07 Credit for Service With Other Employers.** For purposes of determining an Employee's Active Service for eligibility to participate and vesting, his service with Alumi-Brite Corporation, an Illinois corporation, Fruehauf Trailer Corporation, a Delaware corporation, Decatur Aluminum Holdings Corp., a Delaware corporation, (and wholly-owned subsidiaries of Decatur Aluminum Holdings Corp.), Imperial Products, Inc., a Delaware corporation, Alcoa, Inc., a Pennsylvania corporation, Golden Aluminum Company, while owned by ACX Technologies, Inc. or Crown, Cork & Seal Company, Inc., and Temroc Metals, Inc., prior to its sale by the Sponsor, will be counted as Active Service under the Plan.

29. Sections 10.08, 10.09, 10.10, 10.11 and 10.12 of the Plan shall be deleted in their entireties, and Section 10.13 shall be renumbered as Section 10.08.

30. Section 14.08 of the Plan shall be amended and restated in its entirety to provide as follows:

**14.08 Limitations on Legal Actions.** No person may bring an action pertaining to the Plan or Trust until he has exhausted his administrative claims and appeal remedies identified in section 5.13. Further, no person may bring an action pertaining to a claim for benefits under the Plan or the Trust following 180 days after the Committee's final denial of his claim for benefits.

31. Section 14.09 of the Plan shall be deleted in its entirety and the remaining Sections of Article XIV shall be renumbered accordingly.

32. Section 14.11 of the Plan, renumbered as Section 14.10 in accordance with paragraph 31 above, shall be amended and restated in its entirety to provide as follows:

**14.11 Special Provisions Applicable to Nichols Aluminum-Golden, Inc. Employees.**

(a) Cessation of Participation. Upon the closing of the sale by the Sponsor of the stock of Nichols Aluminum-Golden, Inc., (the "NAG Sale"), an individual who is employed by Nichols Aluminum-Golden, Inc. shall cease to be eligible to participate in the Plan.

(b) Sale is Distribution Event. An individual who continues to be employed by Nichols Aluminum-Golden, Inc. following the NAG Sale shall be deemed to have incurred a "Separation From Service" for all purposes under the Plan.

(c) Vesting. Notwithstanding any other provision of the Plan to the contrary, an individual who continues to be employed by Nichols

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Aluminum-Golden, Inc. immediately following the NAG Sale shall have a fully Nonforfeitable Interest in his Account balance upon the Sale.

(d) Loans. Notwithstanding any other provision of the Plan to the contrary, an individual who on the date of the NAG Sale (i) has an outstanding loan from the Plan and (ii) is deemed to incur a Separation From Service as a result of the Sale, will be allowed to repay to the Trustee the outstanding loan principal balance and any accrued but unpaid interest over the remaining term of the loan in accordance with the amortization schedule provided in his loan agreement as if he had not incurred a Separation From Service. The individual's loan repayments will not be required to be made on a payroll deduction basis; but rather may be made utilizing a loan coupon procedure established by the Committee.

33. Subsection (i) of Section C.2 of Appendix C to the Plan shall be deleted in its entirety and subsections (g) and (h) of Section C.2 of Appendix C to the Plan are hereby amended in their entireties to provide as follows:

(g) to direct and instruct or to appoint an investment manager or managers which would have the power to direct and instruct the Trustee in all matters relating to the preservation, investment, reinvestment, management, and disposition of the Trust assets; provided, however, that the Committee shall have no authority that would prevent the Trustee from being an "agent independent of the issuer," as that term is defined in Rule 10b-18 promulgated under the Securities Exchange Act of 1934, at any time that the Trustee's failure to maintain such status would result in the Sponsor or any other person engaging in a "manipulative or deceptive device or contrivance" under the provisions of Rule 10b-6 of such Act; and

(h) to direct and instruct the Trustee in all matters relating to the payment of Plan benefits and to determine a Participant's or former Participant's entitlement to a benefit should he appeal a denial of his claim for a benefit or any portion thereof.

34. Sections C.3, C.4, C.5, C.6, C.7, C.8, C.9, C.10, C.11, C.12, C.13, C.14, C.15, C.16 of Appendix C to the Plan are hereby renumbered as Sections C.4, C.5, C.6, C.7, C.8, C.9, C.10, C.11, C.12, C.13, C.14, C.15, C.16 and C.17, respectively, and a new Section C.3 is hereby added to Appendix C to the Plan to provide as follows:

**C.3 Delegation.** The Committee shall have the power to delegate any of its duties under the Plan, including, but not limited to, its clerical or recordation duties, claims adjudication responsibilities and loan administrative duties, as it may deem necessary or advisable for the proper and efficient administration of the Plan. The Committee shall periodically review the performance of any person to whom duties have been delegated or allocated by it under the provisions of this Plan or pursuant to procedures established hereunder. This requirement may be satisfied by formal periodic review by the Committee or by a qualified person

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specifically designated by the Committee, through day-to-day conduct and evaluation, or through other appropriate ways.

35. Appendix E to the Plan shall be deleted in its entirety.

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**IN WITNESS WHEREOF**, the Sponsor has caused this Agreement to be executed on the 26th day of July, 2006.

**QUANEX CORPORATION**

By: /s/ Kevin P. Delaney  
Title: Senior Vice President — General Counsel and  
Secretary

**FOURTH AMENDMENT TO THE  
QUANEX CORPORATION 401(k) SAVINGS PLAN  
FOR HOURLY EMPLOYEES**

THIS AGREEMENT by Quanex Corporation, a Delaware corporation (the “*Sponsor*”),

**W I T N E S S E T H:**

**WHEREAS**, the Sponsor maintains the Quanex Corporation 401(k) Savings Plan for Hourly Employees, as amended and restated effective January 1, 1998 (the “*Plan*”);

**WHEREAS**, pursuant to Section 13.01 of the Plan, the Sponsor has the right to amend the Plan; and

**WHEREAS**, the Sponsor has determined to amend the Plan;

**NOW, THEREFORE**, the Sponsor agrees that, effective August 1, 2006, the Plan is amended as set forth below:

1. Section 1.01(d) of the Plan shall be completely amended and restated to provide as follows:

(d) Gainsharing Contribution Account — the Employer’s gainsharing contributions, if any, previously made to employees of Temroc Metals, Inc. under the terms of the collective bargaining agreement between Temroc Metals, Inc., a Minnesota corporation, and the United Steelworkers of America, Local 203A.

2. Section 1.06 of the Plan, the definition for “Benefit Payment Date,” shall be completely amended and restated to provide as follows:

1.06 “***Benefit Payment Date***” means the date on which the Trustee disburses the cash lump sum.

3. Section 1.12 of the Plan, the definition for “Committee,” shall be completely amended and restated to provide as follows:

1.12 “***Committee***” means the committee appointed by the Sponsor to administer the Plan, and, as applicable, the individual or entity to which the Committee has delegated its duties.

4. Section 1.14(d) of the Plan shall be completely amended and restated to provide as follows:

(d) Gainsharing Contribution — a gainsharing contribution previously made by the Employer to employees of Temroc Metals, Inc. under the terms of

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the collective bargaining agreement between Temroc Metals, Inc., a Minnesota corporation, and the United Steelworkers of America, Local 203A.

5. Section 1.20 of the Plan, the definition for “Eligible Employee,” shall be completely amended and restated to provide as follows:

1.20 “**Eligible Employee**” means an Employee who is (1) compensated by the Sponsor on an hourly basis and (2) is included in a unit of employees covered by the Teamsters Collective Bargaining Agreement. Effective July 1, 1999, “Eligible Employee” also means an Employee who (1) is compensated on an hourly basis by Nichols Aluminum Alabama, Inc., a Delaware corporation, and (2) is included in a unit of employees covered by the Steelworkers Collective Bargaining Agreement. During any period in which an individual is classified by an Employer as an intern or student with respect to such Employer, the individual is not eligible to participate in the Plan.

6. Section 1.24 of the Plan, the definition for “Employer” or “Employers,” shall be completely amended and restated to provide as follows:

1.24 “**Employer**” or “**Employers**” means the Sponsor, Nichols Aluminum-Alabama, Inc., a Delaware corporation (previously named Decatur Aluminum Corp.) and any other business organization that adopts the Plan.

7. Sections 1.25 and 1.57 of the Plan, the definitions for “Entry Date” and “UAW Collective Bargaining Agreement,” respectively, shall be deleted in their entireties and the remaining Sections in Article I shall be renumbered accordingly.

8. Section 1.52 of the Plan, the definition for “Spouse,” renumbered as Section 1.51 in accordance with paragraph 7 above, shall be completely amended and restated to provide as follows:

1.51 “**Spouse**” means the person to whom the Participant or former Participant is married under applicable local law. In addition, to the extent provided in a Qualified Domestic Relations Order, a surviving former spouse of a Participant or former Participant will be treated as the Spouse of the Participant or former Participant, and to the same extent any current spouse of the Participant or former Participant will not be treated as a Spouse of the Participant or former Participant. For purposes of Section 5.06, a former Spouse to whom all or a portion of a Participant’s or former Participant’s Plan benefit is payable under a Qualified Domestic Order shall, to that extent, be treated as a Spouse or surviving Spouse regardless of whether the Qualified Domestic Relations Order specifically provides that the former Spouse is to be treated as the Spouse for purposes of Sections 401(a)(11) and 417 of the Code.

9. Section 2.01 of the Plan shall be deleted in its entirety and Sections 2.02, 2.03, 2.04, 2.05 and 2.06 shall be renumbered as Section 2.01, 2.02, 2.03, 2.04 and 2.05, respectively.

10. Section 2.02 of the Plan, renumbered as Section 2.01 in accordance with paragraph 9 above, shall be completely amended and restated to provide as follows:

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**2.01 Employees of the Sponsor Covered by the Teamsters Collective Bargaining Agreement.** Each Eligible Employee of the Sponsor who is included in a unit of employees covered by the Teamsters Collective Bargaining Agreement shall be eligible to participate in the Plan for purposes of making Salary Deferral Contributions (and, if applicable, Catch-up Salary Deferral Contributions) and Rollover Contributions on the date on which he completes an Hour of Service. Each such Eligible Employee shall be eligible to participate in the Plan for Supplemental Contribution purposes on the date on which the Eligible Employee completes one year of Active Service.

11. Section 2.03 of the Plan, renumbered as Section 2.02 in accordance with paragraph 9 above, shall be completely amended and restated to provide as follows:

**2.02 Employees of Nichols Aluminum Alabama, Inc. Covered by the Steelworkers Collective Bargaining Agreement.** Each Eligible Employee who is employed by Nichols Aluminum Alabama, Inc. and included in a unit of employees covered by the Steelworkers Collective Bargaining Agreement shall be a participant in the Plan for purposes of making Salary Deferral Contributions (and, if applicable, Catch-up Salary Deferral Contributions) and Rollover Contributions on the date on which he completes an Hour of Service. Each such Eligible Employee shall be eligible to participate in the Plan for Supplemental Contribution purposes on the date on which the Eligible Employee completes one year of Active Service.

12. Section 2.04 of the Plan, renumbered as Section 2.03 in accordance with paragraph 9 above, shall be completely amended and restated to provide as follows:

**2.03 Eligibility Upon Reemployment.** If an Employee incurs a Separation From Service prior to the date he initially begins participating in the Plan, he shall be eligible to begin participation in the Plan on the date on which he performs an Hour of Service after he incurs a Separation From Service. Subject to Section 2.04, once an Employee becomes a Participant, his eligibility to participate in the Plan shall continue until he Severs Service.

13. The first paragraph of Section 3.01 of the Plan shall be completely amended and restated to provide as follows:

**3.01 Salary Deferral Contributions.** Each Employer shall make a Salary Deferral Contribution in an amount equal to the amount by which the Considered Compensation of its Employees who are Participants was reduced on a pre-tax basis pursuant to salary deferral agreements (excluding amounts of Considered Compensation deferred pursuant to Section 3.02 that are properly characterized as Catch-up Salary Deferral Contributions). Any such salary deferral agreement shall be an agreement in a form satisfactory to the Committee to prospectively receive Considered Compensation from the Employer in a reduced amount and to have the Employer contribute an amount equal to the amount of the reduction to the Trust on account of the Participant. Any such salary deferral agreement shall be revocable in accordance with its terms, provided that no revocation shall be retroactive or permit payment to the

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Participant of the amount required to be contributed to the Trust. A Participant's or former Participant's right to benefits attributable to Salary Deferral Contributions made to the Plan on his behalf shall be nonforfeitable.

14. The first paragraph of Section 3.02 of the Plan shall be completely amended and restated to provide as follows:

**3.02 Catch-up Salary Deferral Contributions.** Each Employer shall make a Catch-up Salary Deferral Contribution in an amount equal to the amounts by which its Catch-up Eligible Participants' Considered Compensation was reduced as a result of salary deferral agreements authorizing Catch-up Salary Deferral Contributions (to the extent that their deferrals are properly characterized as Catch-up Salary Deferral Contributions). Any such salary deferral agreement shall be an agreement in a form satisfactory to the Committee to prospectively receive Considered Compensation from the Employer in a reduced amount and to have the Employer contribute an amount equal to the amount of the reduction to the Trust on behalf of the Catch-up Eligible Participant. Further, any such salary deferral agreement shall be revocable in accordance with its terms, provided that no revocation shall be retroactive or permit payment to the Catch-up Eligible Participant of the amount required to be contributed to the Trust. A Catch-up Eligible Participant's or former Catch-up Eligible Participant's right to benefits derived from Catch-up Salary Deferral Contributions made to the Plan on his behalf shall be nonforfeitable.

15. Section 3.03 of the Plan shall be completely amended and restated to provide as follows:

**3.03 Supplemental Contributions.** Each Plan Year, the Sponsor shall make a Supplemental Contribution for its Eligible Employees who are Participants in such amount and at such times as is required under the terms of the Teamsters Collective Bargaining Agreement. Nichols Aluminum Alabama, Inc. shall make a Supplemental Contribution for its Eligible Employees who are Participants in such amount and at such times as is required under the terms of the Steelworkers Collective Bargaining Agreement.

16. Section 3.04 of the Plan shall be deleted in its entirety and Sections 3.05, 3.06, 3.07, 3.08, 3.09, 3.10 and 3.11 shall be renumbered as Section 3.04, 3.05, 3.06, 3.07, 3.08, 3.09 and 3.10, respectively.

17. Section 3.10 of the Plan, renumbered as Section 3.09 in accordance with paragraph 9 above, shall be completely amended and restated to provide as follows:

**3.09 Deadline for Payment of Contributions.** Salary Deferral Contributions and Catch-Up Contributions shall be paid to the Trustee in installments. The installment for each payroll period shall be paid as soon as administratively feasible. The Supplemental Contributions for a Plan Year shall be paid to the Trustee in one or more installments, as the Employer may from time to time determine; provided, however, that such contributions may not be paid later than the time prescribed by law (including extensions thereof) for filing

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the Employer's income tax return for its taxable year ending with or within such Plan Year.

18. Section 4.01 of the Plan shall be completely amended and restated to provide as follows:

**4.01 Information Statements from Employer.** Upon request by the Committee, the Employer shall provide the Committee with a schedule setting forth the amount of its Salary Deferral Contribution, Catch-Up Contributions, Supplemental Contributions, qualified nonelective contributions and restoration contribution; the names of its Participants, the number of years of Active Service of each of its Participants, the amount of Considered Compensation and Annual Compensation paid to each Participant, and the amount of Considered Compensation and Annual Compensation paid to all its Participants. Such schedules shall be conclusive evidence of such facts.

19. Section 4.04 of the Plan shall be completely amended and restated to provide as follows:

**4.04 Allocation of Supplemental Contributions.** The Committee shall allocate the Supplemental Contributions made by an Employer during a Plan Year among the Participants who are employed by the Employer during the Plan Year, based upon each such Participant's Considered Compensation paid by the Employer as compared to the Considered Compensation for all such Participants who are employed by the Employer

20. Section 4.05 of the Plan shall be deleted in its entirety and Sections 4.06, 4.07 and 4.08 shall be renumbered as Section 4.05, 4.06 and 4.07, respectively.

21. Section 5.03 of the Plan shall be completely amended and restated to provide as follows:

**5.03 Form of Distribution.** Any distribution under the Plan shall be made in the form of (a) a single lump sum cash payment, or (b) as a Direct Rollover as provided in Section 5.05.

22. Section 5.04 of the Plan shall be deleted in its entirety and the Sections in Article V shall be renumbered accordingly.

23. Section 5.05 of the Plan, renumbered as Section 5.04 in accordance with paragraph 22 above, shall be completely amended and restated to provide as follows:

**5.04 Immediate Payment of Small Amount Upon Separation From Service.** Each Participant or former Participant whose Nonforfeitable Interest in his Account balance at the time of a distribution to him on account of his Separation From Service is, in the aggregate, less than or equal to \$1,000.00, shall be paid in the form of an immediate single sum cash payment and/or as a Direct Rollover, as elected by him under section 5.05. However, if a Distributee who is subject to this Section 5.04 does not furnish instructions in accordance with Plan procedures to directly roll over his Plan benefit within 45 days after he becomes

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eligible for such distribution, he will be deemed to have elected to receive an immediate lump sum cash distribution of his entire Plan benefit. If a Participant's or former Participant's Nonforfeitable Interest in his Account balance payable upon his Separation From Service is zero (because he has no Nonforfeitable Interest in his Account balance), he will be deemed to have elected and to have received an immediate distribution of his entire Nonforfeitable Interest in his Account balance.

24. Section 5.07 of the Plan, renumbered as Section 5.06 in accordance with paragraph 10 above, shall be completely amended and restated to provide as follows:

**5.07 Required Distributions.**

Notwithstanding any other provision of the Plan, all benefits payable under the Plan shall be distributed, or commence to be distributed, in compliance with the following provisions:

(a) **Required Distributions for Certain Persons Who are 70½ or Older.** Unless a Participant's or former Participant's entire Nonforfeitable Interest in his Plan benefit is distributed to him in a single sum no later than his Required Beginning Date or in the form of an annuity purchased from an insurance company, the Participant's or former Participant's Nonforfeitable Interest in his Plan benefit must begin to be distributed, not later than his Required Beginning Date, over the life of the Participant or former Participant, or the joint lives of the Participant or former Participant and his Section 401(a)(9) Beneficiary, or over a period not extending beyond the life expectancy of the Participant or former Participant or the joint and last survivor expectancy of the Participant or former Participant and his Section 401(a)(9) Beneficiary. The distribution required to be made on or before the Participant's or former Participant's Required Beginning Date shall be the distribution required for his first Distribution Calendar Year. The minimum required distribution for other Distribution Calendar Years, including the required minimum distribution for the Distribution Calendar Year in which the Participant's or former Participant's Required Beginning Date occurs must be made on or before December 31 of that Distribution Calendar Year. In the case of a benefit payable in a form other than a single sum or an annuity purchased from an insurance company, the amount that must be distributed for a Distribution Calendar Year is an amount equal to the amount specified in Paragraph (b) of this Section 5.06.

(b) **Required Minimum Distributions.** If a Participant's or former Participant's Required Beginning Date is before the date on which he incurs a Separation From Service, the Participant or former Participant (if he is then alive) must be paid either the entire amount credited to his Account or annual distributions from the Plan in the amounts required under section 401(a)(9) of the Code and Regulations thereunder commencing no later than his Required Beginning Date until his entire interest under the Plan has been distributed under this Article V. The distribution required to be made on or before the Participant's or former Participant's Required Beginning Date shall be the distribution required for his first Distribution Calendar Year. The minimum required distribution for other Distribution Calendar Years, including the required minimum distribution for the Distribution Calendar Year in which the Participant's or former Participant's Required Beginning Date occurs must be made on or before December 31

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of that Distribution Calendar Year. The amount that must be distributed for a Distribution Calendar Year is an amount equal to (1) the Participant's or former Participant's Account balance as of the last Valuation Date in the calendar year immediately preceding the Distribution Calendar Year, increased by any contributions or forfeitures allocated and made to the Account during such immediately preceding calendar year after the Valuation Date, and decreased by distributions made during such immediately preceding calendar year after the Valuation Date, divided by (2) the Participant's or former Participant's Applicable Distribution Period.

**(c) *Distribution Deadline for Death Benefit When Participant or Former Participant Dies Before His Distributions***

**Begin.** If a Participant or former Participant dies before the date distribution of his Nonforfeitable Interest in his Plan benefit begins, his entire Nonforfeitable Interest in his Plan benefit will be distributed, or begin to be distributed, to his Section 401(a)(9) Beneficiary no later than as follows:

(i) If the Participant's or former Participant's surviving Spouse is the Participant's or former Participant's sole Section 401(a)(9) Beneficiary, then distributions to the surviving Spouse will begin by December 31 of the calendar year immediately following the calendar year in which the Participant or former Participant died, or by December 31 of the calendar year in which the Participant or former Participant would have attained age 70 1/2, if later.

(ii) If the Participant's or former Participant's surviving Spouse is not the Participant's or former Participant's sole Section 401(a)(9) Beneficiary and the payment of Plan death benefits to the Section 401(a)(9) Beneficiary will not be in the form of a single sum, then distributions to the Section 401(a)(9) Beneficiary will begin by December 31 of the calendar year immediately following the calendar year in which the Participant or former Participant died.

(iii) If the Participant's or former Participant's surviving Spouse is the Participant's or former Participant's sole Section 401(a)(9) Beneficiary, and the payment of a Plan death benefit to the Section 401(a)(9) Beneficiary will be in the form of a single sum, then the Participant's or former Participant's entire Nonforfeitable Interest in his Plan benefit will be distributed by December 31 of the calendar year containing the fifth anniversary of the Participant's or former Participant's death.

(iv) If there is no Section 401(a)(9) Beneficiary as of September 30 of the calendar year following the calendar year of the Participant's or former Participant's death, then the Participant's or former Participant's entire Nonforfeitable Interest in his Plan benefit will be distributed by December 31 of the calendar year containing the fifth anniversary of the Participant's or former Participant's death.

(v) If the Participant's or former Participant's surviving Spouse is the Participant's or former Participant's sole Section 401(a)(9) Beneficiary and the surviving Spouse dies after the Participant or former Participant but before distributions to the surviving Spouse begin, this Section 5.06(e), other than Section 5.06(e)(1), will apply as if the surviving Spouse were the Participant.

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Unless the Participant's or former Participant's interest is distributed in the form of an annuity or in a single sum on or before the Required Beginning Date, as of the first Distribution Calendar Year distributions will be made in accordance with Paragraph (b) of this Section 5.06.

(d) **Distribution of Death Benefit When Participant or Former Participant Dies On or After His Required Beginning Date.** If a Participant or former Participant dies on or after his Required Beginning Date, his Plan benefit must be distributed to his Section 401(a)(9) Beneficiary at least as rapidly as the method of payment of minimum required distributions being used as of the date of his death.

(e) **Limitations on Death Benefits.** Benefits payable under the Plan shall not be provided in any form that would cause a Participant's or former Participant's death benefit to be more than incidental. Any distribution required to satisfy the incidental benefit requirement shall be considered a required distribution for purposes of section 401(a)(9) of the Code.

(f) **Compliance with Section 401(a)(9).** All distributions under the Plan will be made in accordance with the requirements of section 401(a)(9) of the Code and all Regulations promulgated thereunder, including, effective January 1, 2003, the Final Section 401(a)(9) Regulations, including sections 1.401(a)(9)-1 through 1.401(a)(9)-9 of the Final Section 401(a)(9) Regulations. The provisions of the Plan reflecting section 401(a)(9) of the Code override any distribution options in the Plan inconsistent with section 401(a)(9) of the Code.

(g) **Compliance with Section 401(a)(14).** Unless the Participant or former Participant otherwise elects, the payment of benefits under the Plan to the Participant or former Participant will begin not later than the 60th day after the close of the Plan Year in which occurs the latest of (a) the date on which the Participant or former Participant attains the later of age 62 or Retirement Age, (b) the tenth anniversary of the year in which the Participant or former Participant commenced participation in the Plan, or (c) the Participant's or former Participant's Separation From Service.

25. Section 5.08 of the Plan, renumbered as Section 5.07 in accordance with paragraph 22 above, shall be completely amended and restated to provide as follows:

**5.07 Consent to Distribution.** Notwithstanding any other provision of the Plan, no benefit shall be distributed or commence to be distributed to a Participant or former Participant prior to his attainment of the later of age 62 or Retirement Age without his consent, unless the benefit is payable immediately under Section 5.04. Any such consent shall be valid only if given not more than 90 days prior to the Participant's or former Participant's Benefit Payment Date and after his receipt of the notice regarding benefits described in Section 5.08(a).

26. Section 5.13 of the Plan, renumbered as Section 5.12 in accordance with paragraph 22 above, shall be completely amended and restated to provide as follows:

**5.12 Claims Review Procedures; Claims Appeal Procedures.**

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(a) **Claims Review Procedures.** When a benefit is due, the Claimant should submit a claim to the Committee. Under normal circumstances, the Committee will make a final decision as to a claim within 90 days after receipt of the claim. If the Committee notifies the Claimant in writing during the initial 90-day period, it may extend the period up to 180 days after the initial receipt of the claim. The written notice must indicate the circumstances necessitating the extension and the anticipated date for the final decision. If a claim is denied during the claims period, the Committee must notify the Claimant in writing, and the written notice must set forth in a manner calculated to be understood by the Claimant:

- (i) the specific reason or reasons for denial;
- (ii) specific reference to the Plan provisions on which the denial is based;
- (iii) a description of any additional material or information necessary for the Claimant to perfect the claim and an explanation of why such material or information is necessary; and
- (iv) an explanation of the Plan claims review procedures and time limits, including a statement of the Claimant's right to bring a civil action under section 502(a) of ERISA.

If a decision is not given to the Claimant within the claims review period, the claim is treated as if it were denied on the last day of the claims review period.

(b) **Claims Appeals Procedures.** If a Claimant's claim made pursuant to Section 5.12(a) is denied and he wants a review, he must apply to the Committee in writing. That application can include any arguments, written comments, documents, records, and other information relating to the claim for benefits. In addition, the Claimant is entitled to receive on request and free of charge reasonable access to and copies of all information relevant to the claim. For this purpose, "relevant" means information that was relied on in making the benefit determination or that was submitted, considered or generated in the course of making the determination, without regard to whether it was relied on, and information that demonstrates compliance with the Plan's administrative procedures and safeguards for assuring and verifying that Plan provisions are applied consistently in making benefit determinations. The Committee must take into account all comments, documents, records, and other information submitted by the Claimant relating to the claim, without regard to whether the information was submitted or considered in the initial benefit determination. The Claimant may either represent himself or appoint a representative, either of whom has the right to inspect all documents pertaining to the claim and its denial. The Committee can schedule any

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meeting with the Claimant or his representative that it finds necessary or appropriate to complete its review.

(c) This Section 5.12 does not apply in connection with determinations as to whether a Participant or former Participant has incurred a Disability. Rather, such determinations shall be subject to the procedures specified in Section 5.13.

27. Article VI of the Plan shall be completely amended and restated to provide as follows:

## **ARTICLE VI**

### **LOANS**

Except as specified below, the Committee may direct the Trustees to make loans to Participants (and Beneficiaries who are "parties in interest" within the meaning of ERISA) who have Nonforfeitable Interests in their Account balances. The Committee will be responsible for administering the Plan loan program. All loans will comply with the following requirements:

(a) All loans will be made solely from the Participant's or Beneficiary's Account.

(b) Loans will be available on a nondiscriminatory basis to all Beneficiaries who are "parties in interest" within the meaning of ERISA, and to all Participants.

(c) Loans will not be made for less than \$1,000.00.

(d) The maximum amount of a loan may not exceed the lesser of (A) \$50,000.00 reduced by the person's highest outstanding loan balance from the Plan during the preceding one-year period, or (B) one-half of the person's Nonforfeitable Interest in his Account balance under the Plan determined as of the date on which the loan is approved by the Committee.

(e) Any loan from the Plan will be evidenced by a note or notes (signed by the person applying for the loan in accordance with procedures established by the Committee) having such maturity, bearing such rate of interest, and containing such other terms as the Committee will require by uniform and nondiscriminatory rules consistent with this Article and proper lending practices.

(f) All loans will bear a reasonable rate of interest which will be established by the Committee. In determining the proper rate of interest to be charged, at the time any loan is made or renewed, the Committee will contact at least two of the largest banks in the geographic location in which the Participant or Beneficiary resides to determine what interest rate the banks would charge for a similar loan taking into account the collateral offered.

(g) Each loan will be fully secured by a pledge of the borrowing person's Nonforfeitable Interest in his Account balance. No more than 50 percent of the person's

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Nonforfeitable Interest in his Account balance (determined immediately after the origination of the loan) will be considered as security for any loan.

(h) The term of the loan will not be less than 18 months. Generally, the term of the loan will not be more than five years. The Committee may agree to a longer term (but not more than seven years) only if such term is otherwise reasonable and the proceeds of the loan are to be used to acquire a dwelling which will be used within a reasonable time (determined at the time the loan is made) as the principal residence of the borrowing person.

(i) The loan agreement will require level amortization over the term of the loan. A Participant's loan agreement will also require that loan repayments be made through payroll deductions.

(j) If a person fails to make a required payment within 30 days of the due date set forth in the loan agreement, the loan will be in default.

(k) If a Participant or former Participant has an outstanding loan from the Plan at the time of his Separation From Service, the Participant or former Participant will have the right to elect to continue to repay the loan in accordance with its terms; provided that if such an election is made such election shall be irrevocable and the Participant shall not be eligible to receive a distribution from the Plan until he has fully repaid the loan. If the Participant or former Participant does not elect to continue to repay the loan in accordance with its terms, the outstanding loan principal balance and any accrued but unpaid interest will become immediately due in full. The Participant or former Participant will have the right to immediately pay the Trustee that amount. If the Participant or former Participant fails to repay the loan, the Trustee will foreclose on the loan and the Participant will be deemed to have received a Plan distribution of the amount foreclosed upon. The Trustee will not foreclose upon a Participant's or former Participant's Salary Deferral Contribution Account or Catch-up Salary Deferral Contributions Account until the Participant's Separation From Service.

(l) If a Beneficiary defaults on his loan, the Trustee will foreclose on the loan and the Beneficiary will be deemed to have received a Plan distribution of the amount foreclosed upon.

(m) No amount that is pledged as collateral for a Plan loan to a Participant will be available for withdrawal before he has fully repaid his loan.

(n) All interest payments made pursuant to the terms of the loan agreement will be credited to the borrowing person's Account and will not be considered as general earnings of the Trust Fund to be allocated to other Participants.

28. Section 7.01 of the Plan shall be completely amended and restated to provide as follows:

**7.01 In-Service Financial Hardship Distributions.**

(a) *General.* Prior to his Separation From Service, a Participant is entitled to receive a distribution from his Salary Deferral Contribution Account

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(except for income that was not credited to his Salary Deferral Account as of December 31, 1988), his Catch-up Salary Deferral Contribution Account (except for income credited to his Catch-up Salary Deferral Contribution Account), his Rollover Account, his Gainsharing Account, and his Nonforfeitable Interest in his Supplemental Contribution Account in the event of an immediate and heavy financial need incurred by the Participant and the Committee's determination that the withdrawal is necessary to alleviate that hardship.

(b) *Permitted Reasons For Financial Hardship Distributions.* A distribution shall be made on account of financial hardship only if the distribution is for: (i) expenses for medical care described in section 213(d) of the Code previously incurred by the Participant, the Participant's Spouse, or any dependents of the Participant (as defined in section 152 of the Code) or necessary for these persons to obtain medical care described in section 213(d) of the Code, (ii) costs directly related to the purchase (excluding mortgage payments) of a principal residence for the Participant, (iii) payment of tuition and related educational fees for the next 12 months of post-secondary education for the Participant, his Spouse, children, or dependents (as defined in section 152 of the Code), (iv) payments necessary to prevent the eviction of the Participant from his principal residence or foreclosure on the mortgage of the Participant's principal residence, or (v) any other event added to this list by the Commissioner of Internal Revenue.

(c) *Amount.* A distribution to satisfy an immediate and heavy financial need shall not be made in excess of the amount of the immediate and heavy financial need of the Participant and the Participant must have obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under all plans maintained by the Employer. The amount of a Participant's immediate and heavy financial need includes any amounts necessary to pay any federal, state or local income taxes or penalties reasonably anticipated to result from the financial hardship distribution.

(d) *Suspension of Participation in Certain Benefit Programs.* The Participant's hardship distribution shall terminate his right to have the Employer make any Salary Deferral Contributions on his behalf until the next time Salary Deferral Contributions are permitted after (1) the lapse of 12 months following the hardship distribution and (2) his timely filing of a written request to resume his Salary Deferral Contributions. In addition, for 12 months after he receives a hardship distribution from the Plan, the Participant is prohibited from making elective contributions and employee contributions to or under all other qualified and nonqualified plans of deferred compensation maintained by the Employer, including stock option plans, stock purchase plans and Code section 401(k) cash or deferred arrangements that are part of cafeteria plans described in section 125 of the Code. However, the Participant is not prohibited from making contributions to a health or welfare benefit plan, including one that is part of a cafeteria plan within the meaning of section 125 of the Code.

(e) *Order of Distributions.* Financial hardship distributions will be made in the following order: First withdrawals will be made from the

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Participant's Rollover Contribution Account, then from his Supplemental Contribution Account, then from his Gainsharing Contribution Account, then from his Salary Deferral Contribution Account, and finally, from his Catch-up Salary Deferral Contribution Account.

29. Section 7.03 of the Plan shall be completely amended and restated to provide as follows:

7.03 **Method of Payment.** Any distribution made pursuant to this Article VII, will be paid in the form of a single lump sum cash payment.

30. The first paragraph of Article VIII of the Plan shall be completely amended and restated to provide as follows:

A Participant or former Participant has a fully Nonforfeitable Interest in his entire Account balance when he (a) incurs a Disability on or prior to the date of his Separation From Service, (b) attains his Normal Retirement Age on or prior to the date of his Separation From Service, or (c) incurs a Separation From Service due to death. A Participant or former Participant shall at all times have a fully Nonforfeitable Interest in amounts credited to his Salary Deferral Contribution Account, his Catch-up Salary Deferral Contribution Account, his Gainsharing Contribution Account and his Rollover Account. A Participant or former Participant shall have a Nonforfeitable Interest in the following percentage of amounts credited to his Supplemental Contribution Account:

31. Section 9.01(a) of the Plan shall be completely amended and restated to provide as follows:

(a) If as a result of his Separation From Service a Participant or former Participant receives (or is deemed to receive under Section 5.04), a distribution of his entire Nonforfeitable Interest in the Plan not later than the end of the second Plan Year following the Plan Year in which his Separation From Service occurs, the remaining Forfeitable Interest in his Account balance will be immediately forfeited upon the distribution.

32. Section 9.04 of the Plan shall be deleted in its entirety.

33. Section 10.07 of the Plan shall be completely amended and restated to provide as follows:

10.07 **Credit for Service With Other Employers.** For purposes of determining an Employee's Active Service for eligibility to participate and vesting, his service with Alumi-Brite Corporation, an Illinois corporation, Fruehauf Trailer Corporation, a Delaware corporation, Decatur Aluminum Holdings Corp., a Delaware corporation, (and wholly-owned subsidiaries of Decatur Aluminum Holdings Corp. and Temroc Metals, Inc., a Minnesota corporation, prior to its sale by the Sponsor, will be counted as Active Service under the Plan.

34. Sections 10.08, 10.09 and 10.10 of the Plan shall be deleted in their entireties and Section 10.11 shall be renumbered as Section 10.08.

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**IN WITNESS WHEREOF**, the Sponsor has caused this Agreement to be executed on the 26th day of July, 2006.

**QUANEX CORPORATION**

By: /s/ Kevin P. Delaney  
Title: Senior Vice President — General Counsel and  
Secretary