

MATERIAL SCIENCES CORP

Form 10-K

May 14, 2004

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United States

Washington, D.C. 20549

X Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended: February 29, 2004

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: 1-8803

(Exact name of registrant as specified in its charter)

Delaware

95-2673173

(State or other jurisdiction of

incorporation or organization)

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

2200 East Pratt Boulevard, Elk Grove Village, Illinois

60007

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: 847-439-8270

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

Title of each class

Common Stock, \$.02 par value

(including Preferred Stock Purchase Rights)

Name of each exchange
on which registered
New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

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

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

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

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The aggregate market value of the voting stock of the registrant held by shareowners of the registrant (not including any voting stock owned by directors or executive officers of the registrant (such exclusion shall not be deemed an admission that any such person is an affiliate of the registrant)) was approximately \$119,858,528 as of August 29, 2003, the last business day of the registrant's most recently completed second fiscal quarter (based on the closing sale price on the New York Stock Exchange on such date, as reported by The Wall Street Journal Midwest Edition).

As of April 28, 2004, the registrant had outstanding an aggregate of 14,263,092 of its Common Stock.

Document Incorporated by Reference

Portions of the following document are incorporated herein by reference into the indicated part of this Form 10-K:

| | |
|--|-------------------------|
| Document | Part of Form 10-K |
| Registrant's Proxy Statement for the Annual Meeting of Shareowners | into which incorporated |
| to be held on June 24, 2004 | Part III |

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PART I

Item 1. Business

Overview

Material Sciences Corporation (unless otherwise indicated by the context, including its subsidiaries, MSC or Company) designs, manufactures and markets material-based solutions. The Company is organized under two business segments MSC Engineered Materials and Solutions Group (EMS) and MSC Electronic Materials and Devices Group (EMD). The Company continues to evaluate the strategic position, growth and economic value potential of portions of its business. Depending on available options, the Company may decide to invest or disinvest with the objective of creating additional value for shareowners. In fiscal 2001, MSC operated under four segments: Coated Products and Services; Engineered Materials; Specialty Films; and Pinole Point Steel. The Specialty Films segment was sold on June 29, 2001, and the Pinole Point Steel business was sold on May 31, 2002. Both of these segments have been reported as discontinued operations since August 31, 2001. In November 2001, the Company announced a reorganization and new operating structure whereby the previous business units and management structures were eliminated, resulting in one reportable segment, EMS. In fiscal 2003, the Company significantly increased its investment in field-effect technology for interface touch controls and sensor solutions in the consumer electronics and transportation markets. This business is now operating as a separate business segment, EMD. For more information concerning the Company s operating results by segment, see Management s Discussion and Analysis of Financial Condition and Results of Operations on pages 14 27, and Note 15 of the Notes to the Consolidated Financial Statements entitled Business Segments, on pages 53 and 54).

EMS, which represented 99.8% of the Company s fiscal 2004 net sales, focuses on providing material-based solutions for electronic, acoustical/thermal and coated metal applications. The electronic material-based solutions include coated and laminated noise reducing materials used in electronic applications to solve customer specific problems and enhance performance. The acoustical/thermal material-based solutions include multilayer composites consisting of metals, polymeric coatings and other materials used to manage noise and thermal energy. The coated metal material-based solutions include coil coated and electrogalvanized (EG) protective and decorative coatings applied to coils of metal in a continuous, high-speed, roll-to-roll process. The Company s material-based solutions are designed to meet specific customer requirements for the automotive, building and construction, electronics, lighting and appliance markets. The electronic and acoustical/thermal products are primarily manufactured and marketed as EMS s own products. With coated metal applications, EMS generally acts as a toll coater by processing its customers metal for a fee, without taking ownership of the metal.

EMD s primary focus to date is designing, developing and commercializing the technology licensed from TouchSensor Technologies, LLC (TST). On January 31, 2002, the Company expanded its electronic material-based solutions by entering into an exclusive license agreement with TST. This agreement provides EMD the right to manufacture, use, further develop and sell TST s patented touch sensor technology for sensors, switches and interface solutions in the consumer electronics and transportation markets. Royalty payments to TST, per the license agreement, consist of a certain percentage of net sales of licensed products plus a certain percentage of sublicense profits subject to a minimum annual royalty amount (see Management s Discussion and Analysis of Financial Condition and Results of Operations on pages 14 27, and Note 14 of the Notes to the Consolidated Financial Statements entitled Contractual Commitment on page 53). In general, the exclusive license period ends on February 28, 2006, subject to the Company s right to extend the exclusive license period under certain conditions.

Headquartered near Chicago, the Company, through its subsidiaries Material Sciences Corporation, Engineered Materials and Solutions Group, Inc., MSC Walbridge Coatings Inc. (MSCWC), MSC Laminates and Composites Inc. (MSCLC) and Material Sciences Corporation, Electronic Materials and Devices Group, Inc. operates six manufacturing plants in the United States and Europe. EMS operates two facilities in Elk Grove Village, Illinois, one facility in Morrisville, Pennsylvania, one facility in Middletown, Ohio and one facility in Eisenach, Germany. MSCWC, a subsidiary of EMS, owns and operates a facility in Walbridge, Ohio, that, until May 7, 2003, was owned by a partnership (the Partnership) between MSCWC and a subsidiary of Bethlehem Steel Corporation (BSC). MSCLC has a 51% ownership interest in a joint-venture partnership in Brazil with Tekno S.A. (Tekno), formed in November 2000. EMD currently does not operate any manufacturing facilities, but instead obtains its products from a number of contract subassemblers. The Company announced the closing of the Middletown, Ohio facility in May 2004, effective July 2004.

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Additional information concerning certain transactions and events is set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations included under Item 7 below.

MSC, a Delaware corporation, was founded in 1971 and has been a publicly traded company since 1984. The principal executive offices of the Company are located at 2200 East Pratt Boulevard, Elk Grove Village, Illinois 60007, and its telephone number is (847) 439-8270.

Available Information

MSC's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of charge on MSC's website at www.matsci.com as soon as reasonably practicable after electronically filing such reports with the Securities and Exchange Commission.

MSC Engineered Materials and Solutions Group

EMS laminates, coats and electrogalvanizes various types of metal. EMS also manufactures composites typically consisting of steel or other metals in combination with polymers or other materials to achieve specific properties, such as noise and vibration reduction and thermal insulation, also known as electronic and acoustical/thermal materials. These products consist of functionally engineered materials that are designed to meet specific customer requirements. Products largely result from EMS's research and development efforts and the proprietary equipment and processes designed and implemented by its engineering and manufacturing organizations. EMS supplies its electronic, acoustical/thermal and coated metal materials to a variety of markets both in the United States and internationally. The majority of these materials are used in the automotive, building and construction, electronics, lighting and appliance markets. The major products included in the electronic material-based solutions product group are computer hard disk drive covers, storage racks and electronic cabinets and boxes. The major products included in the acoustical/thermal material-based solutions product group are disc brake noise dampers and Quiet Steel® for automotive body panels and engine parts. The major products included in the coated metal material-based solutions product group are coil coated and electrogalvanized protective and decorative coatings for use as automotive body skins, metal building skins, appliance cabinets (refrigerators, freezers and other appliances), heating and ventilation applications, lighting fixtures and metal furniture.

Electronic Material-Based Solutions

NRGDamp™ is EMS's proprietary laminated metal used to manufacture disk drive covers to reduce vibrational noise and improve performance. Although hard drives are best known for storing data in computers, they are quickly being adopted for a number of other products such as set-top boxes, home servers, television receivers, audio/video juke boxes and digital video recorders. The need for vibration damping in data-storage applications also extends to storage racks and brackets.

Acoustical/Thermal Material-Based Solutions

The disc brake noise damper market developed as manufacturers moved to asbestos-free brake linings. The increased brake noise these linings produce can be virtually eliminated by the composite materials pioneered by EMS. The Company believes that EMS's material is used in over 50% of the domestic disc brake noise dampers manufactured for the original equipment market and the aftermarket.

Quiet Steel is a multilayer composite consisting of various metals, coatings and other materials, typically consisting of metal outer skins surrounding a thin viscoelastic core material. Quiet Steel is engineered to meet a variety of needs. The Company believes that EMS is a leader in developing and manufacturing continuously processed coated materials that reduce noise and vibration and create thermal barriers. The automotive industry is currently the largest market for metal composites, which are being used to

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replace solid sheet metal parts, including body panels, floor pans, wheel wells, oil pans, valve covers, front engine covers and heat shields. Quiet Steel is also found in a number of other products, including lawn mower engines, appliances and air conditioners. Quiet Steel is being evaluated for use in other internal components in the automotive market to help reduce road noise. EMS produces Quiet Steel at both its Elk Grove Village, Illinois location and at the Walbridge Coatings location in Ohio.

Coated Metal Material-Based Solutions

The Company believes that coil coating is the most environmentally safe and energy-efficient method available for applying paint and other coatings to metal. This continuous, roll-to-roll, highly automated, high-speed process applies coatings to coiled metal of varying widths and thicknesses. In the process,

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sheet metal is unwound from a coil, cleaned, chemically treated, coated, oven-cured and rewound into coils for shipment to manufacturers that fabricate the coated metal into finished products that are sold in a variety of industrial and commercial markets. The coatings are designed to produce both protective and decorative finishes. Through techniques such as printing, embossing and striping, special finishing effects can also be created. The finished product (i.e., pre-painted or coil coated metal) is a versatile material capable of being drawn, formed, bent, bolted, riveted, chemically bonded and welded. EMS generally acts as a toll coater by processing coils for steel mills or their customers, without taking ownership of the metal. EMS charges by weight or surface area processed.

EMS's coil coated products are used by manufacturers in building products, appliances, heating and air conditioning, lighting, automotive and other products. EMS's strategy in coil coating has been to produce high-volume, competitively coated products at low cost, as well as to identify, develop and produce specialty niche products meeting specific customer requirements.

Coil coating technology reduces the environmental impact of painting and reduces manufacturers' energy needs. In coil coating processes, over 98% of the coating material is applied, in contrast with the significant waste from overspray typical in post-fabrication painting. The energy required to cure coil coated metal is substantially less than that required by other coating methods. These savings are achieved because of high-speed material processing and because 90% to 95% of the coatings' volatile organic compounds are recycled back into the curing ovens and/or used as fuel.

Manufacturers that use pre-painted materials can eliminate or significantly reduce on-site post-fabrication paint lines and the associated costs of compliance with complex environmental and other regulations. Pre-painted materials facilitate the adoption of just-in-time and continuous process manufacturing techniques that can result in improvements to work-in-process inventory, plant utilization and productivity. Since pre-painted metal is cleaned, treated and painted while flat, the result is a more uniform and higher quality finished part than can be achieved by even the best post-fabrication painting operation. There are no hidden areas where paint is difficult to reach and where corrosion can begin after the product has been marketed. As a result, companies using pre-painted material generally benefit from lower manufacturing costs and improved product quality. Use of pre-painted metal may, however, require product design or fabrication changes and more stringent handling procedures during manufacturing.

The Company serves the automotive market by electrogalvanizing steel coils. EG is a corrosion-resistant steel product used to manufacture automobile and light-truck body skins. The Company serves the automotive market (including Quiet Steel) through its own marketing efforts and through an EG tolling agreement. However, the use of automotive quality hot-dip galvanized steel has been introduced by the steel industry and continues to make inroads into the EG market. The Company is unable to determine the effect, if any, on the market resulting from the existence of excess capacity, the entrance of additional capacity, changes in galvanizing technology or the substitution of other materials. MSCWC's current and future production levels are also dependent upon economic conditions in the industries that use EG and other coated sheet steel products, including the automotive and appliance industries.

MSCWC electrogalvanizes zinc and zinc-alloy coatings and applies organic coatings onto sheet metal in coil form. MSCWC offers a full complement of pure zinc and zinc-nickel plated products with or without organic coatings or top coats that offer corrosion, forming or cosmetic advantages over competitive products, such as plastic and hot-dip galvanized steel, to the automotive as well as other markets. Demand for coatings over the electrogalvanized plating has increased historically due to greater corrosion expectations for steel products and enhanced cosmetic requirements. The MSCWC facility is the only facility in North America capable of meeting the wide width demand, in a single pass through its line, for this full complement of products. In addition, MSCWC has laminating capability to produce Quiet Steel for acoustical/thermal applications.

On May 7, 2003, International Steel Group Inc. (ISG) purchased substantially all of Bethlehem Steel Corporation's (BSC) assets as part of BSC's bankruptcy proceedings. On the same day, the Company purchased the remaining 33.5% ownership interest in the Partnership from ISG (the ISG Transactions). As a result of the ISG Transactions, the Company has a 100% controlling interest in the Partnership's electrogalvanizing facility in Walbridge, Ohio and has consolidated the results of operations of the MSCWC facility from that date. In connection with the purchase, MSCWC entered into a tolling agreement with ISG to provide EG and other coating and ancillary services to ISG until December 31, 2004. Through the expiration of the tolling agreement, ISG has priority production rights for up to 25% of the available line time at the MSCWC facility (see Note 3 of the Notes to the Consolidated Financial Statements entitled, Joint Venture and Partnership on pages 40 and 41). The EG products processed by MSCWC for ISG are expected to be sold primarily to the automotive industry.

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ISG and the other mills utilizing the MSCWC facility are major suppliers of sheet steel to the United States automobile industry. The orders for MSCWC's toll coating services are primarily and independently generated by ISG and MSC for their respective customers. For reporting periods ending on or before the date of the ISG Transactions, EMS's net sales for electrogalvanizing primarily consisted of various fees charged to the Partnership for operating the facility. Net sales to the Partnership represented 2%, 20% and 21% of MSC's net sales in fiscal 2004, 2003 and 2002, respectively. The fees consisted of a variable portion, based on the production volumes and product mix, and a fixed portion, including taxes, rent, insurance and the fixed portion of electricity. The overall profitability to EMS depended on MSCWC's processing skill and efficiency. MSCWC's pricing of services to ISG is contractually fixed, while pricing of services to other customers is market driven.

MSC Electronic Materials and Devices Group

EMD is now offering the transportation and consumer electronics markets the world's only field-effect sensor that may be implemented as a 5-volt, digital, stand-alone, software-free switch, recognized by Underwriter Laboratories, Inc. Products using the switch/sensor include interface control panels for fluid-level sensing devices for recreational vehicles and marine markets. The switch/sensor operates by generating an electronic field above and below the substrate that covers it—typically a glass or plastic panel. When the field is disrupted, the switch/sensor is triggered. Since the switch/sensor has adjustable sensitivity levels, it can be fine-tuned to meet the requirements of each application. Because the switch/sensor is solid-state with no moving parts and the switch/sensor is mounted entirely behind the interface material (including glass or plastic), it is protected from environmental conditions and operating abuse that often damage ordinary mechanical or membrane switch/sensors. These switch/sensors can be integrated into new or current user interfaces, reducing time-to-market and developmental costs. Since this sensor technology also can be configured to detect non-human machine and material movements, EMD also is developing product solutions for position, as well as, fluid-level sensing applications.

Pinole Point Steel

On May 31, 2002, the Company completed the sale of substantially all of the assets of its Pinole Point Steel business. The Company is in the process of settling the net liabilities of the business. As of February 29, 2004, the Company has received \$58.0 million related to the disposition and liquidation of the business, consisting of \$31.2 million of sale proceeds from Grupo IMSA S.A. de C.V. and \$26.8 million from liquidating the Pinole Point Steel operations. The proceeds from liquidating the Pinole Point Steel operations include an income tax refund of \$10.6 million received during the second quarter of fiscal 2004 related to the sale of Pinole Point Steel. As of February 29, 2004, there are \$0.4 million in net liabilities remaining. The remaining net liabilities include liabilities (primarily workers compensation exposure) not assumed by Grupo IMSA S.A. de C.V. Pinole Point Steel has been reported as a discontinued operation in the Consolidated Financial Statements.

Competition

The market for electronic (both EMS and EMD) and acoustical/thermal material-based solutions is competitive, both domestically and internationally. There are competitors in each product market served by the Company, some of which have greater resources than the Company. The Company believes, however, that its technology, product development capability, technical support and customer service place it in a strong competitive position in the electronic and acoustical/thermal markets.

The coated metal material-based solutions process competes with other methods of producing coated sheet metal, principally post-fabrication finishing methods such as spraying, dipping and brushing. Although there can be no assurance, the Company expects that the market penetration of coated metal (coil coating) will increase as a result of more stringent environmental regulation and the energy efficiency, quality and cost advantages provided by pre-painted metal as compared to post-fabrication painting, particularly in high-volume manufacturing operations. The Company believes it is one of the largest coil coaters, with approximately 12% of the total tons processed in the United States in calendar 2003 based on National Coil Coaters Association data. Competition in the coil coating industry is heavily influenced by geography, due to the high costs involved in transporting sheet metal coils. Within geographic areas, coil coaters compete on the basis of quality, price, customer service, technical support and product development capability. The Company believes the domestic coil coating market is approximately 27% over capacity.

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Competition in the production and sale of EG steel for the automotive industry comes from other steel companies that, either directly or through joint ventures, produce EG steel on seven manufacturing lines in the United States. Limited quantities of EG steel also are imported into the United States from foreign steel suppliers. The Company believes that the Walbridge facility operates at higher costs than the domestic mills and is having difficulty serving the expected end-users of EG steel. The Company is reviewing the profitability of the continued sale and production of EG. In addition, the use of automotive quality hot-dip galvanized steel continues to make inroads into the EG market. The Company is unable to determine the effect, if any, on the market resulting from the existence of excess capacity, the entrance of additional capacity, changes in galvanizing technology or the substitution of other materials.

International

The Company believes that significant opportunities exist internationally, particularly for the Company's computer hard disk drive cover materials, disc brake noise dampers and Quiet Steel products. As a percentage of net sales, direct export sales represented 10%, 8%, and 15% in fiscal 2004, 2003 and 2002, respectively.

The Company has certain distribution agreements and licensing and royalty agreements with agents and companies in Europe, Latin America and the Far East that cover computer hard disk drive covers, disc brake noise dampers, Quiet Steel, lighting products and electronic materials. These agreements provide the Company with opportunities for market expansion in those geographic areas.

The Company is pursuing a variety of other business relationships, including direct sales, distribution agreements, licensing, acquisitions and other forms of partnering to increase its international sales and expand its international presence.

Marketing and Sales

The Company markets its electronic (both EMS and EMD), acoustical/thermal and coated metal products, services and technologies primarily through its in-house sales and marketing organization as well as through independent distributors, agents and licensees. The Company employs key individuals with noise, vibration and harshness (NVH) experience using a proven sales methodology for penetrating the automotive markets served by EMS. The retention of these individuals is important to the development of solutions supporting the growth in sales of the EMS laminate products. The Company focuses its sales efforts on manufacturers, but also sells to steel mills and their intermediaries, metal service centers and metal brokers. EMS markets EG and other products (including Quiet Steel) using the MSCWC production rights to 75% of the available line time at the MSCWC facility. EMS has the right to utilize available line time to the extent that ISG does not provide firm orders for EMS services. In fiscal 2004, EMS utilized approximately 30% of the total available line time, and ISG utilized approximately 30%.

All of the Company's selling activities are supported by technical service departments that aid the customer in the choice of available materials and their use in the customer's manufacturing process.

The Company estimates that customers in the building products market were the end-users for approximately 16%, 18%, and 22% of MSC's net sales in fiscal 2004, 2003 and 2002, respectively. The Company also estimates that the original equipment and aftermarket segments of the transportation industry were the end-users for approximately 44%, 51%, and 48% of MSC's net sales in fiscal 2004, 2003 and 2002, respectively. Due to concentration in the automotive industry, the Company believes that sales to individual automotive companies, including indirect sales, are significant. One end user of the Company's disk drive materials (Western Digital) accounted for approximately 10%, 4% and 7% of the Company's consolidated net sales in fiscal 2004, 2003 and 2002, respectively.

The Company's backlog of orders as of February 29, 2004, was approximately \$20.4 million, all of which is expected to be filled during the remainder of the current fiscal year. The Company's backlog was approximately \$23.0 million as of February 28, 2003.

MSC is generally not dependent on any one source for raw materials or purchased components essential to its business for which an alternative source is not readily available. During the fourth quarter of fiscal 2004, a shortage of available metal and higher pricing developed which impacted each of the markets served by the Company. The Company expects this industry-wide metal

situation to continue for the first three quarters of fiscal 2005.

MSC believes that its business, in the aggregate, is not seasonal. Some of its products, such as materials used for building products and swimming pools, however, experience greater demand in some seasons.

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Environmental Matters

The Company believes it operates its facilities and conducts its business, in all material respects, in accordance with applicable environmental laws. The Company spent approximately \$3.1 million in fiscal 2004, and has budgeted approximately \$3.2 million for fiscal 2005, for maintenance or installation of environmental controls at its facilities. For additional information regarding the Company's environmental matters, see "Legal Proceedings" on pages 10 and 11 and Note 4 of the Notes to the Consolidated Financial Statements entitled "Contingencies," on pages 41 and 42.

Research and Development

Management estimates that it spent approximately \$4.3 million in fiscal 2004, \$3.9 million in fiscal 2003 and \$6.1 million in fiscal 2002 for product and process development activities.

When possible, the Company seeks patent and trademark protection for its products. The Company owns and is licensed under a number of U.S. and foreign patents, patent applications, trademarks and trademark applications. Patents for individual products extend for varying periods according to the date of patent filing or grant and the legal terms of patents in the various countries where patent protection is obtained. While the Company considers its various patents, patent applications, trademarks and trademark applications to be important, it does not believe that the loss of any individual patent, patent application, trademark and trademark application would have a material adverse effect upon its business as a whole. However, the loss of EMD's license with TST and any patents and patent applications related thereto could have a material adverse effect on EMD's business and future growth. EMD represented less than 1% of the Company's net sales in fiscal 2004.

Employees

As of February 29, 2004, the Company had 702 full-time employees. Of these, approximately 473 were engaged in manufacturing, 77 in marketing and sales, 137 in administrative and clerical positions and 15 in process and product development.

The employees at the Eisenach, Germany facility are not represented by a union. Hourly manufacturing employees at Elk Grove Village, Illinois; Morrisville, Pennsylvania; and Middletown, Ohio are covered by separate union contracts expiring in February 2007, November 2005 and May 2007, respectively. The Walbridge, Ohio hourly employees elected in October 2003 to be represented by a union. The Walbridge, Ohio contract is currently being negotiated.

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Executive Officers to the Registrant

The executive officers of the Company as of April 28, 2004, are as follows:

| Name | Age | Position(s) Held |
|------------------------|-----|--|
| Ronald L. Stewart | 61 | President and Chief Executive Officer, MSC and a director of MSC since March 2004. Mr. Stewart is the acting President and CEO of Pangborn Corporation for a transition period ending on or before December 31, 2004 and was President and CEO of Pangborn Corporation from 1999 to 2004. Mr. Stewart was President and CEO of Colt Industries from 1996 to 1998. |
| James J. Waclawik, Sr. | 45 | Vice President, Chief Financial Officer and Secretary, MSC since October 1996. |
| Robert J. Mataya | 61 | Vice President, Business Planning and Development, MSC since July 1991. |
| Ronald L. Millar, Jr. | 53 | Vice President and General Manager of Pre Finish Metals since May 2004; Senior Vice President Operations of EMS since July 2003; President, EMS since November 2001; and Group Vice President and General Manager, MSCLC from November 1995 to November 2001. |
| John M. Klepper | 57 | Vice President, Human Resources, EMS since November 2001; and Director of Corporate Human Resources, MSC from March 2000 to November 2001. Prior to joining the Company, Mr. Klepper was Vice President, Human Resources for Fluid Management, Inc. since 1997. |
| Clifford D. Nastas | 41 | Vice President and General Manager of EMS since May 2004; Vice President, Sales and Marketing, EMS since July 2003; Vice President, Marketing, EMS from November 2001 to July 2003; and Vice President, Marketing, MSCLC from January 2001 to November 2001. Prior to joining the Company, Mr. Nastas was Global Automotive Business Director for Honeywell International Inc. since 1995. |
| Andrew G. Blake | 46 | President, EMD since July 2002. Prior to joining the Company, Mr. Blake was a management consultant for MSC since 1999; President for Innovative Manufacturing Solutions Corporation since 1998. |
| John J. Glazier, Jr. | 42 | Vice President Administration and Finance, EMD since July 2002; Director Corporate Procurement, from April 2000 to July 2002; and Plant Manager, Pre Finish Metals (EGV) Inc. from September 1996 to April 2000. |

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Item 2. Properties

The Company owns or leases facilities with an aggregate of approximately 1,386,000 square feet of space. In addition to the principal physical properties used by the Company in its manufacturing operations as summarized in the table below, the Company leases insignificant sales and administrative offices pursuant to short-term leases. The Company considers all of its principal facilities to be in good operating condition and sufficient to meet the Company's near-term operating requirements. In addition to the properties noted below, the Company also has products manufactured with a joint venture, Tekno S.A. (Tekno), and third parties in North America, South America and Southeast Asia, respectively.

| Location | Approximate Area in Square Feet | Lease Expiration (or Ownership) | Primary Business Segment Served | Description |
|--|------------------------------------|------------------------------------|------------------------------------|--|
| Elk Grove Village, Illinois Plant No. 1 | 58,000 | Owner ⁽¹⁾ | EMS | Coil Coating Facility (Currently Idle) |
| Elk Grove Village, Illinois Plant No. 2 | 223,000 | Owner | EMS | Laminating and Coil Coating Facility |
| Elk Grove Village, Illinois Plant No. 3 | 312,000 | Owner | EMS | Coil Coating Facility |
| Morrisville, Pennsylvania | 121,000 | Owner | EMS | Coil Coating Facility |
| Middletown, Ohio | 170,000 | Owner | EMS | Coil Coating Facility (To be closed July 2004) |
| Walbridge, Ohio | 465,000 | June 2008 ⁽²⁾ | EMS | Electrogalvanizing, Laminating and Coil Coating Facility |
| Eisenach, Germany | 11,000 | Owner | EMS | Stamping and Testing Facility |

(1) On December 15, 2003, the Company entered into a definitive agreement for the sale of the production line in Plant No. 1 in Elk Grove Village, IL. In addition, MSC entered into a letter of intent for the sale of Plant No. 1 contingent upon the removal of the production line by March 2005.

(2) This facility was held under a capital lease until June 30, 2003. The Company extended the lease for five years until June 30, 2008 and this extension period is being treated as an operating lease. The lease may be further extended in five year increments, at the option of the Company, through June 30, 2023. From April 1, 1986 to May 7, 2003, this facility was subleased to the Partnership (see Note 6 of the Notes to the Consolidated Financial Statements entitled Leases, on page 44).

Item 3. Legal Proceedings

Environmental Matters

MSC is a party to various legal proceedings in connection with the remediation of certain environmental matters. The most significant proceedings relate to the Company's involvement in Superfund sites in Kingsbury and Gary, Indiana. MSC has been named as a potentially responsible party (PRP) for the surface, soil and ground water contamination at these sites.

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The United States District Court for the Northern District of Indiana has entered a Consent Decree between the government and certain PRPs on the scope of its remediation work at the Kingsbury site. The participating PRPs account for approximately 75% of the waste volume sent to this site. In December 2001, the PRPs established and funded a trust that has contracted with a remediation contractor to undertake all foreseeable activities necessary to achieve cleanup of the site pursuant to the decree. The trust has purchased an annuity that will pay the remediation contractor the anticipated expenses and oversight costs, including the purchase of stop-loss insurance coverage to reimburse the trust in the event of unforeseen cleanup expenses. The Company contributed \$2.0 million to the trust in December 2001, with no impact to income (loss) before income taxes, and expects that this payment will conclude its financial obligations with respect to the Kingsbury site. In addition, the trust is receiving periodic payments by a non-participating PRP equal to such PRP's share of the trust's ongoing remediation expenses, and the Company will receive credits (which may be distributed as cash at the discretion of the trustees) in the amount of its pro rata share of such periodic payments. Moreover, should site closure be achieved ahead of schedule, the Company will be entitled to receive its pro rata share of the computed value of the annuity less a 25% early closure incentive bonus payable to the remediation contractor. The Company has not recorded any amounts for such potential distributions.

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The United States District Court for the Northern District of Indiana also has entered a Consent Decree between the government and certain PRPs on the scope of the remediation work at the Gary site. The estimate of the Company's liability for this site is \$0.9 million to \$1.1 million. This work has begun, and MSC has maintained a letter of credit for approximately \$1.2 million to secure its obligation to pay its currently estimated share of the remediation expenses at this site.

In November 2003, the Company received notice of a potential liability from the United States EPA regarding a Lake Calumet Cluster Site in Chicago, Illinois. To date, the Company has been unable to estimate the potential liability for this site, if any, due to the limited information that has been provided.

On February 27, 2002, the Company received a notice of alleged violations of environmental laws, regulations or permits from the Illinois EPA related to volatile organic matter (VOM) air emissions and other permitting issues at its Elk Grove Village facility. The Company has filed a response and performed stack testing for one of its production lines (Tested Line) under the supervision of the Illinois EPA. Those recent stack test results, when considered with stack test results from the facility's other production lines taken in the past, indicate the Company's Elk Grove Village facility is in compliance with the overall VOM emission limitations in its Clean Air Act permit. However, the Company's VOM coating application volume on its Tested Line is in excess of the permit limit. To address that issue, the Company has filed a permit modification request to reflect the current VOM application rates on the facility's production lines, which the Illinois EPA granted. The Illinois EPA has indicated that resolution of the matters alleged in the February 27, 2002 Notice of Violation were referred to the office of the Illinois Attorney General for potential enforcement action, which could lead to the imposition of penalties on the Company. On December 22, 2003, the Company received a notice from the office of the Illinois Attorney General of their intent to file an enforcement action regarding the alleged violations. In the fourth quarter of fiscal 2004, the Company recorded a reserve of approximately \$0.2 million for its potential costs related to this action. The Illinois Attorney General filed a complaint on April 8, 2004.

MSC believes its range of exposure for all known sites, based on allocations of liability among PRPs and the most recent estimate of remedial work, is \$1.2 million to \$1.9 million. The Company's environmental reserves were approximately \$1.2 million as of February 29, 2004.

The Company believes that the ultimate outcome of its environmental legal proceedings will not have a material adverse effect on the Company's financial condition or results of operations, given the reserves recorded as of February 29, 2004 and, where applicable, taking into account contributions from other PRPs. However, there can be no assurance that the Company's environmental legal proceedings, individually or in the aggregate, will not have a material adverse effect on the Company's financial condition or results of operations due to a number of uncertainties, including without limitation, the costs of site cleanup, the discretionary authority of the Illinois Attorney General in bringing enforcement actions and other factors.

Other Matters

The Company is also party to various legal actions and customer disputes arising in the ordinary course of its business. These legal actions and customer disputes cover a broad variety of claims spanning the Company's entire business. The Company believes that the resolution of these legal actions and customer disputes will not, individually or in the aggregate, have a material adverse effect on the Company's financial condition or results of operations.

Item 4. Submission of Matters to a Vote of Security Owners

There were no matters submitted to the Company's shareowners during the fourth quarter of fiscal 2004.

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PART II

Item 5. Market for the Registrant's Common Equity and Related Shareowner Matters

The Company's common stock, \$.02 par value, is listed on the New York Stock Exchange under the symbol MSC. The table below sets forth, by fiscal quarter, the high and low sales prices of the Company's common stock during its past two fiscal years.

| Fiscal Year | Fiscal Quarter | High | Low |
|-------------|----------------|------------|-----------|
| 2004 | 1st | \$ 10.5600 | \$ 8.0500 |
| | 2nd | 11.1400 | 8.9500 |
| | 3rd | 10.4900 | 9.2900 |
| | 4th | 12.8700 | 9.4100 |
| Fiscal Year | Fiscal Quarter | High | Low |
| 2003 | 1st | \$ 12.3000 | \$ 9.9700 |
| | 2nd | 15.6500 | 12.4000 |
| | 3rd | 14.1200 | 9.6300 |
| | 4th | 14.9400 | 10.2600 |

There were 748 shareowners of record of the Company's common stock at the close of business on April 28, 2004.

On April 16, 2003, the Company's Board of Directors voted to terminate the Company's shareholder rights agreement. The agreement was terminated by redeeming all of the outstanding rights at a price of \$0.01 per right, payable in cash. There was one right attached to each outstanding share of common stock. The redemption payment was mailed on or about May 27, 2003 to shareowners of record on April 28, 2003. As a result of the redemption, the rights cannot become exercisable, and the shareholder rights agreement was terminated (see Note 11 of the Notes to the Consolidated Financial Statements entitled "Equity and Compensation Plans," on pages 48-51).

MSC has not paid cash dividends, other than the redemption payments for the rights under MSC's shareholder rights agreement discussed above and a nominal amount in lieu of fractional shares in connection with stock dividends. Management currently anticipates that all earnings will be retained for development of the Company's business. If business circumstances should change, the Board of Directors may declare and instruct the Company to pay dividends. However, the Company's ability to pay dividends on its common stock is limited by certain covenants contained in the Company's credit and Senior Note agreements (see Note 5 of the Notes to the Consolidated Financial Statements entitled "Indebtedness" on pages 43 and 44).

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Item 6. Selected Financial Data

The following selected financial data should be read in conjunction with the Company's Consolidated Financial Statements. The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and notes thereto included in Item 8, Financial Statements and Supplementary Data of this Form 10-K in order to fully understand factors that may affect the comparability of the financial data below.

(Dollars and number of shares in thousands,

Fiscal Year

| except per share data) | 2004 | 2003 | 2002 | 2001 | 2000 |
|--|------------|------------|------------|------------|------------|
| Income Statement Data | | | | | |
| Net Sales | \$ 243,218 | \$ 266,818 | \$ 250,506 | \$ 273,860 | \$ 278,669 |
| Income (Loss) from Continuing Operations Before Income Taxes | (17,689) | (1,712) | (7,621) | 10,415 | 21,380 |
| Net Income (Loss) ⁽¹⁾ | (14,537) | 1,494 | (25,083) | (684) | 16,715 |
| Diluted Net Income (Loss) Per Share | \$(1.04) | \$0.11 | \$(1.79) | \$(0.05) | \$1.10 |
| Balance Sheet Data | | | | | |
| Working Capital | \$ 37,875 | \$ 68,398 | \$ 115,463 | \$ 162,735 | \$ 163,378 |
| Net Property, Plant and Equipment | 80,667 | 93,188 | 102,915 | 118,464 | 124,922 |
| Total Assets | 203,954 | 237,809 | 299,474 | 345,539 | 350,564 |
| Total Debt | 43,944 | 55,503 | 105,262 | 137,465 | 120,667 |
| Shareowners' Equity | 110,978 | 121,887 | 128,624 | 149,736 | 158,982 |
| Average Capital Employed | 166,156 | 205,638 | 260,544 | 283,425 | 283,552 |
| Cash Flow Data | | | | | |
| Depreciation and Amortization | \$ 14,929 | \$ 16,397 | \$ 17,826 | \$ 17,064 | \$ 16,803 |
| Net Cash Provided by (Used in) Operating Activities | 4,397 | 33,622 | (25,510) | 12,450 | 47,730 |
| Capital Expenditures | 4,519 | 6,259 | 5,289 | 9,710 | 9,763 |
| Financial Ratios | | | | | |
| Gross Profit as a % of Net Sales | 16.9% | 17.8% | 18.1% | 19.7% | 22.6% |
| SG&A Expenses as a % of Net Sales | 15.8% | 15.2% | 16.9% | 15.3% | 14.0% |
| Income (Loss) from Continuing Operations Before Income Taxes as a % of Net Sales | (7.3%) | (0.6%) | (3.0%) | 3.8% | 7.7% |
| Net Income (Loss) as a % of Net Sales | (6.0%) | 0.6% | (10.0%) | (0.2%) | 6.0% |
| Research and Development as a % of Net Sales | 1.8% | 1.5% | 2.4% | 2.3% | 1.9% |
| Effective Income Tax Rate | 20.6% | 80.2% | 41.1% | 37.4% | 33.3% |
| Return on Average Shareowners' Equity | (12.5%) | 1.2% | (18.0%) | (0.4%) | 10.8% |
| Return on Average Capital Employed | (8.7%) | 0.7% | (9.6%) | (0.2%) | 5.9% |
| Total Debt to Total Capital Employed | 28.4% | 31.3% | 45.0% | 47.9% | 43.1% |
| Other Data | | | | | |
| Per Share Information: | | | | | |
| Net Cash Provided by (Used in) Operating Activities | \$ 0.31 | \$ 2.36 | \$ (1.82) | \$ 0.88 | \$ 3.14 |
| Book Value | \$ 7.93 | \$ 8.57 | \$ 9.18 | \$ 10.59 | \$ 10.46 |
| Market Price: | | | | | |
| High | \$ 12.87 | \$ 15.65 | \$ 10.96 | \$ 14.31 | \$ 15.75 |
| Low | \$ 8.05 | \$ 9.63 | \$ 6.70 | \$ 7.50 | \$ 6.38 |
| Close | \$ 11.38 | \$ 10.26 | \$ 10.00 | \$ 8.80 | \$ 14.44 |
| P/E (High) | NM | 142.3x | NM | NM | 14.3x |
| P/E (Low) | NM | 87.5x | NM | NM | 5.8x |

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| Weighted Average Number of Common Shares | | | | | |
|--|--------|--------|--------|--------|--------|
| Outstanding Plus Dilutive Shares | 13,990 | 14,226 | 14,007 | 14,141 | 15,200 |
| Shareowners of Record | 741 | 826 | 893 | 929 | 950 |
| Number of Employees ⁽²⁾ | 702 | 740 | 745 | 815 | 808 |

- (1) In 2004, the Company has recorded a loss, net of tax, on the sale of Pinole Point Steel of \$489; a pretax gain on the curtailment of Retiree Healthcare of \$1,951; a pretax loss from asset impairments of \$15,810, a pretax restructuring charge of \$1,964, a pretax charge of \$917 related to SERP buyouts, and a pretax charge of \$322 related to retention agreements.

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In 2003, the Company recorded a gain, net of tax, on the sale of Pinole Point Steel of \$1,934; a loss, net of tax, on the sale of Specialty Films of \$101; a pretax contractual debt prepayment penalty of \$2,388; and a pretax restructuring charge of \$855.

In 2002, the Company recorded a gain, net of tax, on the sale of Specialty Films of \$38,787; a loss, net of tax, on the sale of Pinole Point Steel of \$53,287 (including a provision of \$12,278 for future operating losses); a pretax restructuring charge of \$1,450; and a pretax impairment charge of \$8,361.

(2) Represents employees from continuing operations.

NM: Not meaningful.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (In thousands)

The following discussion should be read in conjunction with the Consolidated Financial Statements and the related notes that appear elsewhere in this Form 10-K.

Material Sciences Corporation (MSC or Company) reports segment information based on how management disaggregates its businesses for evaluating performance and making operating decisions. MSC reports results on the basis of two business segments, MSC Engineered Materials and Solutions Group (EMS) and MSC Electronic Materials and Devices Group (EMD). EMS's electronic material-based solutions consist primarily of coated metal and laminated noise reducing materials used in the electronics market. EMS's acoustical/thermal material-based solutions consist of layers of metal and other materials used to manage noise and thermal energy for the automotive, lighting and appliance markets. EMS's coated metal material-based solutions include coil coated and electrogalvanized (EG) products primarily used in the automotive, building and construction, appliance and lighting markets. EMD's electronic material-based solutions include field-effect technology for sensors, switches and interface solutions in the consumer electronics and transportation markets.

As a result of the sale of substantially all of the assets of the Company's Specialty Films segment, including MSC Specialty Films, Inc. (MSC/SFI), to Bekaert Corporation and its affiliates (Bekaert) in the second quarter of fiscal 2002, and the sale of substantially all of the assets of the Company's Pinole Point Steel business, including MSC Pinole Point Steel Inc. and MSC Pre Finish Metals (PP) Inc., to Grupo IMSA S.A. de C.V. (IMSA) and other third parties in the first quarter of fiscal 2003, both Specialty Films and Pinole Point Steel are reported as discontinued operations for all periods presented.

Results of Operations Fiscal 2004 Compared with Fiscal 2003

Executive Summary

Net sales decreased by 8.8% in fiscal 2004 to \$243,218 from \$266,818 in fiscal 2003. MSC's gross profit margin was 16.9%, or \$41,015, in fiscal 2004 as compared with 17.8%, or \$47,575, in the prior year. Selling, general and administrative (SG&A) expenses of \$38,445 were 15.8% of net sales in fiscal 2004 as compared with \$40,476, or 15.2%, of net sales in fiscal 2003.

Results of Operations

| | 2004 | 2003 | 2002 |
|---------------|---------|---------|---------|
| Net Sales | 100.0 % | 100.0 % | 100.0 % |
| Cost of Sales | 83.1 | 82.2 | 81.9 |

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| | | | |
|---|--------|--------|---------|
| Gross Profit | 16.9 % | 17.8 % | 18.1 % |
| Selling, General and Administrative Expenses | 15.8 | 15.2 | 16.9 |
| Asset Impairments, Restructuring and Other | 7.0 | 0.3 | 3.9 |
| Income from Operations | (5.9)% | 2.3 % | (2.7)% |
| Total Other (Income) and Expense, Net | 1.4 | 2.9 | 0.3 |
| Loss from Continuing Operations Before Income Taxes | (7.3)% | (0.6)% | (3.0)% |
| Income Taxes | (1.5) | (0.5) | (1.2) |
| Gain (Loss) on Discontinued Operations, Net of Income Taxes | (0.2) | 0.7 | (8.2) |
| Net Income | (6.0)% | 0.6 % | (10.0)% |

The general state of the principal industries in which the Company operates includes the following risks and opportunities. Overcapacity in the coil coating industry is approximately 27% which has an impact on pricing, facility utilization and the need for competitive terms of sale. In addition, the domestic steel industry has suffered numerous bankruptcies and strong international competition

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which has impacted the Company's EG business and the availability and cost of steel substrate. However, there are significant growth opportunities for the Company's noise, vibration and harshness (NVH) solutions in the acoustical/thermal and electronic markets served. We also believe that the future opportunities for EMD's field-effect technology are significant, as exhibited by the recent commercial successes with Lear Corporation (Lear) and in the recreational vehicle and marine markets.

During fiscal 2004, management executed an action plan to make systemic cost reductions; initiate organizational changes designed to provide focus on operations; evaluate the strategic direction of the Company and its portfolio of operations; and perform a review of underperforming assets with the intent of improving performance, selling or idling those underperforming assets.

During the fiscal year, the Company benefited from approximately \$6,800 of cost savings (including both cost of sales and SG&A cost reductions). These cost savings were due to the Company's production efficiencies (\$899); workforce reductions and reductions in benefit costs (\$5,083, including the reduction of \$1,951 in retiree health care liability in the second fiscal quarter); and other reductions in discretionary spending (\$791).

The Company made certain organizational changes in fiscal 2004, impacting the Company's marketing and manufacturing operations. The last changes were made in May 2004. The primary emphasis of these actions was to focus appropriate resources on the coil coating markets to increase sales and reduce costs. In the growth area of the business, primarily Quiet Steel products, the Company continues to invest in marketing and manufacturing facilities to commercialize its laminate products. These efforts were rewarded with key product wins including the Ford F 150 dash panel and oil pan, and the recessed floor pans for the Stow n Go seat in the new Chrysler Town & Country and Dodge Grand Caravan Minivans. In May 2004, the Company announced the addition of a center of excellence (COE) which will be utilized for the engineering, application and validation of its NVH material solutions.

In connection with its strategic review process, the Company announced the sale of its idled Elk Grove Village production line in January 2004, and entered into a letter of intent for the sale of the Elk Grove Village production facility housing the idled line. In addition, the Company entered into retention agreements with key employees to ensure continuity of business operations. A significant portion of the retention benefits vest on May 31, 2005. The Company also entered into agreements to buyout legacy costs related to certain supplemental pension benefits (SERP) with officers and key employees.

As a result of the strategic review and fourth quarter events (industry wide metal shortages, higher metal pricing and the loss of a significant customer serviced by the Middletown, Ohio facility), the Company announced the closing of the Middletown facility in May 2004. The Board concluded that operating the remaining coil coating facilities would provide the best opportunity for a greater return to shareowners. This resulted in a pretax impairment charge of \$9,071 in the fourth quarter of fiscal 2004. The Company also evaluated the goodwill related to its fiscal 2002 acquisition of Goldbach Automobil Consulting (GAC) in the fourth quarter in accordance with its accounting policy to review goodwill for impairment on an annual basis. The penetration of the European brake market was slower than previously projected. In addition, the Company experienced delays in the negotiation of definitive agreements with a potential strategic partner related to the marketing and sales of Quiet Steel in Europe. Based on these factors, the Company recorded a pretax impairment charge of \$6,739. The Company is reviewing various strategic alliances, including joint ventures, to commercialize these products in Europe. However, we cannot be certain of the success of these efforts.

The Company is also reviewing the continued investment in the EMD business segment. We believe that the field-effect technology has significant value indicated by the acceptance of the technology in several areas including the automotive market (execution of an exclusive supply agreement with Lear), the non-automotive transportation market (products in the recreational vehicle and marine) and the consumer electronics market. The Company is currently discussing a full range of strategic alternatives as it relates to the EMD business. The Company believes that this process will accelerate the market penetration of the technology.

As discussed below, Asset Impairments, Restructuring and Other in the Consolidated Statements of Income total \$17,062 which includes asset impairments of \$15,810, restructuring expenses of \$1,964 and other net benefits of \$712.

MSC Engineered Materials and Solutions Group

Net sales for EMS decreased 8.9% in fiscal 2004 to \$242,748 from \$266,546 in fiscal 2003. Sales of electronic-based materials grew 18.9% to \$26,810 in fiscal 2004 from \$22,540 in the prior year. The

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growth was due to increased sales of NRGDamp™ for computer disk drive covers as well as cabinetry materials. In fiscal 2004, acoustical/thermal materials sales increased 23.0% to \$76,183 from \$61,938 in fiscal 2003 primarily due to continued acceptance of the Company's NVH solutions in the areas of body panel laminate (Quiet Steel), engine and aftermarket brake markets, somewhat offset by lower shipments of Specular+. Coated metal materials sales decreased 23.2% in fiscal 2004 to \$139,755 from \$182,068 in the prior year primarily due to lower electrogalvanizing sales resulting from ISG beginning to exit the EG market. In addition, lower sales to the gas tank, lighting and clutch plate markets were somewhat offset by higher sales to the appliance and swimming pool markets.

EMS's gross profit margin was 16.7%, or \$40,612, in fiscal 2004 as compared with 17.8%, or \$47,540, in the prior year. Gross profit was impacted by several factors including the reduced capacity utilization (61% in fiscal 2004 compared with 77% in fiscal 2003); the inclusion of depreciation of the Walbridge Coatings facility due to the May 2003 purchase of the remaining interest in the Partnership; offset, to some extent, by the Company's cost reduction program. SG&A expenses were \$26,374 in fiscal 2004, an 8.8% decrease from \$28,919 in fiscal 2003. The decrease was due to lower administrative costs resulting from the Company's implementation of its cost reduction program and lower variable compensation expenses, slightly offset by increased investment in marketing and research and development.

On May 7, 2003, ISG purchased substantially all of Bethlehem Steel Corporation's (BSC) assets as part of BSC's bankruptcy proceedings. On the same day, MSC purchased from ISG the remaining 33.5% ownership interest in the Partnership for \$3,600. Accordingly, as of such date, the Company has a 100% controlling interest in the Walbridge, Ohio facility. Prior to May 7, 2003, the Company accounted for the Partnership under the equity method. Beginning May 7, 2003, the results of Walbridge Coatings have been consolidated with the results of MSC and are included in the Consolidated Financial Statements. In conjunction with the ISG Transactions, MSC entered into a tolling agreement with ISG to provide EG and other coating and ancillary services to ISG for a period ending on December 31, 2004. ISG also assumed amounts payable by BSC to the Partnership through the expiration date of the tolling agreements. ISG has priority production rights to 25% of the available line time at the Walbridge, Ohio facility, and MSC markets the remaining 75% of the line time.

On May 13, 2002, the Company completed the purchase of an ownership interest in the Partnership from a subsidiary of LTV Steel Company, Inc. (LTV) for \$3,137. As a result of the purchase, MSC's ownership interest in the Partnership increased to 66.5% and it gained access to an additional 33% of the facility's line time for a total of 37%.

On December 15, 2001, a major fire significantly damaged an electrogalvanizing facility owned by the Double Eagle Steel Coating Company (DESCO), a joint venture between U.S. Steel Corporation and Rouge Steel Company. The Partnership serviced both U.S. Steel Corporation and Rouge Steel Company through September 2002, when the DESCO facility resumed production, in addition to BSC, ISPAT Inland Inc. and other customers with EG and other services in fiscal 2003.

The Company's sales to ISG for fiscal 2004 were significantly less than the fiscal 2003 sales to BSC (\$37,379). For fiscal 2004, ISG utilized 30% of available line time at the Walbridge facility compared with BSC's utilization of 49% in fiscal 2003. Based upon the loss of DESCO's business, the expected decline in ISG's utilization of the facility, partially offset by increased production of Quiet Steel, the Company operated the Walbridge, Ohio facility at approximately 60% of capacity in fiscal 2004 versus 81% in fiscal 2003. The Walbridge, Ohio facility's current and future production levels, however, are dependent, in large part, upon economic conditions in the industries that use EG and other coated sheet steel products, including the automotive and appliance industries, the consumption of laminated noise and vibration products and the potential shifting of EG business between electrogalvanizing facilities by major steel producers. The Company expects the facility to operate at approximately 45% to 50% in fiscal 2005.

MSC Electronic Materials and Devices Group

Sales related to the switch/sensor business increased 72.8% to \$470 from \$272 in the prior year. Sales were related to prototype and product development services, product commercialization in the non-automotive market segment and the revenue associated with an exclusive supply agreement with Lear.

EMD's gross profit margin was 85.7%, or \$403, in fiscal 2004. The margin reflects the revenue generated by EMD's supply agreement, non-recurring engineering revenue, and product sales in the non-automotive and consumer electronics market segments.

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SG&A expenses were \$5,464 in fiscal 2004 as compared with \$3,774 in fiscal 2003. The SG&A expenses relate to marketing, research and development, and application development efforts related to

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the switch/sensor business and the license fee payable to TouchSensor Technologies, LLC (TST). The Company anticipates marketing, research and development and application development spending and the license fee payable to TST related to the switch/sensor business to be approximately \$6,200 for fiscal 2005 based on anticipated spending levels.

The TST agreement provides EMD the right to manufacture, use, sell and further develop TST 's patented touch sensor technology for sensors, switches and interface solutions in the consumer electronics and transportation markets. Royalty payments to TST, per the license agreement, consist of a certain percentage of net sales of licensed products plus a certain percentage of sublicense profits subject to a minimum annual royalty amount (see Note 14 of the Notes to the Consolidated Financial Statements entitled Contractual Commitment, on page 53). In general, the exclusive license period ends on February 28, 2006, subject to the Company 's right to extend the exclusive license period under certain conditions (see Contractual Obligations on page 22).

On August 1, 2003, EMD entered into a supply and joint development agreement with Lear . This agreement provides Lear the exclusive right to incorporate EMD 's field effect technology-based MIRUS detector cells into specific interior applications on passenger cars and light trucks. In consideration of this exclusive supply relationship, Lear has agreed to pay EMD \$1,500 over the initial two years of the agreement. Both parties retain specific rights of termination during the term of the agreement. The consideration of \$1,500 will be amortized into income over a three year period which coincides with the initial period of exclusivity. Under the exclusive supply portion of the agreement, any sales of product would be in addition to the \$1,500 of consideration.

Asset Impairments

As one of the results of the Company 's strategic review process, the Company announced in May 2004 the closing of the Middletown, Ohio facility. This action was taken due to the underutilization of the facility, recent industry wide metal availability and pricing issues and the loss of a significant customer which made the facility noncompetitive in the market place. The aforementioned factors resulted in a pretax asset impairment charge of \$9,071 being recorded in the fourth quarter of fiscal 2004. In addition, the Company expects to incur approximately \$1,600 in fiscal 2005 related to location closing costs including severance and other expenses. The facility is expected to be closed by July 2004.

In the fourth quarter of fiscal 2004, MSC completed its annual assessment of goodwill under SFAS No. 142, Goodwill and Other Intangible Assets. Based on the assessment of the goodwill associated with the acquisition of GAC, the Company recorded a pretax impairment charge of \$6,739. The impairment resulted from slower growth in the penetration of the European brake market than previously projected. In addition, the Company experienced delays in the identification and negotiation of definitive agreements with potential strategic partners related to the marketing and sales of Quiet Steel in Europe. The Company is reviewing various strategic alternatives, including strategic alliances, to commercialize these products in Europe.

In fiscal 2002, the Company reviewed its investment in its powder coating assets. MSC reevaluated its efforts to commercialize its proprietary powder coating capabilities and, based on the projected cash flows from the powder coating assets, recorded a \$5,929 charge to earnings in fiscal 2002.

In fiscal 2002, the Company also reviewed its investment in the capitalized intangible assets and equipment related to its license with Northwestern University to commercialize Solid State Shear Pulverization (SSSP) technology. The Company completed research studies with potential licensees of the SSSP technology. Based on the projected cash flows from the SSSP assets, MSC recorded a \$2,001 charge to earnings in fiscal 2002. The total impairment charge recorded in fiscal 2002 was \$8,361.

Restructuring Expenses

On April 17, 2003, the Chairman, President and Chief Executive Officer resigned and was replaced by a non-executive Chairman of the Board and a new President and Chief Executive Officer. A separation arrangement was entered into resulting in a pretax charge to earnings of \$1,821 in the first quarter of fiscal 2004. Of this amount, \$1,543 is scheduled to be paid over two years and the remainder relates to the executive 's non-contributory supplemental pension plan to be paid in accordance with the plan. The Company recorded additional restructuring expenses of \$143 in the first quarter of fiscal 2004. Total restructuring expenses for fiscal 2004 were \$1,964. Of this amount, net cash of \$977 was paid during fiscal 2004. A total of \$559 is recorded as Accrued Payroll Related Expenses and \$122 is recorded as Other Long-Term Liabilities in the Consolidated Balance Sheet as of February

29, 2004. The Company expects to incur approximately \$700 in severance expense (in addition to Middletown related severance and closing costs) related to further reductions in labor and overhead in fiscal 2005.

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On November 20, 2002, the Company announced it had implemented a program to reduce overhead and improve efficiencies. The program involved restructuring the Company's manufacturing organization, including terminating 14 salaried employees in the third quarter of fiscal 2003. The Company recorded a restructuring charge of \$855 for severance and other related costs in the third quarter of fiscal 2003, \$677 of which pertained to severance expenses and \$178 for other related costs. Total cash paid in fiscal 2003 related to this restructuring program was \$383. Total net cash paid in fiscal 2004 related to this restructuring program was \$440, and as of February 29, 2004, all such amounts under this program were paid.

On November 15, 2001, the Company announced it implemented a reorganization and cost reduction program. MSC terminated 41 employees primarily in its sales, general and administrative departments and recorded a restructuring charge of \$1,450 in fiscal 2002. Of this amount, \$1,110 pertained to severance expenses and \$340 for other related costs. As of February 28, 2003, all amounts under this restructuring program were paid.

| | Severance | Other | Total |
|---|-----------|--------|----------|
| Restructuring Reserve Recorded on November 15, 2001 | \$ 1,110 | \$ 340 | \$ 1,450 |
| Cash Payments, Net | (676) | (236) | (912) |
| Restructuring Reserve as of February 28, 2002 | \$ 434 | \$ 104 | \$ 538 |
| Restructuring Reserve Recorded on November 20, 2002 | 677 | 178 | 855 |
| Cash Payments, Net | (720) | (201) | (921) |
| Restructuring Reserve as of February 28, 2003 | \$ 391 | \$ 81 | \$ 472 |
| Restructuring Reserve Recorded During Fiscal 2004 | 1,013 | 951 | 1,964 |
| Reclassification of Supplemental Pension Reserve | | (338) | (338) |
| Cash Payments, Net | (794) | (623) | (1,417) |
| Restructuring Reserve as of February 29, 2004 | \$ 610 | \$ 71 | \$ 681 |

Other

During the second quarter of fiscal 2004, as part of its implementation of systemic cost reductions, the Company curtailed the future retiree health care benefits for certain active employees. This resulted in a one-time reduction in operating expenses and improvement in income from continuing operations of \$1,951. This amount is recorded in the Asset Impairments, Restructuring and Other line in the Consolidated Statements of Income (Loss).

As noted in the Executive Summary, the Company entered into retention agreements with certain officers and key employees and bought-out certain SERP benefits. Approximately \$322 and \$917 were expensed in the fourth quarter of fiscal 2004 for retention and the buyout of SERP, respectively. In addition, a contingent liability (based on employees remaining with the Company through various dates through May 31, 2005) of approximately \$1,850 will be expensed in fiscal 2005 and approximately \$550 will be expensed in fiscal 2006 related to these agreements.

Total Other Expense, Net and Income Taxes

Total other expense, net, was \$3,197 in fiscal 2004, compared with \$7,956 in fiscal 2003. The variance was primarily due to the charge related to the early extinguishment of debt of \$3,934 in fiscal 2003. Fiscal 2003 also included an allocation of consolidated interest expense to Pinole Point Steel (see Note 8 of the Notes to the Consolidated Financial Statements entitled Interest (Income) Expense, Net on page 47). No interest costs were allocated in fiscal 2004. Equity in Results of Joint Ventures was a net loss of \$211 in fiscal 2004 as compared with a net loss of \$1,557 in fiscal 2003. The Partnership loss is no longer being incurred effective with the Company's purchase of the remaining interest in the Partnership on May 7, 2003.

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MSC's effective income tax rate was 20.6% (benefit) in fiscal 2004 as compared with 80.2% (benefit) in fiscal 2003. During fiscal 2003, the Internal Revenue Service completed its review of fiscal years 1997, 1998 and 1999. The Company analyzed its income tax reserve position based on this event and reduced its previously provided income tax reserves by \$673 in the fourth quarter of fiscal 2003. The variance in the effective tax rate compared to the statutory rate was due to the income tax reserve adjustment and tax credits, valuation allowances for net operating losses and other permanent items relative to income (loss) before income taxes.

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Results of Discontinued Operations Fiscal 2004 Compared with Fiscal 2003

Pinole Point Steel

On May 31, 2002, the Company completed the sale of substantially all of the assets of its Pinole Point Steel business. The Company is in the process of settling the net liabilities of the business. As of February 29, 2004, the Company has received \$58,016 related to the disposition and liquidation of the business, consisting of \$31,174 of sale proceeds from Grupo IMSA S.A. de C.V. and \$26,842 from liquidating the Pinole Point Steel operations. The proceeds from liquidating the Pinole Point Steel operations include an income tax refund of \$10,589 received during the second quarter of fiscal 2004 related to the sale of Pinole Point Steel. As of February 29, 2004, there are \$414 in net liabilities remaining. The remaining net liabilities include liabilities (primarily workers compensation exposure) not assumed by Grupo IMSA S.A. de C.V. Pinole Point Steel has been reported as a discontinued operation, and the Consolidated Financial Statements have been reclassified to segregate the net assets or liabilities and operating results of the business.

As of February 28, 2002, the Company recorded a provision for loss on discontinued operation, net of income taxes, of \$53,287. The loss on discontinued operation, net of income taxes, included the allocation of consolidated interest expense of \$5,391 incurred from September 1, 2001 through May 31, 2002. The allocations were based on the debt associated with the original purchase of Pinole Point Steel in December 1997 and Pinole Point Steel's subsequent cash flow. During fiscal 2003, the Company recorded an adjustment on sale of discontinued operation, net of income taxes, of \$1,934 to reduce the previously provided loss on discontinued operation. The adjustment consisted of a favorable change in the estimated proceeds of the sale of \$2,436 and a reduction for estimated operating losses of \$1,247 due to higher plant utilization and customers' willingness to accelerate product deliveries prior to the closing of the transaction. The adjustment also included an additional loss of \$949 related to bad debt, product claims, workers compensation and employee expenses as well as a reduction of \$800 primarily due to a change in the estimated apportionment of state income taxes.

Net sales of Pinole Point Steel for the partial year of fiscal 2003 were \$48,050 versus \$128,397 for the entire year of fiscal 2002. Loss from discontinued operation, net of income taxes, was \$2,136 for the partial year of fiscal 2003 as compared to \$16,456 for the entire year of fiscal 2002. The loss from discontinued operation, net of income taxes, includes the allocation of consolidated interest expense of \$1,797 in fiscal 2003 versus \$8,100 in the prior year.

Results of Operations Fiscal 2003 Compared with Fiscal 2002

Net sales in fiscal 2003 increased by 6.5% to \$266,818 from \$250,506 in fiscal 2002. MSC's gross profit margin was 17.8%, or \$47,575, in fiscal 2003 as compared with 18.1%, or \$45,231, in the prior year. SG&A expenses of \$40,476 were 15.2% of net sales in fiscal 2003 as compared with \$42,333, or 16.9%, of net sales in fiscal 2002.

MSC Engineered Materials and Solutions Group

Net sales for EMS increased 6.4% in fiscal 2003 to \$266,546 from \$250,506 in fiscal 2002. Sales of electronic-based materials grew 13.5% to \$22,540 in fiscal 2003 from \$19,856 in the prior year. The growth was due to an increase in NRGDamp sales for computer disk drive covers as well as set-top box sales. Acoustical/thermal materials sales declined 2.2% in fiscal 2003 to \$61,938 as compared with \$63,306 in fiscal 2002 primarily due to lower sales to the aftermarket brake and lighting markets, offset in part by higher shipments to the body panel laminate and engine markets. In fiscal 2003, sales of coated metal materials increased 8.8% to \$182,068 from \$167,344 in fiscal 2002.

EMS's gross profit margin was 17.8%, or \$47,540, in fiscal 2003 as compared with 18.1%, or \$45,231, in the prior year. The decrease in gross profit margin was primarily the result of an unfavorable product mix and lower capacity utilization due to sales shortfalls of coated metal products and higher operating costs.

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SG&A expenses were \$28,919, or 10.8%, of net sales in fiscal 2003 versus \$32,764, or 13.1%, of net sales in fiscal 2002. The decrease in SG&A percentage was due to the increase in net sales offset by \$1,270 of bad debt expense incurred due to several customers declaring bankruptcy.

MSC Electronic Materials and Devices Group

SG&A expenses were \$3,774 in fiscal 2003 which related to marketing and research and development spending related to the switch/sensor business and the license fee payable to TST.

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Total Other Expense, Net and Income Taxes

Total other expense, net, was \$7,956 in fiscal 2003 as compared to \$708 in fiscal 2002. The variance was primarily due to the allocation of interest expense to the Pinole Point Steel business for all of fiscal 2002 versus only the first quarter of fiscal 2003. In addition, fiscal 2003 included a charge related to the early extinguishment of debt of \$3,934. Equity in Results of Joint Ventures was a net loss of \$1,557 in fiscal 2003 as compared with a net loss of \$1,560 in fiscal 2002.

MSC's effective income tax rate was 80.2% (benefit) in fiscal 2003 as compared with 41.1% (benefit) in fiscal 2002. During fiscal 2003, the Internal Revenue Service completed its review of fiscal years 1997, 1998 and 1999. The Company analyzed its income tax reserve position based on this event and reduced its previously provided income tax reserves by \$673 in the fourth quarter of fiscal 2003. The variance in the effective tax rate compared to the statutory rate was due to the income tax reserve adjustment and tax credits and other permanent items relative to income (loss) before income taxes.

Results of Discontinued Operations Fiscal 2003 Compared with Fiscal 2002

Specialty Films

On June 29, 2001, the Company completed the sale of substantially all of the assets of its Specialty Films segment, including its interest in Innovative Specialty Films, LLC, to Bekaert pursuant to the terms of the Purchase Agreement by and among MSC, MSC/SFI, Bekaert and N.V. Bekaert S.A., dated June 10, 2001. The Company received cash of \$121,982 and recorded an after-tax gain of \$38,787 in the second quarter of fiscal 2002. Net proceeds after taxes and transaction costs were \$90,537.

Net sales of Specialty Films for the partial year of fiscal 2002 were \$21,578. Income from discontinued operation, net of income taxes, was \$1,469 for the partial year of fiscal 2002.

During the second quarter of fiscal 2003, the Company recorded an after-tax charge of \$101 related to a decrease in the previously estimated insurance premium refund for the Specialty Films business.

Liquidity and Capital Resources

The Company has historically financed its operations with funds generated from operating activities, borrowings under credit facilities and long-term debt instruments and sales of various assets. The Company believes that its cash on hand and availability under its amended and restated credit facility will be sufficient to fund its operations, redeem its 1998 senior notes and pay a contractual debt prepayment penalty associated therewith, and working capital needs.

MSC generated \$4,397 of cash from operating activities in fiscal 2004, as compared with \$33,622 in the prior fiscal year. The decrease in cash generation was due mainly to the investment in working capital of \$18,652 in fiscal 2004 as compared with an investment of \$2,398 in fiscal 2003. The increase in working capital was due mainly to the purchase of the Partnership interest in fiscal 2004, a change in payment terms, and an increase in inventory due to the growth in the Quiet Steel business and other building products using an organic coating over an EG substrate in the second half of the fiscal year. The working capital is now consolidated on MSC's balance sheet versus recorded in investment in joint ventures in the prior year. The liquidation of Pinole Point also generated less cash from operating activities in fiscal 2004 as compared with fiscal 2003.

In fiscal 2004, MSC invested \$4,519 in capital improvement projects compared with \$6,259 in fiscal 2003. Investments in joint ventures were \$358 in fiscal 2004 compared with \$3,405 in fiscal 2003. The change in investments in joint ventures related to the Company's purchase of LTV's ownership interest in the Partnership for \$3,137 in fiscal 2003. There were no investments in joint ventures related to discontinued operations in fiscal 2003 compared with \$5,114 in fiscal 2002 due to the investment in the joint venture with Bekaert Corporation prior to the disposition of the Company's Specialty Films business. On May 7, 2003, the Company invested \$3,600 to purchase the remaining ownership interest in the Partnership from ISG. Fiscal 2005 capital expenditures are projected to be approximately \$9,500. The increase is primarily due to the investment in the COE announced in May 2004.

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MSC's total debt decreased to \$43,944 in fiscal 2004 from \$55,503 as of February 28, 2003. The Company made principal debt payments of \$11,278 on June 2, 2003 related to the 1998 Senior Notes. Total interest paid on the Senior Notes was \$3,364 in fiscal 2004. In the fourth quarter of fiscal 2004, the results of operations, including the asset impairment charge, caused the Company to be out of compliance with the minimum net worth covenant under the terms of the 1998 Senior Notes. Accordingly, the Company notified the holders of the 1998 Senior Notes that it intended to repay the principal, interest and contractual debt.

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prepayment penalty on or before June 1, 2004. The Company paid principal of \$36,167, interest of \$1,086 and a contractual debt prepayment penalty of \$3,318 to all but two noteholders on May 10, 2004. The remaining noteholders elected to receive payment on or before June 1, 2004. The Company expects to pay the remaining principal (\$7,778), approximate interest (\$264) and estimated contractual debt prepayment penalty (\$713) on or before June 1, 2004. In addition, the remaining noteholders waived the noncompliance of the minimum net worth covenant until June 1, 2004 or earlier upon prepayment of the notes (see Note 5 of the Notes to the Consolidated Financial Statements entitled *Indebtedness*, on pages 43 and 44). On July 31, 2002, the Company made a debt payment of \$39,432 to the holders of the 1997 Senior Notes. The debt payment consisted of principal of \$35,714 and a contractual debt prepayment penalty of \$3,934 (pretax basis). The contractual debt prepayment penalty included the prepayment penalty of \$3,718 and a \$216 write-off of debt issuance costs.

The Company entered into an amended and restated \$30,000 committed line of credit (*New Line*) on April 30, 2004. The agreement expires on October 11, 2007. No borrowings were outstanding under the *New Line* or previous line as of February 29, 2004. There were \$3,357 in outstanding letters of credit as of February 29, 2004. Under the *New Line*, fees are charged for the unused portion of the line. At the Company's option, interest is at the bank's prime rate (4.0% as of February 29, 2004) or at LIBOR plus a margin based on funded debt to EBITDA (as defined in the agreement). The financial covenants include a fixed charge coverage ratio of not less than 1.25 to 1.0 commencing May 31, 2004; a maximum leverage ratio (3.0 to 1.0); and minimum net worth of \$80,000 plus 50% of positive consolidated net income ending on or after May 31, 2004. As of February 29, 2004, the outstanding letters of credit were cash collateralized. A total of \$3,357 was classified as *Restricted Cash* in the Consolidated Balance Sheets. There are restrictions on the Company's use of its cash and cash equivalents related to repurchase of stock, dividends and acquisitions. The *New Line* is secured by specific personal property (including receivables, inventory and property, plant and equipment) and intangible property of the Company.

On March 1, 2002, the Company purchased 13,593 of its shares from certain employees at \$10.00 per share related to the vesting of the Company's 1999 Long-Term Incentive/Leverage Stock Awards Program. The Compensation Committee of the Board of Directors approved the share repurchase under the provisions of the Material Sciences Corporation 1992 Omnibus Awards Plan for Key Employees to cover a portion of the participants' tax withholding liability for the vesting of these shares under the 1999 Program. On June 20, 2002, the Company resumed the previously approved repurchase program (suspended in fiscal 2001) and purchased the remaining of the authorized shares for a total of 290,619 shares with an average purchase price of \$14.89 per share by February 28, 2003. On June 20, 2002, MSC's Board of Directors also authorized a new program to repurchase up to an additional 500,000 shares of the Company's common stock. The repurchase of 500,000 shares was complete as of February 28, 2003 with an average purchase price of \$14.50 per share. No further share repurchase programs have been approved by the Company's Board of Directors.

MSC had a capital lease obligation of \$281 as of February 28, 2003 and \$905 as of February 28, 2002, relating to a facility that the Company subleased to the Partnership. The capital lease expired on June 30, 2003. In the fourth quarter of fiscal 2003, the Company renewed the term of the lease for five years ending June 30, 2008. The extension is being treated as an operating lease (see Note 6 of the Notes to the Consolidated Financial Statements entitled *Leases*, on page 44).

The Company paid minimum royalty fees of \$1,500 in fiscal 2004 and \$1,167 in fiscal 2003 related to the license agreement with TST. The Company has a contingent liability related to the license agreement with TST to pay minimum royalty fees of \$2,750 in fiscal 2005 and \$2,750 in fiscal 2006.

On April 16, 2003, the Company's Board of Directors voted to terminate the Company's shareholder rights agreement. The agreement was terminated by redeeming all of the outstanding rights at a price of \$0.01 per right, or approximately \$148 in the aggregate, payable in cash and recorded as a charge to Shareowners' Equity in the Consolidated Balance Sheets. There was one right attached to each outstanding share of common stock. The redemption payment was mailed on or about May 27, 2003 to shareowners of record on April 28, 2003. As a result of the redemption, the rights cannot become exercisable, and the shareholder rights agreement was terminated.

The Company is continuously reviewing the potential for investments in its growth markets. In addition, the Company also reviews the potential value to shareowners of divesting facilities or other assets which are not performing to the Company's expectations.

The Company is party to various legal actions arising in the ordinary course of its business. These legal actions cover a broad variety of claims spanning the Company's entire business. The Company believes that the resolution of these legal actions will not, individually or in the aggregate, have a material

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adverse effect on the Company's financial condition or results of operations. The Company is also a party to various legal proceedings in connection with the remediation of certain environmental matters. MSC believes its range of exposure for all known and quantifiable environmental exposures, based on allocations of liability among potentially responsible parties, the most recent estimate of remedial work, and other information available, is \$1,200 to \$1,900 as of February 29, 2004 (see Legal Proceedings on pages 10 and 11, and Note 4 of the Notes to the Consolidated Financial Statements entitled Contingencies, on pages 41 and 42).

Contractual Obligations

The following table summarizes the contractual obligations the Company has outstanding as of February 29, 2004.

| Contractual Obligations | Obligations Due In | | | | |
|--------------------------|--------------------|---------------------|------------------|---------------|----------------------|
| | Total | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
| Operating Leases | \$ 6,879 | \$ 1,975 | \$ 4,350 | \$ 554 | \$ |
| Minimum Royalties | 5,500 | 2,750 | 2,750 | | |
| SERP | 917 | 917 | | | |
| Purchase Obligations | 32,232 | 32,232 | | | |
| Long-Term Debt Principal | 43,944 | 36,944 | 7,000 | | |
| Total | \$ 89,472 | \$ 74,818 | \$ 14,100 | \$ 554 | \$ |

Inflation

MSC believes that inflation has not had a significant impact on fiscal 2004, 2003 and 2002 results of operations.

Critical Accounting Policies

MSC's significant accounting policies are presented within the Notes to the Consolidated Financial Statements (see Note 1 of the Notes to the Consolidated Financial Statements entitled Summary of Significant Accounting Policies, on pages 36-40) included elsewhere in this Form 10-K. While all of the significant accounting policies impact the Company's Consolidated Financial Statements, some of the policies may be viewed to be critical. These policies are those that are both most important to the portrayal of the Company's financial condition and results of operations and require management's most difficult, subjective or complex judgments and estimates. Management bases its judgments and estimates on historical experience and various other factors that are believed to be reasonable under the circumstances. The results of judgments and estimates form the basis for making judgments about the Company's value of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates under different assumptions or conditions. Management believes the following critical accounting policies, among others, affect its more significant judgments and estimates used in the preparation of its Consolidated Financial Statements.

Revenue Recognition. The Company recognizes revenue upon shipment of goods to customers, at which time title (MSC's value added content in the case of toll processing) and risk of loss pass to the customer. The Company records shipping and handling billed to a customer in a sales transaction as revenue. Costs incurred for shipping and handling are recorded in cost of sales. Volume discounts due customers are recognized as earned and reported as reductions of revenue in the Consolidated Statements of Income (Loss). The Company's revenue recognition policies comply with the criteria set forth in Staff Accounting Bulletin No. 104, Revenue Recognition. The Company also records expenses for manufacturing claims for product defects based upon historical experience and upon specific claims issues as they arise. Any material differences between these estimates and our actual costs

are recorded on a monthly basis and are reflected in the historical experience prospectively.

Long-Lived Assets. Long-lived assets consist of property, plant and equipment and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable based on projections of cash flows on a non-discounted basis. If the fair value is less than the carrying amount of the asset, a loss is recognized for the difference. Fair value is determined based on market quotes, if available, or is based on valuation techniques, such as discounted cash flows. The valuation techniques utilize certain assumptions made by the Company including, but not limited to,

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estimated fair market value of assets, which are based on additional assumptions such as public market data, depreciation factors for orderly liquidation, including allowances such as dismantlement and removal, and the relationship between replacement cost new and market value based on the age of the assets.

Goodwill. In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets. With the adoption of SFAS No. 142 on March 1, 2002, goodwill will no longer be subject to amortization over its estimated useful life. Goodwill will be subject to at least an annual assessment of impairment by applying a fair value based test. This test requires that the Company estimate the fair value of its goodwill and compare that estimate to the amount of goodwill recorded on the Consolidated Balance Sheet. The estimation of fair value requires that the Company make judgments concerning future cash flows and appropriate discount rates. The estimate of the fair-value of goodwill could change over time based on a variety of factors, including the actual operating performance of the relevant portion of the business (see Note 1, of the Notes to the Consolidated Financial Statements entitled, Summary of Significant Accounting Policies Goodwill on pages 37 and 38).

Income Taxes. The provision for income taxes is determined under the liability method pursuant to SFAS No. 109. Under this method, deferred tax assets and liabilities are recognized based on differences between the financial statement and tax bases of assets and liabilities using presently enacted tax rates. The Company has net deferred tax assets of \$7.3 million at February 29, 2004. In assessing the need for valuation allowances, the Company considers future forecasted taxable income and tax planning strategies. The Company has determined that it is unlikely that it will be able to realize certain deferred tax assets in the foreseeable future relating its GAC operation. A valuation allowance of \$2.6 million was recorded during fiscal 2004 related to these deferred tax assets. Although the Company's management believes its tax accruals are adequate, differences may occur in the future depending on the resolution of pending and new tax matters.

Defined Benefit Retirement Plans. The plan obligations and related assets of defined benefit retirement plans (including the non-contributory supplemental pension plans for some MSC officers) are presented in Note 7 of the Notes to Consolidated Financial Statements entitled Retirement Plans. Plan assets, which consist primarily of marketable equity and debt instruments, are valued using market quotations. Plan obligations and the annual pension expense are determined by consulting actuaries using a number of assumptions. Key assumptions in measuring the plan obligations include the discount rate at which the obligation could be effectively settled and the anticipated rate of future salary increases. Key assumptions in the determination of the annual pension expense include the discount rate, the rate of salary increases and the estimated future return on plan assets. To the extent actual amounts differ from these assumptions and estimated amounts, results could be adversely affected.

Accounting Pronouncements

In June 2001, FASB issued SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 requires that all business combinations initiated after June 30, 2001, be accounted for using the purchase method of accounting. With the adoption of SFAS No. 142 on March 1, 2002, goodwill will no longer be subject to amortization over its estimated useful life. Goodwill will be subject to at least an annual assessment of impairment by applying a fair-value based test, beginning on the date of adoption of the new accounting standard. The Company completed its initial assessment as of August 31, 2002 and its annual assessment as of February 28, 2003, as required under the impairment requirements of SFAS No. 142 and no impairment was deemed necessary. The Company also completed the required annual impairment assessment as of February 29, 2004 and recorded an impairment charge of \$6,739 related to GAC (see Note 13 of the Notes to the Consolidated Financial Statements entitled, Asset Impairments and Restructuring on page 52 and 53).

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations, which is effective for financial statements issued for fiscal years beginning after June 15, 2002. SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated retirement costs. This Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The adoption of SFAS No. 143 did not have an impact on the financial position or results of operations of the Company.

The Company adopted SFAS No. 144, Impairment or Disposal of Long-Lived Assets on March 1, 2002. This statement addresses accounting and reporting for the impairment or disposal of long-lived assets, including discontinued operations, and establishes a single accounting model for long-lived assets to

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be disposed of by sale. MSC has assessed the impairment requirements of SFAS No. 144 and has reviewed all assets for potential impairment and determined that there are no other impairments other than the charge for the Middletown, Ohio facility as of February 29, 2004.

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. SFAS No. 145 makes changes to several areas, including the classification of gains and losses from extinguishment of debt and accounting for certain lease modifications. The statement is effective for fiscal years beginning after May 15, 2002. With the adoption of SFAS No. 145 on March 1, 2003, the contractual debt prepayment penalty is no longer classified as an extraordinary item and is reflected as a component of income from continuing operations in the Consolidated Statements of Income (Loss).

In November 2002, the FASB issued Interpretation No. 45 Guarantees, Including Indirect Guarantees of Indebtedness to Others, which expands previously issued accounting guidance and disclosure requirements for certain guarantees. Interpretation No. 45 requires the Company to recognize an initial liability for fair value of an obligation assumed by issuing a guarantee. The provision for initial recognition and measurement of the liability will be applied on a prospective basis to guarantees issued or modified after December 31, 2002. The Company has evaluated the provisions of Interpretation No. 45, and has determined that no guarantees or indemnifications currently exist that must be disclosed or accounted for according to the requirements of Interpretation No. 45.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an Amendment of FASB Statement No. 123. This statement amends FASB No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair-value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition guidance and disclosure provisions of SFAS No. 148 are effective for the February 28, 2003 and February 29, 2004 financial statements.

In December 2003, the FASB issued SFAS No. 132 (revised 2003), Employers Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88 and 106, and a revision of FASB Statement No. 132. This standard revises employers disclosures about pension plans and other postretirement benefit plans. It does not change the measurement or recognition of those plans required by FASB Statements No. 87, Employers Accounting for Pensions, No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, and No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions. The new rules require additional disclosures about the assets, obligations, cash flows and net periodic benefit cost of defined benefit pension plans and other postretirement benefit plans. The required information should be provided separately for pension plans and for other postretirement benefit plans. The new disclosures are effective for the Company in fiscal year 2004. As a result, we have modified the related discussion in Note 7 entitled Retirement Plans to comply with this revised standard.

Effective March 1, 2003, the Company adopted SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, which rescinds Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred, rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by this statement include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing or other exit or disposal activity. Adoption of this statement had no material impact on the company's financial position, results of operations or cash flows.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity, which requires certain financial instruments that were previously presented on the consolidated balance sheets as equity to be presented as liabilities. Such instruments include mandatorily redeemable financial instruments and certain options and warrants. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise was effective for the company as of July 1, 2003. Adoption of this standard had no impact on the Company's financial position, results of operations or cash flows.

Effective July 1, 2003, the Company adopted EITF Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables, which establishes criteria for whether revenue on a deliverable

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can be recognized separately from other deliverables in a multiple deliverable arrangement. The criteria considers whether the delivered item has stand-alone value to the customer, whether the fair value of the delivered item can be reliably determined and the customer's right of return for the delivered item. Adoption of this standard had no material impact on the Company's financial position, results of operations or cash flows.

In January 2003 and December 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), and its revision, FIN 46-R, respectively. FIN 46 and FIN 46-R address the consolidation of entities whose equity holders have either not provided sufficient equity at risk to allow the entity to finance its own activities or do not possess certain characteristics of a controlling financial interest. FIN 46 and FIN 46-R require the consolidation of these entities, known as variable interest entities (VIEs), by the primary beneficiary of the entity. The primary beneficiary is the entity, if any, that is subject to a majority of the risk of loss from the VIE's activities, entitled to receive a majority of the VIE's residual returns, or both. FIN 46 and FIN 46-R are applicable for financial statements of public entities that have interests in VIEs or potential VIEs referred to as special-purpose entities for periods ending after December 15, 2003. Application by public entities for all other types of entities is required in financial statements for periods ending after March 15, 2004. Adoption of both of these standards is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

On December 17, 2003, the Staff of the Securities and Exchange Commission (SEC or the Staff) issued Staff Accounting Bulletin (SAB) No. 104 Revenue Recognition, which amends SAB 101, Revenue Recognition in Financial Statements. SAB 104's primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, superseded as a result of the issuance of EITF 00-21. Additionally, SAB 104 rescinds the SEC's Revenue Recognition in Financial Statements Frequently Asked Questions and Answers (the FAQ) issued with SAB 101 that had been codified in SEC Topic 13, Revenue Recognition. Selected portions of the FAQ have been incorporated into SAB 104. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104. Adoption of this standard had no material impact on the Company's financial position, results of operations or cash flows.

Cautionary Statement Concerning Forward-Looking Statements

The Securities and Exchange Commission encourages companies to disclose forward-looking information so that investors can better understand a company's future prospects and make informed investment decisions. This Form 10-K contains forward-looking statements, which include, without limitation, those statements regarding our estimated loss and proceeds from the disposition of discontinued operations, that set out anticipated results based on management's plans and assumptions. MSC has tried, wherever possible, to identify such statements by using words such as anticipates, estimates, expects, projects, intends, plans, believe, words and terms of similar substance in connection with any discussion of future operating or financial performance.

Achievement of future results is subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Many factors could also cause actual results to be materially different from any future results that may be expressed or implied by the forward-looking statements contained in this Form 10-K, including, among others:

- The Company's ability to successfully implement its restructuring and cost reduction plans and achieve the benefits it expects from these plans, net of estimated severance-related costs;
- Impact of changes in the overall economy;
- Changes in the business environment, including the transportation, building and construction, electronics and durable goods industries;
- Competitive factors (including changes in industry capacity);
- Changes in laws, regulations, policies or other activities of governments, agencies and similar organizations (including the ruling under Section 201 of the Trade Act of 1974);
- Continuation of the favorable environment to make acquisitions, including regulatory requirements and market values of candidates;
- The stability of governments and business conditions inside and outside the U.S., which may affect a successful penetration of the Company's products;
- Acts of war or terrorism;

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Acceptance of brake damping materials, engine components and body panel laminate parts by customers in North America and Europe;