Trex Company, Inc.

Fourth Quarter 2016 Conference Call

February 21, 2017 at 8:30 a.m. Eastern

CORPORATE PARTICIPANTS

Jim Cline – *President, Chief Executive Officer*

Bryan Fairbanks – *VP, Chief Financial Officer*

Bill Gupp – *SVP, General Counsel and Secretary*

Jon Friedman – *Associate - MBS Value Partners*

PRESENTATION

Operator
Good morning, and welcome to the Trex Company Fourth Quarter 2016 Conference Call. All participants will be in listen-only mode. Should you need assistance please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask questions, you may press star then one on your touchtone phone. To withdraw your question, you may press star then two. Please note, this event is being recorded.

I would now like to turn the conference over to Jon Friedman. Mr. Friedman, please go ahead.

Jon Friedman
Thank you, everyone, for joining us today. With us on the call are Jim Cline, President and Chief Executive Officer; and Bryan Fairbanks, Vice President and Chief Financial Officer. Joining Jim and Bryan will be Bill Gupp, Senior Vice President, General Counsel and Secretary, as well as other members of Trex's management team.

The company issued a press release this morning containing financial results for the fourth quarter of 2016. This release is available on the company's website. The conference call is also being webcasted on the Investor Relations page of the company's website, where it will be available for 30 days.

I'd now like to turn the call over to Bill Gupp. Bill?

Bill Gupp
Thank you, Jon. Before we begin, let me remind everyone that statements on this call regarding the company's expected future performance and conditions constitute forward-looking statements within the meaning of federal securities law. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements.

For a discussion of such risks and uncertainties, please see our most recent Form 10-K and Form 10-Qs, as well as our 1933 and other 1934 Act Filings with the SEC. The company expressly disclaims any obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

With that introduction, I will turn the call over to Jim Cline.

Jim Cline
Thank you, Bill, and thanks to those who are joining this morning's call to discuss our fourth quarter full year results, as well as our business outlook. We ended 2016 with record sales and record earnings, and with an impressive showing in the fourth quarter.

Net sales in the fourth quarter increased 7% to a record $95 million, coming in $2 million higher than guidance. This performance was noteworthy as it was achieved following a record fourth quarter 2015 when sales increased 20% year-over-year. For full year 2016, net sales increased by 9% to a record $480 million, representing broad-based growth across our decking and accessory products, which more than offset our planned reduction in poly film sales.

There have been no independent market data published since 2014, but we are confident that Trex continues to gain market share. We believe a portion of this gain is coming from wood conversions. This view is supported by anecdotal evidence from our retail and pro channel partners. We are still in the very early innings of our campaign targeting a wood market conversion and are quite pleased with the progress. Every 1% of market share that composite takes from wood is equivalent to approximately $50 million in composite sales.

We saw many of you at the International Builders Show in January, where attendance was up again this year, and there was a high level excitement around the upcoming outdoor living season. Certain published notes after the show referenced the greater emphasis on design elements in the building product space. As you know, Trex has been a leader in providing a wide range of design options for outdoor living spaces. We have developed online tools to assist consumers with the design, and to enable them to customize their own projects. These offerings helped to drive record traffic to our website last year, and resulted in a record number of searches for contractors and dealers.

We also attended the BAU trade show in Munich this year. The event had many manufacturers of wood alternative products present and a larger international attendance compared to prior years. Our sales outside of North America remain a small percentage of our overall sales, but showed a significant double-digit growth over the prior year as we continue to strengthen our distribution network and expand our branding initiatives.

We were very pleased with the level of operating leverage we achieved in the fourth quarter, which was similar to what we delivered throughout 2016. Significant gross margin expansions of 420 basis points and 390 basis points, respectively, in the fourth quarter and full year were driven in part by our ability to successfully implement major manufacturing cost reductions. Gross margins also benefited from lower input cost and greater capacity utilization.

Maintaining our cost discipline, we have been consistent throughout the year in delivering earnings per share growth that substantially outpaced revenue growth. We posted earnings per share growth of 64% for the fourth quarter and 51% per share growth for the year, while making significant investments in product development and branding that will support our future growth.

To sum up, the 2016 fourth quarter and full year periods were excellent results for Trex across key operating metrics, reflecting the superior performance of our products and the increase in consumer recognition of our brand.

Now, I'd like to turn the call over to our Chief Financial Officer, Bryan Fairbanks, to provide a financial review.

Bryan Fairbanks
Thank you, Jim. Good morning, everyone. This was another record quarter and year for Trex, reflecting favorable business conditions in the repair and remodeling sector, increasing demand for our high-performance decking and railing products, substantial reductions in manufacturing costs, and excellent execution by our employees and trade partners.

Fourth quarter net sales were $95.3 million, up 7% year-on-year. We delivered a 420 basis point increase in gross margin during the fourth quarter, resulting from ongoing manufacturing cost reduction programs, higher capacity utilization, and lower input costs. This gross margin performance included the impact of a $1.3 million one-time charge that will support sales expansion in 2017 and beyond. This charge reduced sales, as well as gross profit.

SG&A for the quarter amounted to $18.4 million compared to $18.7 million in the 2015 fourth quarter.

As a percentage of sales, however, we saw a 170 basis point reduction in SG&A in this year's fourth quarter despite higher product development cost. Our operating income margin reached 20.7% for the fourth quarter, significantly ahead of the 14.9% reported in last year's fourth quarter.

Net income was $12.6 million for the fourth quarter, a 56% year-over-year increase. Diluted earnings per share were $0.43, up 65% year-over-year, reflecting higher income and the effect of a lower share count resulting from our share repurchases during 2016. Our fourth quarter diluted weighted average number of shares outstanding was 29.5 million, down from 31 million shares in the same period last year.

Full year 2016 revenues were $479.6 million, up 9% from 2015. This increase was driven mainly by sales volume growth of our core Trex branded decking and railing products that benefited from the solid execution of our market share growth strategies. This increase in sales was achieved despite a $7.6 million decrease in full year poly film sales and the $1.3 million charge mentioned earlier.

2016 gross margin was 39%, a 390 basis point improvement from last year. Exclusive of legacy warranty reserve charges, gross margin would have been 41.1%, a 470 basis point increase. The key drivers of this improvement were lower raw material costs, our cost-saving initiatives and increased capacity utilization.

Our SG&A expenses for 2016 were $83.1 million compared to $77.5 million in 2015. This increase was mainly attributable to higher personnel-related expenses of $2.2 million, research and development expenses of $2.2 million, as well as increased advertising and branding activities of $1.4 million. As a percentage of sales, our SG&A improved from 17.3% from 17.6% in 2015.

Our effective tax rate of 34% in 2016 declined 340 basis points compared to 2015 due to several factors, including non-deductible compensation expense recognized in the prior year, increased utilization of federal research and development tax credits in the current year, and early adoption of a FASB pronouncement related to changes in accounting for stock compensation. The latter had a $1.7 million favorable impact on full year 2016, which improved net income by $0.05 per share. This affected primarily the first three quarters of 2016 with a nominal impact to the fourth quarter. The retrospective application of the FASB guidance for the first three quarters can be found in our 10-K.

Net income for the full year totaled $67.8 million and earnings per diluted share were $2.29. Year-on-year increases of 41% and 51%, respectively. Exclusive of legacy warranty reserve charges, net income and diluted EPS would have been $74.3 million and $2.51, up 44% and 55%, respectively, compared to the same period in the prior year. Operating cash flow increased to $85 million, up $23 million compared to the 2015, due primarily to higher income.

For financial modeling purposes, please note the following items: We're projecting incremental margin guidance of 45% to 50% for the 2017 year. Given the success of our 2016 marketing and R&D programs, we're expanding our spend in the first quarter to support growth. We expect this expanded spend will be supported by expanded full year sales without a growth in the overall SG&A spending as a percentage of sales.

We're expecting a full year tax rate of approximately 35%, and full year CapEx is projected between $15 million and $20 million.

We also wanted to bring to your attention that on February 16th, the board of directors authorized a common share repurchase program of up to 2.96 million shares of our outstanding common stock with no expiration date.

Now, I'll turn the call back to Jim for his closing remarks.

Jim Cline
Thanks, Bryan. Looking ahead to 2017, we are confident in our ability to continue increasing shareholder value through advancing our industry-leading market share and expanding margins. Organic revenue growth drivers include market share gains as Trex is well positioned to grow faster than the single-digit growth the industry forecasts over the next several years. We also expect Trex to benefit from a modest acceleration in wood conversion trends.

Second, new product introductions will be focused on those attributes that are important to consumers and will support our drive to take share from wood. And third, our international business will continue to grow at a significantly faster rate than North America.

Gross margin expansion, while not the magnitude that we experienced in 2016, will continue to play an important part in driving operating leverage in 2017. Acquisitions remain a part of our long-term growth strategy. We have a highly leverageable brand that we have proven can be successfully extended to other outdoor living products such as Trex Furniture, Trex RainEscape and Trex Pergola.

Specifically for the first quarter, we have provided revenue guidance of $144 million, representing a 9% year-over-year growth.

Operator, I would now like to open the call up for questions.

QUESTIONS AND ANSWERS

Operator
Yes. Thank you. We will now begin the question-and-answer session. To ask a question you may press star then one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time we will pause momentarily to assemble the roster.

And the first question comes from Keith Hughes with SunTrust.

Keith Hughes
Thank you. So, going back to the prepared statements, there was a charge in cost of goods sold in the fourth quarter, is that correct?

Bryan Fairbanks
Yes, there was a $1.3 million charge related to future business opportunities that we have, will support sales in 2017-2018 timeframe.

Keith Hughes
Okay. And the 40% gross margin you referred to in the press release, does that include or exclude that charge?

Bryan Fairbanks
That includes it.

Keith Hughes
Includes it, okay.

Jim Cline
Keith, just for clarification, that reduced sales and reduced gross profit hit both lines.

Keith Hughes
Okay. So, I don't understand exactly what this is if these were to hit both lines. It was just a cost program, correct?

Bryan Fairbanks
Yes, so it's a cost program. We're not able to specifically comment on specifics related to this business and which customers it's related to, but it is related to future growth opportunities for the company.

Keith Hughes
Okay. And then moving forward, as you have begun the season here, and I know you still have difficult comparisons with the weather, not quite as much in the fourth quarter, how do you see the season playing out? Will it be heavier first half, second half? Any sort of views there will be helpful.

Jim Cline
Yes. I think when you look at the prior year, you saw a very mild first quarter. This year, we're starting out pretty well in the East, but everybody has been watching California, Oregon and Nevada, in particular, have been getting very heavily affected by the rain and heavy snow. So, certainly, a little bit of a drag there. We anticipate that we have not seen the end of winter yet, and we anticipate that March will become more seasonable in nature. And having said that, our typical pattern of sales is what we would generally expect to see. Obviously, weather dependent, it could move the sales from first to second quarter if we had an exceptionally harsh March.

Keith Hughes
Thank you. And final question on SG&A. It sounds like there's going to be heavier spend beginning of the year. Can you give us any feel on dollar level, what that will look like early in the year?

Bryan Fairbanks
Not specifically related to dollar, but as you recall last year, we deferred some of our marketing spending out into the second quarter based on how we saw the season developing. This year, I expect we'll see more of a normalized season with a little bit heavier load focused on the first quarter as you've historically seen with the company.

Keith Hughes
Thank you.

Operator
Thank you. And the next question comes from Al Kaschalk with Wedbush Securities.

Al Kaschalk
Good morning, guys.

Jim Cline
Good morning, Al.

Bryan Fairbanks
Hi, Al.

Al Kaschalk
Just to follow up on the seasonality here. So, the guidance is 9% sequential—sorry, year-over-year. I thought last year was a very good period, so help me appreciate if this is being conservative or more aggressive, particularly in light of the weather, maybe articulating a little bit better on your ability to, I guess, recognize the sale as a sell-in versus maybe a sell through.

Jim Cline
Well, Al, first of all, we had a very strong response to our early buy. You're correct; we do not know exactly what the sales will be through the end of March. There is a certain level of organic sales and reorders that we expect will begin to take place as we move into March in particular. And the milder the weather as we go through March, the better the sales results should be.

Al Kaschalk
Okay. All right. And then, how much of the—can you share if it's from new product growth that's in 2017 in terms of your outlook or what expectations we should have for new product contribution?

Jim Cline
Al, we haven't announced any dates for new product introductions. And so, it'd be premature at this point to talk about what the implications may be. As you clearly noted, we have expanded our spend in R&D and product development, as noted in Bryan's discussion, quite significantly in the fourth quarter. And I can tell you, it will be considerably greater than that as we go through at least the first two quarters of 2017.

Al Kaschalk
Okay. So, thanks for clarifying that because most of this then is, in addition to just the organic growth, there's also some market share gains in there.

Jim Cline
And in the first quarter, clearly, there were no new products that were introduced that would have an upward lift in that first quarter.

Al Kaschalk
Okay. And then, finally, is there any—I don't know if you necessarily need to parcel out, but help in terms of what was the benefit on raw materials and the cost savings and utilization? And I know there's a continued ongoing program to improve, but it would seem like the major contributors have been realized, but you guys continue to prove us wrong. So, could you parcel out any of that in terms of either 2017 or how to think about that from the gross margin perspective because you did raise, I guess, or tighten maybe the range to 45% to 50%?

Bryan Fairbanks
Yes. So, if we look back at 2016, about 50% of the gains were through lower raw material cost and other cost-saving initiatives, while the remaining 50% was capacity utilization and other operating efficiencies. Those are the gains similar for the full year and for the fourth quarter.

As we look out to 2017, we expect we will continue to generate benefit from expanded capacity utilization, our cost-saving initiatives and other ongoing improvements within our plant. We don't see nearly the same opportunity for raw material cost reductions that we saw in the 2016 year. So, those three items are all baked within our 45% to 50% incremental margin guidance.

Jim Cline
Al, one thing I'd like to add to that, I know as we went through the economic downturn and we made

quite a bit of progress during that period, a lot of people kept thinking that the cost reduction initiatives and profit enhancement opportunities would be limited as we go forward. We have a number of very meaty projects not only that will be impacting 2017, but also 2018 and beyond. So, it's an ongoing process with Trex. We continue to look for those opportunities. And as we can complete those implementations, we certainly are very aggressive at making sure we do so.

Al Kaschalk
Great. Good luck, guys. Thank you for the time.

Bryan Fairbanks
Thanks.

Jim Cline
Thanks, Al.

Operator
Thank you. And the next question comes from Matt McCall with Seaport Global Securities.

Matt McCall
Thank you. Good morning, guys. So, Bryan, maybe, could you go back to the gross margin expectations for 2017, kind of what's driving—I know you said 50% leverage and 50% savings in 2016? But can you talk about 2017, the buckets again, and do you have any impact from mix layered into that guidance?

Bryan Fairbanks
No. We're expecting a very similar mix in 2017. As Jim mentioned, right now, we haven't talked about any product launches during the year. But just to review what I went through, 50% of the gains were through lower raw material costs and cost-saving initiatives, 50% in capacity utilization and other operating efficiencies. So, that's baked within the 45% to 50% incremental margin for next year. And the piece of that we don't expect to see as much benefit from is the lower raw material cost, primarily in the form of poly.

Matt McCall
Okay. Got it. Got it. Okay. And then I would imagine higher virgin is going to help demand just in general. So, is there an element of that baked into the top line expectations?

Jim Cline
No. There's no increase anticipated of any significance related to our pellet business and the effect that, that would have from increased polyethylene prices.

Matt McCall
Okay. And, Bryan, you said, I think, that SG&A leverage, you're not expecting much. Was that flat as a percent of sales expectation for all of 2017? Is that what you said?

Bryan Fairbanks
Yes.

Matt McCall
Okay. And going back to that charge for Q4, I just want to make sure I understood that it's a charge you're taking, but it supports future sales, but you say you can't give any more details or what was the—that's a new one on me, a charge that supports future sales. I'm trying to understand what's the

dynamic there.

Bryan Fairbanks
Yes. So, we mentioned it was $1.3 million. There are certain opportunities that arise in the course of business that sometimes require an upfront capital commitment, and this is one of those opportunities and we'll recognize the benefits for that over the coming year. That commitment resulted in a charge during the fourth quarter. And due to competitive reasons, we prefer not to give out the complete details behind it.

Matt McCall
Okay. So, but by calling it a charge, it's not a—I usually think of a charge as something we need to strip out because it's onetime in nature, it's non-operating. This sounds like a onetime in nature that maybe is operating.

Bryan Fairbanks
No, I wouldn't necessarily strip this out as a onetime. We were just putting it in there to give everybody a little bit of flavor for the quarter and where revenue would have been without it.

Matt McCall
Okay. Okay. Got it. And then potentially related, any update on the private label business at the big boxes?

Jim Cline
Yes. One of the things that we have been very mindful of is that we don't discuss individual customer opportunities that are completed. Certainly, both of the major retailers in the category have been doing a fair amount of review and evaluation of their full product lines, not just private label. And at some point, if they see fit, they'll discuss that in detail, but it's not really appropriate for us to have that discussion here.

Matt McCall
I understand. Thank you, Jim.

Jim Cline
Thank you.

Operator
Thank you. And once again, if you would like to ask a question, please press star then one on your touchtone phone. And the next question comes from Blake Hirschman with Stephens.

Blake Hirschman
Yes. Good morning, Jim and Bryan.

Bryan Fairbanks
Good morning, Blake.

Blake Hirschman
Just quickly, where do we stand on the pellets business? I know you touched on it a little bit just a second ago, but is it more of an afterthought at this point? Or if oil prices continue to trend upward, could this business become—could it come back in any kind of meaningful way? Just kind of looking to get a little bit more color there.

Jim Cline
We're executing our business model not waiting on polyethylene prices. I can tell you that we did get a certification on our pellets, confirming that they are recycled material, and that is beginning to generate a modest level of interest with bag manufacturers both here and overseas. It remains to be seen how impactful that will be. At this point, I would not include any significant impact for that in 2017.

Blake Hirschman
All right, got it. Thank you for that. And then on M&A, you talked about it a little bit in the opening comments, what kind of M&A would you be interested in here at this point? Does it have to be outdoor product kind of related? And then that will do it for me. Thanks.

Jim Cline
Certainly, what we would be interested in is something that is consistent with outdoor living primarily. We have not shut the door to something that might have elements that would go inside the house or inside the building, but we do have some specific interests in mind. And we are actively looking for those good opportunities.

And having said that, Trex has done essentially no acquisitions since I've been with the company, which goes back to March of 2008.

Blake Hirschman
Thank you. Good luck.

Jim Cline
Thank you.

Operator
Thank you. And as there are no more questions, I would like to return the call to management for any closing comments.

CONCLUSION

Jim Cline
Well, thank you, everyone, for participating in today's call. We look forward to seeing you at the upcoming conferences and investor meetings. Have a good day.

Operator
Thank you. Your conference has now concluded. Thank you for attending today's presentation. You may now disconnect.